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Merrill O'Sullivan, LLP, Attorneys at Law 541.389.1770 • Fax 541.389.1777 • www.merrill-osullivan.com

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What Will Happen to Your Business When You Die?

By Rodney P. Mock

Business owners often take the time to carefully purchase or incorporate and operate a business, yet fail to sufficiently plan for what will happen to their business when they die. If you have a closely-held business, whether it is a limited liability company, a subchapter S corporation or a C corporation, you should consider exactly what will happen to your business when you pass away.

1. Draft and execute a buy-sell agreement.

A buy-sell agreement is a key estate planning component for any closely-held business owner who wants to ensure that the business will smoothly transfer to the right person when the business owner dies. Sometimes the right person is a spouse or other family member. Sometimes the right person is another owner of the business. The right person could be a colleague. If the right person is not a family member, then the buy-sell agreement typically outlines the method for valuing the deceased owner's interest in the business and the payment terms to the decedent's family. By this method, the buy-sell agreement can either keep the business in the family or keep the value of the business in the family while allowing the business to move outside the family.

An appropriate buy-sell agreement will address the issue of transferring your business during your lifetime and after your death. The buy-sell agreement becomes critically important when a business is owned by two or more people, regardless of whether they are related. It should address areas such as:

- Your ability to sell or transfer your business interest.
- The valuation of your business for purposes of transfer.
- Payment terms with regard to purchasing the interest.
- Transfer of the business as a result of divorce.
- Transfer of the business as a result of disability.
- Transfer of the business as a result of the death of an owner.

Without a buy-sell agreement, the above issues are generally left unaddressed until a crisis situation arises.

A buy-sell agreement is like an estate plan; it should be revisited every seven years to ensure that it still states your intent for your business. For example, if a shareholder has gotten married, that shareholder may want to have the business interest pass to his or her spouse rather than passing as it was planned prior to the marriage. Conversely, if a shareholder has gotten divorced, he or she will likely want to ensure that their former spouse is not the declared recipient of the business interest after the divorce is final. You should watch out for existing buy-sell agreements that may not reflect your intended desires with regard to the succession of your business

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interest.

2. Avoid probate of your closely-held business interest.

Another layer to the analysis of succession planning for your closely-held business is avoidance of probate. Probate is the court-supervised implementation of your will. Whether your particular business interest will go through probate depends upon how it is held. If it is held jointly with a survivorship feature with your spouse or another individual, then it will pass to that person by operation of law, thereby avoiding probate. If it is held in your name individually and is transferable upon your death to your spouse or to another individual, then probate may also be avoided. Placing your business interest in a revocable living trust also avoids probate.

If you presently have a revocable living trust that holds your closely-held business interest, be sure that the terms of the trust specify what will happen to your business interest upon your passing. In addition, make sure that the provisions in your trust are consistent with the company's buy-sell agreement. If you intend to keep the business going, make sure the trustee has the appropriate trustee powers to continue to operate the business.

3. Buy life insurance if liquidity is an issue.

If non-family members will purchase your business interest either from your family or your estate, then another element in the analysis involves whether the buyer (usually a company, a corporation, members or other shareholders) has sufficient funds with which to purchase the interest. Life insurance can be used to address this issue. In other words, the buy-sell agreement can provide that the parties to the buy-sell agreement may purchase life insurance on each other's lives in order to have adequate funding to pay for purchasing the business interest.

4. Plan around Federal estate and Oregon inheritance tax laws.

If you own a closely-held business or multiple closely-held businesses, or have a significant amount of assets in your name individually, then most likely you will have Federal estate tax and/or Oregon inheritance tax issues with which to contend. Therefore, tax considerations will govern a portion of the analysis with respect to whom and in what manner your business interest is transferred during your lifetime or upon your death.

As a business owner, if you transfer your entire business interest to your surviving spouse, there will likely be no death taxes due on your death. The reason there would be no death taxes due is that your accountant would probably utilize the unlimited marital deduction on your estate tax return with respect to the business interest transferred. This means that the value of the business interests transferred to your spouse would be deducted from the total value of your estate on the death tax return. Therefore, there would be no death taxes due as a result of the business interest passing to the surviving spouse.

Transferring all your business interest to the surviving spouse when the first spouse dies, however, may have adverse death tax consequences upon the death of the surviving spouse. It is not always a good idea to transfer all of your business interest to the surviving spouse because it is important that you fully utilize the state or Federal applicable exclusion amount upon your passing (more on the state and Federal limits in a minute).

On the other hand, if you transfer or intend to transfer all of your business interests to your children or other family members (instead of to your surviving spouse), then there will be no marital deduction taken on your business interest. In addition, there may be death taxes to pay because you can only transfer a certain amount of property upon your death to individuals other than your surviving spouse with no Federal estate tax and/or Oregon inheritance tax consequences.

<u>Federal estate taxes</u>. The applicable exclusion amount is the amount of money or other assets that can be passed free of Federal death tax when you die. The amount of money or other assets that can pass free of Federal death tax under the applicable exclusion amount is currently $2 million for individuals, which means that with proper

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planning, a married couple can pass $4 million.

State estate taxes. At this time, $1 million is the maximum amount of cash, assets or other value that a decedent can pass to people other than his or her spouse without owing Oregon state inheritance tax. Thus, there is a gap between the $2 million Federal allowance and $1 million Oregon allowance. This means there may be an Oregon state death tax owed by a decedent even if no Federal death tax is owed by the decedent. The Federal allowance is slated to increase over time. Therefore, the gap between the amount permitted to pass free of Federal death tax and the amount permitted to pass free of state inheritance tax continues to widen. As a result, individuals should consider whether to subject a relatively small amount of their estate to state inheritance tax in order to maximize their Federal death tax savings.

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Estate planning attorneys have a number of different options to address these issues. One method of reducing your estate may be making lifetime transfers of some of your business interests up to the annual gift tax exclusion amounts of $12,000 for an individual or $24,000 for an individual and his or her spouse, assuming they elect to treat the gift as being given by both of them even if only one is making the gift. By doing such transfers during your lifetime, you can slowly transfer your business interest out of your estate. Of course, you will also be relinquishing some ownership and control with regard to your closely-held business. This may not be entirely bad, however, if you transfer business interests that are substantially appreciating and if your long-term goal is to transfer your business interests to the gift recipients upon your passing.

Another method of wrestling with estate tax issues involving closely-held businesses owned by individuals with taxable estates is to transfer enough interest in order to take certain discounts on those business interests. If you transfer enough of your business interest so that you no longer have a controlling interest in the closely-held business, then the IRS may allow your estate to take a "minority discount" on that particular interest. You may also be allowed to take a "lack of marketability" discount on that particular interest. This makes sense because one should receive a discount with respect to an interest that is not a controlling interest. A minority interest does not have the same value per share as the controlling interest. One also should be able to take a discount on an interest because of lack of marketability, because an interest in a closely-held business is not the same as an interest in a publicly-traded business because the publicly-traded business has a ready market.

5. Conclusion.

This article touched upon just a few of the issues involved with planning for the succession of your business. Part of the planning process involves ensuring adequate liquidity to implement your plan, making sure the right person will receive your business and reviewing the estate tax issues on your overall estate.

Even if you do not wish to transfer any of your business interest during your lifetime in order to reduce your taxable estate, you should be sure that a proper plan -- including a buy-sell document -- is in place in order to address the non-tax issues surrounding the transfer of that interest.

The great thing about a business is that it can continue to flourish for many generations with the right planning. If you have worked hard to start and operate a business, it does not make sense to ignore your exit strategy. There is no "one-size-fits-all" solution to the best way to transfer your closely-held business during your lifetime or upon your passing. The appropriate transfer of your business interest takes a carefully-considered succession plan. It takes walking through your goals and objectives with an attorney and reviewing the specific facts surrounding your closely-held business.

Attorney Rodney P. Mock, author of this article and an associate at Merrill O'Sullivan, LLP, will be a guest speaker at an Estate Planning Workshop sponsored and hosted by Jake Paltzer of A. G. Edwards & Sons on Thursday, June 8, 2006 at 6:00 p.m. The "Six Easy Steps to an Effective Estate Plan" workshop will assist you in understanding the initial steps involved with developing an effective estate and financial plan. Please call (541) 389-1770 for additional information or to RSVP.

Merrill O'Sullivan, LLP
1070 NW Bond Street, Suite 303
Bend, Oregon 97701

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david E. Petersen
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Patricia L. Heatherman
Rodney P. Mock
David G. Brown

Meet Max Merrill

Max has practiced law in Bend for 35 years. His practice areas include business law, domestic relations, estate planning, real estate, elder law, and adoptions. He believes that good communication and rapport with his clients is at the heart of a good attorney-client relationship. He prides himself in professionalism; prompt, accurate services; and, most importantly, solving a client's problems as expeditiously as possible. He takes issue with the current trend in the delivery of legal services of making the practice of law a business in and of itself. This trend detracts from the professional approach to the practice of law and increases the cost of legal services to the client. Max prefers to keep his clients' personal and financial needs as his highest priority.

Photograph by Nancy Ryan

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For more information regarding our legal services, please contact our office at (541) 389-1770 or visit http://www.merrill-osullivan.com.

Patricia L. Heatherman is the Editor of Deschutes Discovery. If you have questions regarding this issue, please contact Ms. Heatherman at (541) 389-1770 or e-mail feedback to lawfirm@merrill-osullivan.com.

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