BUY–SELL PLANNING: PART II

IN OUR LAST NEWSLETTER we discussed some of the reasons for buy-sell agreements, the two different types and their advantages and disadvantages. In this edition, we will discuss estate planning considerations.

For many agency owners, a relatively substantial business value creates or otherwise adds to an already taxable estate at death. When an owner dies, the agency must be valued for Form 706, the federal estate tax return and this is often a value challenged by the IRS because of its subjectivity (the higher the value the more tax the IRS ultimately collects). The agency is worth what a willing buyer will pay a willing seller neither being under compulsion to buy or sell and both having knowledge of relevant facts. Although the rules are somewhat complex, a properly drafted buy-sell agreement can therefore fix the value of the agency for estate tax purposes.

There are several tests to determine whether the agreement is "bona-fide" which are more stringent when dealing with family members but an agreement among non-related parties (or non-lineal descendants) typically is considered to be at arms length and would meet the tests. Many agency owners have some flexibility in setting the value for the agreement because the value is subjective and they can agree "at arm's length" so long as it is reasonable. There is an opportunity here. Many would choose to value the business at the higher end of reasonable to provide greater benefit to heirs and then fund the obligations with insurance. If the value will then be fixed for estate tax purposes this will increase the family tax burden.

Perhaps the owners should agree on a lower value, insure that, and agree to buy additional insurance (perhaps with company funds) so that family will realize the higher amount at death. For example, two partners may decide the value of a business should be $30,000,000 ($15,000,000 each), the amount they would like to see their families receive at death. There is no absolute value. Even a qualified business appraisal would consider a range of values. After consultation with advisers they agree to implement an agreement that fixes the value at $20,000,000 also considered reasonable, and they insure it with $10,000,000 of life insurance on each of their lives. They place an additional $5,000,000 of insurance each in an irrevocable life insurance trust and the business also funds these premiums through bonuses or perhaps a more creative split-dollar arrangement. If properly executed, the end result will be that each family will receive $15,000,000 as they would if the agreement placed such value on the business but only $10,000,000 should be included in the taxable estate potentially saving the family tax on $5,000,000 or approximately $2,500,000 in tax savings after considering both federal and state estate taxes.

Closely-held businesses are characterized by the financial and emotional investments of their owners. The time and energy needed to develop a sound buy-sell agreement is clearly well worth the effort. For more information on this or any tax or accounting concerns, please feel free to contact us.

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