1Q 2006

Trusts & Estates Advantage

A special supplement to the Anchin Advantage

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Stockholder Agreement Key to Business Survival

Succession planning for a family business is essential for the growth and survival of the business. More than two-thirds of family businesses fail, with one cause being the lack of a succession plan. A key part of any succession plan is the Stockholder/Partnership Agreement.

A carefully drafted Agreement will consider the following issues: Management Succession, Buy-Sell Valuation, Compensation, Disability, Divorce, Tag Along Rights on Sale, Non-Compete, and the Funding Mechanism.

The buy-sell provisions generally will use a formula to arrive at the value of the entity or it may use a stated value that is reviewed periodically. The tax law has some specific provisions that must be incorporated into the buy-sell formula or the valuation will not be accepted by the IRS. The agreement must be a bona fide business arrangement that is not a device to pass wealth to family members and it must be similar to an arms-length negotiation.

The Agreement's buy-sell provisions will generally not be accepted if book value is used for the buy-out price. This applies especially if the Agreement is between lineal descendants. The IRS has even litigated situations where book value was used by unrelated individuals, but to date has not been successful. In some instances, unrelated individuals will use a low value in the Agreement and utilize life insurance outside the business to supplement the value. This saves estate taxes and reduces the financial burden on the business to buy-out the withdrawing member.

If possible, the Agreement should be funded. The most popular funding method is life insurance. The life insurance can be owned by the corporation or partnership, and this will result in the owner being redeemed out by the business. Alternatively, the life insurance can be owned by the stockholders/partners (cross purchase) which will result in the owners buying out the withdrawing member.

Both methods have their pluses and minuses, but in most cases, if the entity is a corporation, a cross purchase agreement is more advantageous. A cross purchase agreement will result in the remaining owners receiving an increase in tax basis in the shares purchased equal to the purchase price. This is not the case in a redemption agreement. In addition, if the corporation is a C Corp, a redemption could result in a dividend to the stockholders and alternative minimum tax to the corporation.

One disadvantage to a cross purchase is the insurance proceeds are paid to the remaining stockholders. This does not guarantee all the funds will be used for the buy-out. Therefore, a trust or escrow arrangement should be considered. Where there are many stockholders, a cross purchase arrangement may not be practical and a partnership should be considered to own the insurance and purchase the shares.

The advantage of an Agreement is that it assists the owners in planning for funding of the buy-out. This will help insure the businesses' working capital is not unduly burdened when an owner dies or withdraws from the business.

PARTNER PROFILE:

Jane E. Bernardini, CPA, PFS

A tax partner at Anchin, Block & Anchin LLP, Jane has more than 30 years of experience in public accounting. She provides high net worth individuals and family groups with a full range of estate planning and wealth preservation services. A Certified Personal Financial Specialist, Jane also holds Series 6 and 63 Securities licenses and is a licensed Life and Health Insurance provider.

Jane specializes in estate planning, gifting and charitable giving strategies, and the preparation of estate and income tax returns. She has particular expertise in foreign trust planning and administration. Additionally, Jane manages the financial planning for multi-generational families, including asset protection planning, planning for long-term financial security, and wealth preservation.

She is also an active member of the estate planning community. Jane is a member of the Estate Planning Committee of the New York State Society of Certified Public Accountants (NYSSCPA), a member of the Personal Financial Specialist division of the American Institute of Certified Public Accountants (AICPA), and a member of the Financial Women's Association. She is also a member of the Estate Planning Council of NYC. Jane can be reached at 212.840.3456 or by email at jane.bernardini@anchin.com.

Federal and State Estate Changes Increase Cost of State Estate Tax

By Bernard Rappaport, CPA

The federal government has reduced the estate tax cost by increasing the exemption and reducing the tax rate (for 2006, $2,000,000 and 46%). The changes began in 2001 and results in elimination of the Estate Tax in 2010 and then reversion to the pre-2001 rates and exemption (55% and $675,000).

One of the provisions that was changed increased federal estate taxes and, in some cases, eliminated state estate taxes. The provision that allowed credit of state estate taxes against the federal estate tax was reduced and then in 2005 eliminated and replaced by a deduction. This resulted in additional Federal Estate Taxes because a deduction is worth less than a credit.

Initially, elimination of the credit reduced state estate taxes because many states had their estate tax linked to the federal credit. Many states have decoupled from the federal system because of this change. The decoupling, combined with the loss of a federal credit, increased the cost of state estate tax because a deduction for state estate taxes is less of a benefit than a credit.

The following chart shows the state estate tax for several states in 2006 for a $2 million estate. The federal estate tax is zero.

	Estate Tax	Lifetime Exemption	Top Tax Rate
California	0	0	0
Connecticut	0	$2,000,000	16%
Florida	0	0	0
Massachusetts	$99,600	$1,000,000	16%
New York	$99,600	$1,000,000	16%
New Jersey	$99,600	$ 675,000	16%

Florida and California have not decoupled and therefore their estate tax is zero. Connecticut has recently changed its state estate tax to decouple but inserted a $2 million exemption. New York estate taxes were not linked to the Federal system, and like New Jersey and Massachusetts, its lifetime exemption is well below the Federal.

In Connecticut, an estate of $2,000,001 would be subject to a $101,700 tax because the next $1 of taxable estate assets in excess of $2 million results in the entire $2,000,001 being subject to tax. In addition, Connecticut, unlike New York and New Jersey, has a gift tax. The gift tax is similar to the estate tax, i.e., a $2 million exemption and a tax of $101,700 on cumulative gifts of $2,000,001 after 12/31/04. The federal annual exclusion is allowed for gifts of present interests ($11,000 in 2005 and $12,000 in 2006). The estate and gift tax are effective as of 1/1/05.

Therefore, even though federal estate taxes have been reduced, the overall top combined estate tax rate for a New York resident in 2006 is 54.64%. In 2001, before federal estate taxes were reduced, the top combined rate for a New York resident was 55%.

Transfer on Death (TOD) Registration Now Available in New York

New York State residents can register securities so that they automatically pass to a pre-designated beneficiary starting in 2006. This new form of registration has advantages and certain pitfalls. The main advantage is that it allows you to transfer securities at your death without first having to go through the probate process. Your designated beneficiary will therefore not be burdened with the time and expense and market risk associated with probate. The disadvantage is it may unintentionally change your estate plan unless you coordinate the TODs with your Will.

You can register a security with a beneficiary designation whether it is held in certificate form or in an account. It can be done by using the words "transfer on death" or the abbreviation TOD after your name and before the name of the beneficiary. The beneficiary designation is only effective at death. It can be changed or cancelled at any time and revoked or amended by your Will. You do not need the beneficiary's consent to change the designation.

Compared to a joint account with right of survivorship, this is a much more flexible arrangement. A joint account designation results in permanent control and entitlement and only works when both owners cooperate. Problems could and often do arise between the owners when there is a disagreement or one becomes incapacitated or insolvent. In addition, if the account is funded by only one individual and the other is not a spouse, unwanted gift tax liability may arise.

The beneficiary designation takes effect only if the beneficiary survives you. If the beneficiary does not survive you, your Will controls who receives the assets and, therefore, the TOD designation has to be reviewed as part of the periodic review of your Estate Plan.