

# Insight on Estate Planning

Year End 2007



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# Plan ahead for peace of mind

## *The benefits of using a buy-sell agreement*

If you're an owner of a closely held business, consider creating a buy-sell agreement. It provides the means for an orderly transfer of ownership at your death, whether to family members or to remaining owners.

It also can establish what will happen to your interest in the event of other triggering events, such as disability, retirement, withdrawal or other specified event. Moreover, it details the terms of the future sale — such as who will have the obligation or option to buy your interest and how the sale price will be established.

### Buy-sell agreement objectives

A buy-sell agreement sets a value for your ownership interest (generally based on an independent appraisal of your business or an appropriate valuation formula) and provides a market for the interest. It also can help set the value of the interest for federal estate tax purposes, which reduces the likelihood of challenges by the IRS. (See “Determining value” on page 3 for more on valuation methods.)



### Two types of agreements

The two basic types of buy-sell agreement — cross purchase and redemption — are typically funded by life insurance. Using life insurance to fund the agreement helps ensure that your business partners will have adequate liquidity to cover the full buyout of your ownership interest. This, in turn, provides your heirs and your estate with liquidity that might otherwise be lacking if there were no ready buyer for the shares.

Let's take a closer look at each agreement type:

**Cross purchase agreement.** With this agreement, each owner owns life insurance policies on the other owners' lives. When an owner dies, the surviving owners buy his or her interest.

Cross purchase agreements can offer several tax advantages. For example, the surviving owners receive a stepped-up basis equal to the purchase price, which reduces income taxes in the event they later sell their shares. Also, because the insurance proceeds bypass the company, the surviving partners avoid corporate alternative minimum tax (AMT) issues.

On the down side, this agreement can be tedious when there are more than a few owners. Why? Because the number of policies required expands so quickly. For example, a company with three owners would require six policies, but a company with double the owners (six) would require five times as many policies (30).

This issue can be avoided by using a trustee cross purchase agreement, whereby the trustee is the owner and beneficiary of one policy on each life. The trustee is required to fulfill the obligations under the agreement.

There also can be issues with how premiums will be paid — especially if there are significant age differences between the owners. In such a situation, the premiums on the policies for the older owners likely will be much higher.

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**Redemption agreement.** In this agreement, the company owns the life insurance policies on the owners' lives. After an owner dies, the company buys back that owner's shares. Because the company is the sole policy owner, fewer policies are needed and the payment of premiums is simpler.

A redemption agreement may be easier to administer than a cross purchase agreement, but it also can create tax problems. Remaining owners may not receive a stepped-up basis, and the company may be subject to corporate AMT on the life insurance proceeds.

In certain situations, combining elements from both a cross purchase agreement and a redemption agreement to create a hybrid agreement may be the ideal solution for all involved parties.

### Tailoring the agreement

There's no "one-size-fits-all" buy-sell agreement; it must be customized to meet your company's and its owners' needs. Specifically, the agreement should:

- Stipulate the triggering events for the sale of an owner's interest in the company,
- Set a method for valuation, and
- Outline the purchase price for the owner's interest and determine funding.

Regularly review the buy-sell agreement to ensure it meets all requirements and tax laws, as well as the evolving needs of your business.

### Plan for your heirs' financial future

A buy-sell agreement can ensure the value of your business interest transfers according to your wishes. By making preparations today, you can help alleviate potential discomfort between the company's remaining owners and members of your family — and also help contribute to your heirs' financial well-being. ■

## Determining value

There are several methods for valuing a business interest when drafting a buy-sell agreement, such as:

**Formula pricing.** This method provides a means to estimate fair market value. Formulas are objective but they may not consider factors that influence fair market value. When using a formula price, regularly review it to ensure that it remains in line with your objectives.

**Book value.** This is the net book value determined by the entity's records or tax returns or as determined under Generally Accepted Accounting Principles (GAAP). This value may be based on your company's financial statement, audit or tax return. Net book value is not typically indicative of fair market value.

**Certificate of agreed value.** Sometimes the purchase price of an interest in a closely held company is based on an amount agreed on by the owners, which often is predicated on the amount of an owner's life insurance policy proceeds. This method may be simple, but it may not reflect fair market value.

The method you choose can affect whether the value will apply for estate tax purposes. After you've determined which method is best for you, be sure to periodically review and update it as needed.

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# Up your estate tax exemption ante with a credit shelter trust

**T**hink of your estate tax exemption as a “do not pay taxes” card that, under current law, allows you to transfer at your death \$2 million worth of assets without paying estate tax. But the “card” isn’t transferable. So if you bequeath everything to your surviving spouse (automatically tax-free under the marital deduction if your spouse is a U.S. citizen, easily made tax-free if your spouse is not a U.S. citizen), your \$2 million “card” doesn’t get played at all.

*If your and your spouse’s combined gross estate exceeds — or is likely to exceed — a single exemption, a credit shelter trust should likely be part of your game plan.*

Your assets will be included in your spouse’s estate, and only your spouse’s own \$2 million “card” can be used at his or her death. A credit shelter trust allows both your and your spouse’s “cards” to be played so that you can pass up to twice the exemption amount tax-free to your children or other loved ones.

## Rules of the game

If your and your spouse’s combined gross estate exceeds — or is likely to exceed — a single exemption, a credit shelter trust should likely be part of your game plan. Be aware that your gross estate generally will include all assets you have any interest in at death — including some you may not have considered, such as life insurance proceeds for policies owned in your name, retirement accounts and 50% of jointly owned property.

How does a credit shelter trust work? At your death, assets equal in value to the estate tax exemption are placed in the trust to be held for your surviving spouse and, ultimately, other heirs. The trust provides income to your spouse during his or her lifetime and can provide principal payments if needed.

Assets allocated to the trust — including growth — aren’t considered part of the surviving spouse’s estate. The estate tax exemption of the first spouse to die “shelters” these assets from estate tax when they are distributed to heirs on the surviving spouse’s death.

For example, Tom and Patricia — married with five children — have a combined total estate of \$4 million when they decide to include a credit shelter trust in their estate plan. Tom holds \$3 million of assets in his name, and he transfers \$1 million to Patricia (gift-tax-free under the marital deduction) so that they each hold \$2 million. Tom dies in 2006, and his assets are transferred to a credit shelter trust.

Patricia uses the income payments from the credit shelter trust plus funds from her own assets to maintain her lifestyle without tapping into the credit shelter trust’s principal. Patricia dies in 2008, and her taxable estate includes only the \$2 million of assets in her name, which pass tax-free to the children, protected by her estate tax exemption.

The assets in the credit shelter trust — which have grown to \$2.5 million — are excluded from Patricia’s taxable estate and also distributed to the children tax-free. The children each enjoy a total distribution of \$900,000.

Without the credit shelter trust, the \$4.5 million would have been taxable in Patricia’s estate, resulting in federal estate taxes payable in the amount of approximately \$1,125,000. \$3,375,000 would have been left with the children, with each receiving \$675,000 — \$225,000 less than with the credit shelter trust in place.

## Play your cards right

When creating a credit shelter trust, there are issues to consider. For example, should your surviving spouse act as sole trustee or should a co-trustee be appointed?

Your decision likely will be based on several factors, such as whether your spouse has investment experience. If not, appointing a co-trustee may be wise. Another benefit of appointing a co-trustee is that the trust can distribute funds to your spouse under broad standards, such as for his or her “best interests,” without causing any estate tax problems.

If your surviving spouse acts as sole trustee, however, the trust can distribute funds to him or her under only narrower, “ascertainable” standards, such as for “health, education, maintenance and support.” If your spouse is sole trustee and distributes funds to him- or herself for his or her “best interests,” the trust assets will be included in his or her estate for federal estate tax purposes.

Another issue to consider is which assets your surviving spouse should use first. Generally, the survivor should use assets held in his or her name before using credit shelter trust assets. Why? Because the survivor’s assets will be included in his or her estate for federal estate tax purposes but the assets in the credit shelter trust — including growth — won’t be. For this reason,

## Matters of trust

Consider allowing your surviving spouse to direct the distribution of the credit shelter trust’s assets among your descendants as he or she deems best by giving him or her a limited power of appointment. The purpose of the power of appointment is to allow the survivor to re-evaluate the ultimate disposition of the credit shelter trust assets, and modify them accordingly.

This can help address unforeseeable circumstances that arise. For instance, on your surviving spouse’s death, it may be desirable to treat your adult children unequally if one child has a child with special needs who will require a lifetime of care.

also consider investing credit shelter trust assets for growth and your surviving spouse’s own assets for income.

## A winning hand

Creating a credit shelter trust involves many details, from how it’s structured to appointing a trustee. To ensure that the trust is customized to your needs, consult a professional estate planning advisor. With proper planning, a credit shelter trust can give you a winning hand. ■



# Help wanted: Seeking competent and committed trustee

**A** trustee has the authority to oversee and administer a trust's assets according to your wishes. So selecting a competent trustee who will act in your — and your beneficiaries' — best interest is essential.

## Trustee responsibilities

Before you select a trustee, it's important to consider the range of duties associated with managing a trust, including:

- Managing all assets, including securities and business and real estate interests,
- Maintaining detailed records and preparing transaction statements,
- Handling collections, distributions and payments,
- Preparing and filing all tax returns,
- Communicating with and responding to all inquiries from beneficiaries,
- Advancing trust principal or providing care for a beneficiary as permitted by the trust, and
- Settling the trust, when applicable.

Select a trustee who's not only reliable and trustworthy, but also willing and committed to serving for the life of the trust.

## Determine the best fit

The two types of trustees are:

**Individual trustee.** This trustee may be a family member or close friend, a business advisor, an attorney or another professional. A family member or friend may seem like the natural choice because of the trust, common bond and likelihood that he or she understands your wishes for your family's future. It's also likely that he or she will charge little or nothing in trustee fees.



But keep in mind that, ideally, a trustee should have financial knowledge, be familiar with taxes and accounting, and have good business sense. So it's essential that individual trustees without professional expertise in managing trusts consult with accountants, attorneys and investment advisors to help them get the job done effectively.

**Corporate trustee.** This trustee typically is a financial institution, a bank trust department or a trust company. A corporate trustee specializes in managing estates and trusts and generally is free of conflicts of interest, allowing it to carry out its duties impartially.

A corporate trustee also has direct access to investment advisors, tax planners and other financial experts. Most institutional trustees charge fees based on a percentage of the trust's assets. For long-term trusts, an institutional trustee can be beneficial because you don't have to worry about the trust outliving the trustee.

In some cases, you can create a hybrid trustee by appointing an institution and an individual as co-trustees. The institution provides the professional experience and skills needed to effectively oversee the trust assets, while the individual is someone you can trust to act in your family's best interests.

### Outline responsibilities

After choosing a trustee, it's important to determine the amount of control that he or she will have over the trust assets and distributions to beneficiaries. Consider giving your beneficiaries the power to remove an institutional trustee and replace it with another that's a better fit as needs change or evolve. This provides an extra layer of protection from a trustee charging exorbitant fees or mismanaging the trust.

Outline what standards the trustee should use to determine when to make distributions to

beneficiaries and in what amounts. The standards of providing for health care, education, maintenance and support often allow a trustee substantial latitude to determine what is appropriate while still keeping the trust assets out of the beneficiary's estate.

In addition, make your trustee aware of the liabilities involved. For example, the trustee may be held personally liable in instances of poor investment decisions, not exercising discretion or inappropriate allocation of assets.

### Choose carefully

Whether you choose an individual trustee, institutional trustee or both, your trustee(s) will be responsible for the financial well being of your beneficiaries. Careful thought and selection today can help ensure that your trust estate is managed with skill and care. ■

## Estate Planning Pitfall

### You haven't planned for long-term care costs



Effective estate planning also means planning for your potential long-term care needs. Until you have a plan for long-term care expenses, the rising cost of care will be a constant threat to the wealth you intend to leave to your heirs.

Don't allow your estate to be diminished by long-term care expenses. One option is long-term care insurance. This coverage can prevent you from having to exhaust your assets to pay your long-term care expenses. Long-term care benefits may allow you to enter the nursing home or assisted living facility of your choice — or pay for a home care provider.

Consider a tax-qualified policy to help minimize the cost of long-term care insurance. It potentially allows a portion of your premium payments to be tax deductible — and any benefits you receive are tax-free.

If you're reluctant to pay for insurance to cover expenses you may never need, consider purchasing a policy that combines life insurance with long-term care coverage. If you don't need long-term care, the full value of the life insurance passes to your heirs.

But long-term care insurance isn't for everyone. If your investment income will be sufficient to cover long-term costs, you probably don't need long-term care insurance. Consult your estate planning advisor to determine whether you can benefit from such a policy and, if so, to find the best one to meet your needs.

# A message to our clients and friends:

Hall Render is excited to provide you with this issue of Insight on Estate Planning. Should you have any questions regarding the articles in this newsletter, please feel free to contact one of the attorneys listed below.

**We are experienced in assisting clients in implementing a wide range of estate planning and tax strategies, including the use of:**

- Revocable (Living) Trusts
- Wills
- Estate and Trust Administration
- Estate and Trust Litigation
- Estate and Gift Valuation Planning
- Federal Estate & Gift Tax Strategies
- Generation-Skipping Trusts
- Grantor Retained Annuity Trusts
- Guardianships and Conservatorships
- Income Tax Planning
- Irrevocable Trusts
- IRS Controversies
- Life Insurance Taxation & Planning
- Pension & IRA Planning
- Qualified Domestic Trusts (QDOT)
- Marital Trusts (QTIP)
- Qualified Personal Residence Trusts (QPRT)
- Real Estate Management & Transfer
- Business Formation & Governance
  - Corporations
  - Limited Liability Companies
  - General and Limited Partnerships
  - Family Limited Partnerships
  - Limited Liability Partnerships
  - Business Succession Planning
  - Family Business Planning
- Charitable Trusts & Foundations
  - Gift Annuities
  - Charitable Lead Trusts
  - Outright Gift Planning
  - Private Family Foundations
  - Charitable Remainder Trusts
  - Donor Advised Funds
  - Public Charities

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