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What's Inside

Income Tax Aspects of Buy-Sell Planning Using Life Insurance, Part I

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A buy-sell agreement enables businesses to be transferred by plan, not chance. It is a contractual agreement that spells out what will happen to the owner's business interest when certain events, such as death, disability and retirement — known as triggering events — occur. Although buy-sell agreements come in many flavors, there are fundamentally two types: entity purchase and cross purchase, and all others are variations. Tax consequences can differ significantly depending on how a buy-sell agreement is arranged, as well as the types of business entity involved.

Income Tax Issues Related to Entity Purchase

In an entity purchase agreement (also known as stock redemption), the business will purchase the owner's interest when a triggering event occurs. If the triggering event is death, and the agreement is funded with life insurance, the death benefit is paid to the business at the owner's death. The business uses the death proceeds to purchase the deceased owner's business interest from his or her estate. The surviving owners' ownership percentages increase proportionately unless, of course, the agreement states otherwise.

Tax Considerations in General

At the most basic level, the tax treatment of the insured entity purchase arrangement is fairly straightforward. No deduction is allowed for premiums paid on a life insurance policy to fund the buy-sell agreement. Life insurance proceeds are generally received income tax free. In addition, because the business entity, not the surviving owners, is the buyer of the deceased owner's interest, there is generally no basis step up for the remaining owners. To the decedent's estate (or the retired owner, as the case may be), the sale of the business interest is generally considered to be a sale or exchange of property under IRC Sec. 1221, and receives a capital gain treatment. But since the estate receives a basis step up for the business interest sold, no capital gain results from the sale. There are several significant exceptions to these general rules as discussed below.

Alternative Minimum Tax: Additional Tax Burden for the C Corporation

In addition to the regular income tax liability, the C corporation must generally account for what amounts to two more sets of tax rules: alternative minimum tax (AMT) and adjusted current earnings (ACE). The AMT, imposed only on "large" C corporations, is equal to 20 percent of the alternative minimum taxable income (AMTI) above an exemption amount. (AMT exemption for 2005 was $40,000 subject to a phase-out; it is completely phased out at $310,000 of AMTI.)

To determine AMTI, tax-preference items are added to, or subtracted from, regular taxable

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income of the corporation. For example, depreciation is computed differently under the regular method and the AMT method (and the ACE method, for that matter; more on ACE later). A difference between regular and AMT depreciation methods results in either a positive or negative adjustment to the regular taxable income. If the AMT liability exceeds the corporation's regular income tax liability, then the corporation must pay the AMT.

As mentioned, the AMT applies only to the large C corporation, and therefore a "small" corporation is exempt from the AMT. A corporation is treated as a small corporation and is exempt from the AMT for the current year, if that year is the corporation's first tax year in existence, regardless of its gross receipts for the year. If the corporation exists for more than a year, it is treated as a small corporation if:

- it was treated as a small corporation exempt from the AMT for all prior tax years beginning after 1997, and
- its average annual gross receipts for the three-tax-year period (or portion thereof during which the corporation was in existence) ending before the current tax year did not exceed $7.5 million ($5 million if the corporation had only one prior tax year).

One of the preference items added to arrive at AMTI is the ACE. It is similar to the corporate earnings and profits, and determined by the corporation's accounting method. If the ACE exceeds the AMTI (computed without the ACE adjustment), 75 percent of such excess is added to the regular taxable income base.

For corporate-owned life insurance, both the cash value buildup and death benefits greater than basis must be adjusted for ACE. Stated differently, the current year increase in the cash surrender value over the current year policy premium paid represents an ACE adjustment. Similarly, the death benefit received in excess of the higher of cash surrender value or premiums paid is an ACE adjustment.

These rules are a departure from the general rule that allows for tax-deferred cash-value buildup, as well as tax-free death benefit. In effect, such adjustments increase the AMTI, which then increases the AMT, thereby increasing the odds of AMT liability. The results: Though normally tax free, life insurance proceeds above the higher of cash surrender value or premiums paid are potentially subject to the AMT at an effective rate of 15 percent (75 percent of 20 percent).

After all is said and done, payment of the AMT is not the end of the world. Rather than treating it as a separate tax, AMT payments should be viewed as a prepayment of tax. Payments of AMT can offset future regular income tax liability of the corporation as credit up to the AMT in any given year.

Stock Redemption for the C Corporation: Ordinary Income or Capital Gain?

When the C corporation redeems a deceased (or retired) owner's shares, any distribution of property or cash made by a corporation to redeem such shares is generally a dividend. However, a transfer of stock in exchange for property may qualify as a sale if certain conditions are met, in which case the selling shareholder may report the transaction as the sale of a capital asset instead of a dividend. This is a favorable treatment to the deceased shareholder for an obvious reason: the gain on the sale of the shares would be a capital gain rather than ordinary income, as with a dividend. Since the deceased shareholder's estate gets a step up in basis for his or her shares in the business, no gain would result from such transaction.

To receive the favorable capital gain treatment, however, one of three tests must be met:

1. Redemption must not be essentially equivalent to a dividend.
2. Redemption is substantially disproportionate.
3. Redemption is a complete redemption of the entire stockholder's interest in the corporation.

The first test is a facts-and-circumstances test, and is perhaps the most difficult for which to qualify objectively. It is generally understood that this test should be relied upon only if the other two tests cannot be satisfied. The two other tests employ objective, mathematical tests. In the second test, substantially disproportionate redemption is accomplished if, immediately after the redemption, all of the following three mathematical tests are met:

1. The stockholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

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2. The stockholder's percentage of voting stock is less than 80 percent of the voting stock, prior to redemption.
3. The stockholder's percentage of common stock (voting and nonvoting) must be less than 80 percent of the percentage of voting stock owned prior to redemption.

In the third test, if all of the shares owned are redeemed, the transaction will result in a capital gain, not dividend. The shareholder (or his or her estate) can avoid a dividend treatment (ordinary income) of a stock redemption if substantially all of the shares owned are redeemed, and control is relinquished.

Attribution Rules: Yet Another Wrinkle for the C Corporation

Even if the C corporation redeems all of the shareholder's shares and if the shareholder (or the executor of his or her estate) believes he or she no longer owns the company, it may not be enough to qualify for the capital gain treatment under the three exceptions. In determining how many shares the stockholder owns, not only must shares actually owned be considered, but those constructively owned under the attribution rules must be added up as well.

For the purposes of meeting the substantially disproportionate redemption and complete redemption (i.e., the second and third tests) discussed above, the rules of constructive stock ownership apply. A stockholder will be treated as owning the stock in a corporation that is owned directly or indirectly by:

- ***Family attribution:*** Shares actually owned by spouse, children, grandchildren and parents. There is no attribution among siblings or to grandparents.
- ***Corporations:*** A 50 percent or more shareholder of a corporation is deemed to proportionately own the shares of stock that his or her corporation owns.
- ***Partnership:*** Stock owned by a partnership is attributed proportionately to its partners; stock owned by a partner is attributed to the partnership.
- ***Estates:*** Stock owned by an estate is attributable to the beneficiaries of the estate; stock owned by the beneficiaries of an estate is attributable to the partnership.
- ***Trusts:*** Stock owned by a trust is attributed to its beneficiaries in proportion to their actual interests. Stock owned by beneficiaries of a trust is attributable to the trust.

Assume a corporation has 100 outstanding shares of stock. The father owns 60 shares and the two daughters own 20 shares each. Immediately after the father's death, his actual ownership is 60 percent, but the 40 percent interest owned by the two daughters would be attributed to the father. This makes the father a 100 percent owner of the corporation. Likewise, after the corporation redeems the father's 60 shares, even though the two daughters have become 100 percent owners with each owning half of the corporation, the father still is a 100 percent owner attributed by estate attribution. This transaction will be treated as a fully taxable dividend, not as a sale of capital asset. Using the same example, if the mother owned some shares, it would still be attributed to the father by family attribution.

There is an important exception to the family attribution rule, known as "10-year rule," which demands that three requirements be satisfied. The three requirements essentially mandate that the exiting shareholder not reacquire an interest (except by bequest or inheritance) or become involved in the corporation as an employee, officer or otherwise (except as creditor) for 10 years following the redemption. Attribution rules are highly complex and warrant a separate discussion. Suffice it to say that the adviser should think of constructive ownership as well as actual ownership when planning for business continuation for the C corporation.

IRC Section 303 Redemption: Exception to the Attribution Rules

The attribution rules can be avoided under the entity purchase agreement by Section 303 redemption. It is specifically exempt from the attribution requirements, helping family corporations to make a stock redemption possible without the threat of dividend treatment. Without the Section 303 exception, a stock redemption may be fully taxable as a dividend. This exception provides that a portion of the stock can be redeemed without dividend treatment. There are several requirements in order to qualify for the Section 303 redemption:

- Redeemed stock must be includible in the decedent's gross estate.
- Value of the corporate stock must exceed 35 percent of the decedent's adjusted gross estate. If the decedent owns 20 percent or more of the value of each of two or more corporations, they can be combined to meet the 35 percent requirement.
- Only death taxes, interest, funeral and administrative expenses are allowed, to the extent that the stock redemption is necessary for administrative costs.
- Distributions by the corporation must be made after the shareholder's death.

Basis Step Up for Life Insurance Proceeds Available for the Pass-Through Entities

There is generally no basis step up for the surviving owners under the entity purchase. As stated above, this is because the entity, and not the surviving owners, is buying the deceased owner's business interest. The surviving owners' increase in ownership is simply a function of the deceased owner's interest vanishing. There is no basis adjustment resulting from the ownership interest adjustment. This rule applies to the C corporation, as well as for pass-through entities such as partnerships, limited liability companies (LLC), and S corporations.

However, if the buy-sell agreement is funded with life insurance, to the extent the pass-through entity receives tax-exempt death proceeds, each surviving owner receives an increase in basis in proportion to his or her pro-rata share of the death proceeds. This is the case even though the policy proceeds are received income tax free.

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To reiterate, it is not the redemption of the deceased owner's interest that inherently increases the surviving owners' basis. Rather, it is the tax-exempt life insurance proceeds received by the business entity that result in the increase in the surviving owner's basis. If a cash value insurance policy is used, basis increase technically equals the net death proceeds minus the net premiums paid. Net premium in this case is the premium expenditures, less the corresponding increase in cash value, but not below zero. This is because each premium payment lowers each owner's basis while cash-value increase adds to the owner's basis (again, no more than zero).

This basis step up is a positive result for the surviving owners because it effectively reduces future gains from a disposition of their interests. For the deceased owner's estate, however, any basis allocated to such decedent is "wasted." This is because the decedent's interest in the business automatically will be stepped up to its fair market value. Therefore, the basis step up received from the allocation of death proceeds results in a duplicate, and not additional, benefit in terms of basis step up.

To possibly mitigate such wasted basis, the partnership (or LLC) may be able to draft its agreement so that the death benefit is allocated only to the surviving owners, thus eliminating any such wasted basis. One strong caveat to the allocation of death proceeds to only the surviving partners is that the IRS requires that a special allocation, such as allocation of death proceeds, have "substantial economic effect." In other words, the allocation must be substantial and consistent with the underlying economic arrangement of the partnership. Any economic burden or benefit that corresponds to an allocation must be borne or received by the partner to whom the allocation is made.

Contrary to the partnership, which is contractual in nature among the partners and can be extremely flexible, the S corporation cannot be so accommodating in allocations of death benefit to its shareholders' bases. The allocation of basis for the S corporation is based on a "per share/per day" formula. For example, if a 50 percent shareholder dies on June 30, and the death proceeds were $200,000, the death proceeds allocated to the deceased shareholder's basis are $49,589 ($200,000 x 50 percent share x 181/365 days). Again, similar to the partnership/LLC, this increase is also wasted because the decedent receives a step up in basis regardless of the death proceeds. Under the entity purchase agreement for an S corporation funded with life insurance, the amount of the deceased shareholder's basis increase becomes, in effect, a function of his or her ownership percentage and, to a larger extent, the timing of his or her death.

However, if the S corporation is a cash basis taxpayer, it is possible to eliminate the wasted basis. An S corporation may terminate a tax year, which has the effect of dividing the normal tax year into two shorter tax years. To illustrate, assume again a 50 percent shareholder of a cash basis corporation dies on June 30, and the corporation receives death proceeds of $200,000 on July 20. The corporation can write a promissory note immediately after the death to the estate of the deceased shareholder and subsequently elect to terminate the tax year as of the same date. When the death proceeds are received on July 20, the only shareholder for that tax year is the surviving shareholder. The entire $200,000 of income-tax-free death proceeds increases the remaining shareholder's basis.

"Hot Assets"

Under the entity purchase arrangement, a partnership's payments for the retiring or deceased partner's interest in partnership property are generally treated as distribution in liquidation of such interest. Liquidating payments are taxable to the extent that they exceed the partner's basis in the partnership interest. If the liquidation is from a deceased partner's estate, there is usually no gain or loss since the decedent's basis is stepped up to the fair market value.

However, several categories of assets are excluded from the favorable liquidation treatment, namely, unrealized receivables, goodwill — except to the extent that the partnership agreement provides for a payment with respect to goodwill — and substantially appreciated inventory (defined to include all assets except cash, capital assets and Section 1231 assets).

Payments received for these assets — commonly called "hot assets" — are considered as either distributive share of partnership

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income or guaranteed payment, which means they are treated as ordinary income. For the decedent, such payments are, in effect, income in respect of a decedent (IRD). IRD refers to income a decedent is entitled to at the time of death, but is not properly includible as gross income in any federal income tax return. Commonly, this involves a cash-basis taxpayer with the right to receive income who had not received it at the time of death.

In practical terms, if the partnership is an accrual basis taxpayer, income for the unrealized receivables was already accounted for and included in income. As a result, there is presumably no ordinary income attributable to unrealized receivables for an accrual basis entity. However, for a cash-basis partnership with a large unrealized receivable (e.g., a physicians' group), ordinary income required to be recognized can be significant.

As for the payment received with respect to goodwill, to the extent the partnership agreement provides for payment for goodwill, this amount will receive a capital gain tax treatment. On the other hand, if the partnership agreement does not provide for payment for goodwill, the payment received will be treated as ordinary income.

As mentioned above, the term "appreciated inventory" is not limited to actual inventory items. Inventory, for this purpose, is defined to include all partnership assets except cash, capital assets and Section 1231 assets, such as business equipment and furniture.

Note: Part II will run in the Nov/Dec issue of *The Planner*.

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"In practical terms, if the partnership is an accrual basis taxpayer, income for the unrealized receivables was already accounted for and included in income."

Revised Uniform State Trust Laws and the Accountant's Role

By Seymour Goldberg, CPA, MBA, JD

Over the last few years, most states enacted significant changes in state trust laws regarding the definition of accounting income and principal. For the most part, these laws and rules apply to existing trusts and newly formed trusts.

These state laws have a dramatic effect on the rights of trust beneficiaries, as well as the rights and liabilities of trustees. Accountants for trustees are placed in a difficult position because they may:

- not know that the state trust laws have been changed;
- have heard that the state trust laws have changed, but they may not know what the changes are;
- not know how to apply the state trust laws;
- feel that the trustee should be responsible for the interpretation of the state trust laws; and
- feel that the attorney for the trustee should be responsible for interpreting state trust laws.

As a result, the problem for the accounting profession becomes particularly acute when the accountant may prepare trust returns, may be asked to examine the trust document to determine the identity of the income beneficiary and remainder beneficiaries, and may represent that s(he) is knowledgeable in the trust area. Many accounting firms represent their expertise in firm brochures; if the accountant represents specialized knowledge in trust accounting, then s(he) may be held to a higher level of liability if challenged on this knowledge.

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"From my experience in speaking at various professional seminars and conferences, I believe that many accountants may not be familiar with the detailed state trust law changes in their respective states."

The reason for the difficulty in understanding these state trust laws is simple: most accountants are not trained in interpreting these revised state trust laws. These state trust laws will trigger adjusting entries where transfers may be made from income to principal or vice versa.

The state trust laws are composed of either two or three elements, including 1) Uniform Principal and Income Act, 2) Power to Adjust, and 3) Unitrust Conversion.

The Uniform Principal and Income Act provides for the authority of the trustee to determine income and principal based on a number of state law options. For example, in a number of states, the Act permits the trustee to transfer an appropriate amount from income to principal in one or more accounting periods in order to reimburse principal for periodic payments on an obligation secured by a principal asset subject to certain limitations.

The Power to Adjust allows the trustee to make decisions each year on how much to transfer from principal to income, and vice versa, based on certain factors reflected in the state law. The state law prohibits adjustments from being made under certain circumstances.

The Unitrust Conversion allows a certain election to be made which will provide that the income beneficiary will receive a certain percentage of the trust assets each year regardless of the actual income of the trust.

The Unitrust Conversion must satisfy the requirements under the state trust law. In New York State, for example, any trustee – including a trustee who is a beneficiary of a trust – is not prohibited from electing the Unitrust Conversion. However, under Pennsylvania state law, a trustee who is a beneficiary of a trust may not convert a trust into a unitrust. Connecticut and New Jersey law do not provide for a Unitrust Conversion.

On top of all this, the IRS issued final regulations on the definition of what is "accounting income" from an IRS point of view.

From my experience in speaking at various professional seminars and conferences, I believe that many accountants may not be familiar with the detailed state trust law changes in their respective states.

If the accountant is a trustee and does the tax return for the income beneficiary, then this person may have a conflict of interest and a potential ethics violation, unless s(he) fully discloses the potential conflicts that exist between a trustee and income beneficiary under the revised state trust laws. The accountant should secure written consents to continue the dual representation engagement.

In the event that the accountant is not a trustee, but does the income tax return for the trust and the income beneficiary, then the accountant may or may not have an ethics issue depending on the facts and circumstances.

Seymour Goldberg is a CPA and attorney and a senior partner at the law firm of Goldberg & Goldberg, P.C. in Jericho, NY. He has taught many CPE/CLE courses on taxation throughout the United States, and has written publications for the ABA and the AICPA. His recent Retirement Distribution Practice Aids is a collection of letters, forms, checklists and related guidance, available by download from www.CPA2biz.com (Product No. 017247DOC). Contact Goldberg at info@goldbergira.com. ●

ElderCare Spotlight
Early Warning Signs That Care Is Needed

By Mike Seefeld, CPA, and Debra Seefeld, CPA

Small changes in the way an elderly family member, friend or client lives and behaves can be signals that help is needed. This is especially true when you see signs that they are losing the ability to care for themselves. Too often, family members shrug off these signs until a crisis occurs – like an emergency trip to the hospital.

Watch for these early warning signs that indicate care is needed:

- Stacks of unopened mail and bills.
- Not taking medications properly.
- Difficulty preparing meals.
- Change in appearance, looking unkempt.
- Unsafe driving.

Many people are surprised that a stack of unopened mail is a warning sign. For most of us, sorting through the mail and paying bills is something we do easily because our "executive function" is not impaired. Executive function is the part of our mental processing that provides us with our ability to plan and schedule activities, especially as circumstances change. Many older adults develop difficulties with their executive functioning as they advance in years. This makes sorting through the mail, paying bills on time and managing their checkbook an extremely difficult, if not impossible task. It is often the first sign that something is not right.

Occasionally we have an older client who comes to our office at tax time with their records in disarray. In prior years, this person may have been very organized and on top of their finances, but now he or she cannot seem to get things together. Over the next few years, we watch as this client struggles to remain independent.

If you see any of the warning signs above, here are some things to consider:

- Start a conversation with the person. Share your feelings of concern. Ask questions in a kind way, not as an interrogation. Ask as many questions as needed to get a clear picture of their situation. Older adults often need help in more than one area.
- Help the older adult maintain as much control as possible. Make the smallest adjustments necessary to help them maintain safety and independence. Fear of loss of independence can derail the best plans.
- Start educating yourself. If your caregiving responsibilities increase, you will need to know about the person's medical, legal and financial situation. You will also need to know what resources and services are available to help. The Internet is a great source of information.
- Consider hiring help. Whether it is help with managing the checkbook or assisting with house cleaning, a little help can work wonders for both the older person and their family caregivers.

A watchful eye and a sympathetic ear are important when assisting our elderly friends, relatives and clients. Being attentive and responsive to some of these small changes in their lives will go a long way to preventing a crisis.

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