We now have certainty regarding the federal estate and gift tax laws. The 2012 Taxpayer Relief Act (the “2012 Act”), the legislation that avoided the so-called fiscal cliff, has given us much-needed certainty regarding the federal estate and gift tax laws. This article will review several of the major features of the 2012 Act and discuss how these changes may affect our clients.

Before the enactment of the 2012 Act, the exemption amount for gift, estate, and generation-skipping transfer (“GST”) taxes was scheduled to be reduced to $1 million after December 31, 2012. The 2012 Act sets the exemption amount at $5 million adjusted for inflation. This results in an exemption amount of $5,250,000 for 2013. Thus, spouses who use both of their exemption amounts may transfer a total of $10.5 million in 2013 without incurring any transfer tax. The top tax rate, imposed on all transfers over the exemption amount, is now set at 40 percent.

Before 2010, each spouse needed to use his or her own estate and gift tax exemption amounts for estate and gift tax purposes; if a spouse did not use the full exemption, it was lost. The 2010 Tax Relief Act introduced the concept of portability, and the 2012 Act made this concept a permanent part of the tax law. In general terms, portability allows a surviving spouse to use the unused portion of the deceased spouse’s exemption amount. To illustrate, assume that each spouse has a $5 million estate and that the husband dies first and leaves his entire estate to his wife. Because there is no estate tax on transfers between spouses, the husband’s estate owes no federal estate tax and has used none of his exemption amount. Thus, before 2010, his entire exemption amount would have been wasted. A common way to avoid this waste is for the husband to pass his exemption amount to a bypass trust, which could benefit his wife until her death and then pass to the husband’s ultimate beneficiaries. Portability offers an alternative to the bypass trust. With portability, the wife’s exemption amount is the total of her exemption amount (currently, $5.25 million) and her husband’s unused exemption amount (in this case, also $5.25 million). Thus the wife has an exemption amount of $10.5 million, which she can use either to make gifts or to pass assets at her death.

The 2012 Act also makes permanent certain pro-taxpayer GST tax provisions that make less complicated the allocation of GST tax exemption to certain trusts. These provisions include automatic allocation of GST exemption to indirect transfers to certain trusts, the right to retroactively allocate GST exemption if there is an out-of-order death in the family, and the right to divide a trust that is only partially exempt from GST tax into two trusts.

A natural question for those couples with less than $10.5 million in assets is whether they need to be concerned about estate taxes given the increased exemption amount and portability. For those living in Washington and Oregon, there is the state estate tax to plan for. In Washington, the exemption is $2 million per person; it is only $1 million in Oregon. Neither state currently allows portability. In addition, there are...
Business owners who have other partners, members, or shareholders need to consider what will happen to their ownership interest on retirement, death, divorce, or permanent disability. The same is true for co-owners of major investment assets such as real estate held in a corporation, limited liability company, or partnership.

A buy-sell agreement might well be the most important document that an owner will ever sign. It is an important part of a business owner’s estate plan because it often creates a flow of cash to the owner on retirement, death, or permanent disability. Each owner needs to consider five major issues before entering into a buy-sell agreement.

**Pick the Right Buyout Triggers.** The typical events that trigger the obligation to sell or buy an ownership interest are known as buyout triggers. These typically are retirement, death, divorce, disability, and, in some situations, a breach of obligations under a major agreement with the entity, such as a failure to make an agreed-upon capital contribution.

But in some situations, certain triggers may not be the right choice. If the entity owns an investment asset such as an apartment building that has a professional manager, the death, divorce, or disability of an owner may not be important to the ongoing operation of the asset. It might be just fine if the ownership interest passed to a surviving spouse or children at death.

Another issue: what does the trigger trigger? A trigger normally triggers one of three rights—an option of a buying owner to buy out the selling owner’s interest, an option of the selling owner to force the buying owner to buy out the interest of the selling owner (also known as a “put right”), or a mutual obligation on both the buying owner to buy and the selling owner to sell the ownership interest. Of course, the owner who retires, becomes disabled, or dies wants to know that his ownership interest will be purchased. On the other hand, the potential buying shareholder wants to make sure that she is not forced to purchase an ownership interest that she cannot afford.

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**Pick the Right Buyer.** For a key owner of an operating business, picking the right buyer is the most important decision the owner may ever make. The key owner must find a buyer who can successfully run that business in the future. If not, unless the purchase price can be funded with life insurance (which obviously works only on death) or by a loan (which is very hard to do for a small business), the business may not generate enough cash to fund the purchase of the interest.

In a family-owned business, that right person to buy the interest may be a son or daughter. It may be an easy decision if one of your children is in the business and you know that child has what it takes to run the business. But this is not always the case, and it may be necessary to pick only a single child or two and not others to actually have the voting rights needed to make all important business decisions. If a business is a very significant asset in the owner’s estate, it may be necessary to transfer at death an equal interest in the business to each of the owner’s children. To make sure that children who will not have voting control of the business are not squeezed out by their siblings, their ownership interest can be in the form of a nonvoting preferred interest (similar to a long-term note), while the other children who will run the business receive a voting interest. Another approach is for the sibling or siblings who will run the business to buy out the interest of the other siblings.

**Pick the Right Way to Set the Price.** Once the parties agree on the right triggers and buyout parties, a mechanism must be established to set the price of the ownership interest. It is, of course, very difficult to set a price today that will accurately reflect the value of an entity years off in the future.

Buy-sell agreements solve this problem in numerous ways. One is to have the owners set the price each year. This method has a couple of flaws. One is that inevitably, the parties forget to set the price. Or, as often is the case, because of age or disease, it is apparent that one party will die, become disabled, or retire (and be a selling owner) before the other owners (who will be the buying owners). At that point, the selling owner is pushing for a high value while the buying owners want a low value.

A more common approach is to determine the purchase price by an appraiser or by arbitration. The agreement should provide guidance to the appraiser or arbitrator whether the values should be discounted for (continued on next page)
Time for a Checkup?

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The annual physical is very much an American tradition. But what about legal checkups—how often should people have their estate plans examined to be sure they carry out their wishes, are tax-efficient, and are legally sound? The best answer is that “it depends”—on a number of personal and legal factors. Symptoms suggesting that a legal checkup may be in order include the following:

• **Your net worth.** Periodically estimate the value of assets owned by you and your spouse. Add life insurance, IRAs, pensions, and similar assets. When the total approaches the Oregon estate tax exemption limits of $1 million (individual) and $2 million (married couple), the Washington $2 and $4 million exemptions, or the $5.5 and $10.5 million federal estate tax exemptions, it’s time to review your planning to ensure that your estate plan makes full use of the available exemptions.

• **Changes in your family situation.** Have there been changes in your marital status? Have children or grandchildren been born or adopted? Have there been marriages or divorces among your children or grandchildren? Do you need to deal with the incapacity of a parent, spouse, child, or grandchild?

• **Child coming of age.** Has a child, grandchild, or other person named in your estate planning documents turned 18 or otherwise reached a milestone established by your estate plan?

• **Business changes.** Have you bought or sold a business interest or investment real property? Do you anticipate a significant capital gain in the near future?

• **Change in responsible people.** If you have named guardians for your children, do they still live in the area? Are your designated personal representatives and successor trustees still able to serve, and do you still have confidence in them?

• **Changes in relationships with beneficiaries or charities.** Are there individuals or charities that you would like to include in—or delete from—your estate plan?

• **Change of residence.** Are you moving to another state? Have you acquired a vacation home or other real property in another state? If so, community property or other legal considerations may affect your estate planning.

• **Tax law changes.** Although state and federal estate and gift tax exemptions and rates now appear to be fixed for the foreseeable future, do changes in capital gains rates, dividend taxation, and charitable deduction eligibility require review of parts of your estate plan?

Keeping your estate plan in mind when there are changes affecting your economic or personal situation simply makes good sense—in estate planning as well as medicine, an ounce of prevention may well be worth a pound of cure.

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lack of marketability (unlike Google stock, most ownership interests are not publicly traded, and the appraiser can determine an appropriate value discount) or, if applicable, discounted to reflect a noncontrolling minority interest (if the interest being sold is less than 51 percent). If the ownership interest will be sold between family members and an estate tax might be due, the discounts for minority interest and lack of marketability will reduce estate taxes—normally a positive result. It may not be a particularly positive result, however, if the nonowning sibling will be bought out at a discount or the surviving spouse is left without enough income to live on.

Pick the Right Buyout Terms. Setting the right buyout terms is very important. If the price is too high or the terms are too onerous, a buying owner may just not be able to swing a buyout. This is not good news for the buying owner because he or she may end up defaulting on the payment obligation. On the other hand, it is not good for the selling owner either—who will lose the cash flow needed for retirement or to support a surviving spouse.

Typically, buyout terms for smaller businesses tend to favor the buyer. That means lower interest rates, lower down payments, and longer buyout periods. Buyouts are often structured with a small down payment. Perhaps the down payment is the amount of life insurance proceeds, if any, available for a buyout on death, but in no event less than 10 percent of the purchase price. The payout periods are often based on

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As advisors, we often hear from business owners some variation of the following comments:

- “I think it is time to back away from my business.”
- “I’d really like the freedom to do whatever I want, whenever I want.”
- “I’m tired of running this company, but if I sell, I’m not likely to get the sale price I want in today’s merger and acquisition marketplace.”
- “If I could cash out, where could I invest and generate a reasonable rate of return? Don’t even think about suggesting that I put my money in the stock market! I doubt the stock market can match the return I would get on a similar investment in my own business.”

Faced with limited prospects, owners often wonder whether, rather than exiting, they can “back away” from their companies—be less active and treat their companies as investments that they continue to own.

Many owners realize that today’s merger and acquisition market contains fewer cash buyers. Consequently, owners may be reluctant to offer their companies for sale. They may be convinced that there could be less risk in keeping their businesses—at least in the short term.

In addition to a scarcity of all-cash buyers, except for top companies in the market, the merger and acquisition market is no longer supporting the valuation multiples of six or seven times EBITDA (“Earnings Before Interest, Taxes, Depreciation, and Amortization”) achievable just a few years ago.

This combination of the lack of cash buyers willing to pay fair value for successful companies and the poor available investment opportunities may be sound reasons for owners to choose to stay in their companies. If you are in this group, the next question is: how do I back away and let others run the business without transferring ownership and control?

One answer is to engage in exit planning as if you were going to exit your business. After all, someday you will exit—even if you are carried out. While traditional exit planning can help you orchestrate a successful, permanent exit, intermediate exit planning can help you to forge a path toward an exit without giving up ownership or having to compromise your investment opportunity.

To create an intermediate exit plan, you should:

- Establish your (owner-based) ongoing business objectives;
- Determine future cash flow needs for yourself and for your business; and
- Build a stronger business—defined as one capable of running without you.

Let’s look briefly at each component.

First, establish your timetable for backing away from your business. Communicate your wishes clearly: What does backing away mean to you in terms of time commitment, emotional involvement, financial guarantees, etc?

Second, determine the amount of income that you need the business to provide you. Ask your advisors to help you make this determination.

Third, the characteristics of a stand-alone business (one that can run without you) may be the same characteristics that third-party cash buyers look for: a company that can be managed from a distance and that is able to pay adequate cash flow with little risk of nose-diving without its owner at the helm. That is often a highly attractive business for purchase. It can be valuable both to third parties and to the owner who wants to step away. To create that type of business, you should have in place some critical “value drivers.” They are:

- Increasing cash flow;
- Operating systems that improve sustainability of cash flows;
- Improved facility appearance;
- Debt reduction;
- Documented sustainable earnings;
- Growth strategy; and
- Strong management team.

When you work with your advisors to fashion your stand-alone business, pay particular attention to creating repeatable, sustainable internal systems and developing and properly motivating your management team. To run successfully without you, your company needs systems and management in place capable of replicating your leadership.

The most valuable businesses are those in which the owners are no longer valuable. Planning to step away using intermediate exit planning can create a more vibrant business. When your day of departure does eventually arrive, both you and your business will be prepared.
a 20 year amortization with the note coming due in 10 years. This prevents the company from being starved for cash. Some agreements might reduce monthly payments or even eliminate them if the entity’s cash flow is low.

Another issue is whether the purchase price should be secured. If the buyer is the entity, a guaranty of the other owners may be appropriate. Some potential buyers may be unwilling to put their personal assets at risk and may be unwilling to sign a guaranty. Another form of security is a lien against the entity assets. This can be tricky. Often, other financing has terms that prevent placing a second lien on business assets. Even if a second lien can be placed on the property, it may as a practical matter not help the seller if there is a default, since the first lienholder often insists on the right to be paid off in full and the selling owner does not have sufficient cash to do so. Even if that is not the case, the lien may prevent an operating business from obtaining needed operating cash from traditional financing sources, and thus the lien designed to protect the selling owner could cause a default on the payments due to the selling owner.

Generally, except for a personal guaranty, most buy-sell agreements for smaller businesses settle for a lien against the stock, partnership interest, or limited liability company membership interest being acquired.

Pick a Structure Without Tax Surprises. Finally, the structure must be scrutinized to avoid tax surprises. Thus, owners need to work through the buy-sell agreement with an advisor who is knowledgeable about tax issues.

Most tax surprises occur when using a corporation. For an S corporation, interests can be held only in certain types of trusts. Shares can never be owned by a nonresident alien or by a corporation, limited liability company, or partnership. An S corporation buy-sell agreement should generally be structured as a buyout by the buying shareholder directly and not by the corporation. This structure creates a higher basis in the buying shareholder. This not only will reduce gain if the stock is ever sold, but will also provide a basis that allows tax losses to pass through to the shareholder in bad years.

For a regular corporation, if it buys the stock of a retiring owner and the other shareholders are also family members, and the selling shareholder continues as an employee or even as a consultant of the corporation, the buyout will be treated as a dividend and not a sale. If it is treated as a dividend, the selling shareholder cannot reduce the gain on the sale (treated as a dividend) by her basis in her stock. For most regular corporations, it is generally more tax-efficient if the corporation buys out the interest of the selling shareholder.

But that is not always the case.

Perhaps the most important action that a business owner will ever take is to enter into a buy-sell agreement. This article touches on just a few of the many issues that may need to be considered. The economic future of a business owner, and of those who depend on him, will depend on negotiating a buy-sell agreement that makes sense for that particular business. There can be no substitute for very carefully thinking through these issues with your legal and tax advisors.
disadvantages to relying on portability rather than creating a bypass trust. Some of the major disadvantages are these:

- In states that do not allow portability (such as Washington and Oregon), state exemptions will be lost. A bypass trust allows the deceased spouse to use his available state exemption amount.

- The husband’s federal unused exemption is fixed as of his death and is not adjusted for inflation that occurs after his death. If a bypass trust is used, assets held in that trust will pass free of estate tax to the ultimate beneficiaries regardless of how much the assets have appreciated in value since the husband’s death.

- If the wife remarries, and her second husband also dies, she will lose the unused exemption amount of her first husband, since the rule is that a spouse may use the unused exemption amount only of his or her most recently deceased spouse.

- Portability applies only if a federal estate tax return is filed for the husband and an election made (even if an estate tax return would otherwise not be required).

- The bypass trust offers the surviving spouse creditor protection and helps to maintain the assets as her separate property if she lives in a community-property state, such as Washington.

- Because portability does not apply to the GST exemption, it is wasted if a bypass trust is not created. If a bypass trust is created, GST exemption may be allocated to that trust so that the trust assets can be held for future generations without tax.

We always suggest that our clients review their estate planning documents each year when they file their income tax returns. That advice is particularly important this year. The permanent changes made by the 2012 Act may necessitate changes in your documents or may cause you to rethink your previous decisions.