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REAL ESTATE, TRUSTS & ESTATES, BUSINESS PRACTICE GROUPS ■ when it really matters

CONSIDERATIONS WHEN SELLING YOUR BUSINESS TO YOUR EMPLOYEES

Jane M. Myers, Esq.

The entrepreneurial spirit is both a blessing and a curse – ask any business owner. Years of hard work and countless sleepless nights are hopefully rewarded by the development of a thriving business that runs like a well oiled, revenue producing machine, which, in turn, allows the business owner to relax and sleep soundly. As the years pass, the business owner begins to think about how to transition out of the business and "cash out".

The sleepless nights resume as the business owner considers the options: sell the business to a third party or transfer ownership to people within the firm. This article will explore the choice by the business owner to transfer ownership to employees of the firm

Identifying your Business Plan

While some businesses stumble along without leadership and clear vision, it is indisputable that to achieve maximum success, every business owner should prepare a business plan that identifies the short-term and long-term goals for the firm, the steps to achieve those goals, a projection of the firm's growth and a review of the firm's successes and failures. The business plan can be developed at any time and should be reviewed and adjusted not less than annually. With a strong plan in place, the business owner can identify and carefully evaluate the potential candidates for ownership. However, in order for the transition process to be successful, the business owner must be certain that they are ready to begin relinquishing control of the business.

Which One Are You?

In New York, most businesses are typically organized as either a sole proprietorship, a business corporation ("Corporation"), a general partnership ("Partnership"), or a limited liability company ("LLC"). Professional services firms are typically organized as either a professional service corporation ("PC"), or a limited liability partnership ("LLP"). The sole proprietorship is owned by one person. The Corporation, LLC and PC can have single or multiple person ownership. The Partnership and the LLP must have at least two partners. In New York, shareholders, officers and directors of a PC and partners in an LLP must be licensed in the State of New York to provide the professional services offered by the PC or LLP. A shareholder in a Corporation, member in an LLC, or partner in a Partnership must be at least eighteen years of age. These issues must be considered when deciding on suitable candidates for future ownership.

Once the candidates have been identified, the business owner must arrive at a valuation of the firm. Valuation of a business is key to planning ownership transition. There are a myriad of formulas and methodologies to determine the worth of a business, however, a discussion of business valuation is beyond the scope of this article. Once the value is determined with the assistance of the firm's financial advisors, the business owner must focus on the structure of ownership, management of the firm, and how to deal with life changing events such as death and disability of an owner.

Taking the First Step

The first step is to decide on the percentage interest the candidate will have in the business. After the percentages are determined, ownership is transferred by the sale or gift of the interest to the candidate. The importance of documenting the transaction cannot be overstated. A handshake is not

enough to protect the business owner or the candidate. Generally, the parties will need a Purchase Agreement, a Promissory Note evidencing the amount and terms of payment of the purchase price, and a Security Agreement. The candidate typically pays the business owner 10% of the purchase price for the business interest in cash up front, with the balance paid over a three to five year period pursuant to the terms of the Promissory Note and depending on the agreement between the parties.

If it is intended for the candidate to eventually own 100% of the business, the business interest is typically transferred over a period of years rather than all at once. This approach protects the business owner and the candidate as they both

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ESTIMATING YOUR ESTATE TAXES

Mark S. Charwat, J.D., CPA and Ilene D. Samuel, Esq.

Many persons are unaware of the potential estate taxes that may apply to their estate, and when they finally do the calculation they are frequently surprised and even astounded at the estate tax bite that the government takes out of their estate. For New York State residents the concern for estate taxes extends to both the federal estate tax as well as the New York estate tax.

The Estate Tax Exemptions

Commencing January 2006 through December 2008 the federal estate tax exemption is $2 million, while the New York estate tax exemption remains at only $1 million. However, the New York estate tax qualifies as a deduction in computing the federal estate tax.

While each person is entitled to both a federal and a New York estate tax exemption, in situations where assets are left by one spouse to the other spouse, estate taxes will only apply when the survivor passes away. That is, by passing assets on to the surviving spouse, the first spouse to pass away will be using his or her marital deduction, but by doing so he or she will not be utilizing his or her estate tax exemptions. As a result, only the survivor's estate tax exemptions will apply, even though each of the spouses has exemptions from the federal and the New York estate tax. Thus by leaving all assets or substantially all to the surviving spouse, the first spouse's estate tax excemptions will be lost.

Assets may be left by one spouse to the other by various means, such as owning assets jointly, utilizing a payable on death account or an account "in trust for" the spouse, designating the other as beneficiary of a pension plan, IRA, annuity or life insurance policy or simply having a Will leaving assets to the survivor. For many couples the result of such ownership, beneficiary designation or Will may be that all or substantially all of their assets will be left to the survivor, to be subject to estate taxes in the survivor's estate when the survivor passes away.

What Assets Are Taxable?

Broadly speaking, taxable assets include all assets owned by the decedent. For example, it includes bank and brokerage accounts, collectibles, real estate, business interests, life insurance policies, pension and IRA accounts, annuities, cars, boats, etc. Essentially, the IRS seeks to include in the taxable estate all of the decedent's assets, although technicalities often apply.

If you should wish to estimate your estate taxes, then add up all of your assets. If you are a couple who is leaving all or substantially all of your assets to the other, then add up all of the assets to be owned by the survivor, including any life insurance. The total value will constitute the estimated gross taxable estate. From this total deduct mortgages and debts. Funeral and administration expenses are also deductible, but for purposes of making an estimate it may be advisable to simply disregard these relatively minor deductions.

The following are the total of federal and New York estate taxes that will apply in 2006 with respect to the following taxable estates:

Taxable Estate	Federal and NY Estate Taxes
$ 1,000,000	- 0 -
2,000,000	99,600
3,000,000	558,280
4,000,000	1,071,416
5,000,000	1,591,464
6,000,000	2,115,832
7,000,000	2,644,520
8,000,000	3,177,528
9,000,000	3,714,856
10,000,000	4,256,504

You will note that with a $5 million taxable estate, estate taxes are $1,591,464. Considering that for 2006 the federal estate tax exemption is $2 million, this amounts to combined federal and New York estate taxes of 53% of taxable assets in excess of $2 million.

This should not be surprising since for 2006 at the $5 million taxable estate level the federal estate tax rate is 46%, and the New York estate tax rate is 11.2%. Since the New York estate tax is deductible in computing the federal estate tax, the combined rate for federal and New York estate taxes is approximately 51%. If potential estate taxes in excess of 50% do not compel persons to undertake estate planning, then I do not know what will!

Estate Planning...Begin Early & Plan Ahead

Estate taxes can be roughly estimated from the foregoing schedule simply by assuming a proportionate increase in estate taxes based upon the same proportionate increase in the net taxable estate.

Estate planning employs many strategies to reduce or possibly avoid estate taxes, such as utilizing a bypass (credit shelter) trust, setting up life insurance trusts, undertaking a gift giving program, transferring business interests, establishing a family limited partnership ("FLP") or a grantor retained annuity trust ("GRAT").

The list of estate planning strategies is far longer than those mentioned, and what strategies are appropriate for each individual will depend on each person's circumstances and personal needs. Many of these strategies are implemented best over a period of years if the estate is substantial. Therefore it is always prudent to begin early and plan ahead ■

THE LATEST . . .

What's happening here at LBC&C

- On March 1, 2006 Dee Barcham will be moderating a Dean's Hour at the Nassau County Bar Association on Business Valuations Explained.
- Jane Myers is presenting "The Ten Secrets to Creating a Succeesful Deal." Call for details.

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adjust to the transition. The business owner's financial future hangs in the balance -- he or she is relying on the candidate to successfully run the business to ensure that it will generate enough money to enable the business owner to "cash out". By spreading the acquisition over a period of time, the candidate is given the opportunity to transition from the role of employee to the role of owner.

After the sale of the business interest to the candidate, the parties will require another document that addresses how they will conduct themselves as co-owners. Shareholders in a Corporation or a PC will enter into a Shareholders' Agreement; Partners in an LLP will enter into a Partnership Agreement; and members of an LLC will enter into an Operating Agreement. Regardless of the form of entity, there are core issues that are addressed in the respective Agreements. Terms of employment, such as scope of services, compensation, benefits and grounds for termination, are addressed in a separate Employment Agreement.

The main points for a business owner to consider in the transition planning process are restrictions on the transfer of a business interest once it has been acquired by the candidate and whether those same restrictions should apply to the business owner who, presumably, retains a majority interest in the business at the beginning of the transition period. Their concerns are not the same and should be addressed separately in the Agreement. Without restrictions on the sale or transfer of ownership interests, the non-selling owners can find themselves in business with the other owner's spouse or next door neighbor! Issues to address also include the impact of death or disability of one of the business owners -- a crucial consideration especially if that person is key to the continuation of the business. The looming issue is how the remaining owner will obtain the assets to buy out the estate or the interests of the disabled party when they are no longer involved in the business and generating revenue. Retirement, voting rights, and issues concerning restrictive covenants are also addressed in the Agreement.

Planning your Business for the Future

The transition process requires discussion with legal and financial advisors to tailor the result to the individual business owner's requirements and when approached in a systematic manner, the entrepreneur will rest easy. There is no reason why a business owner should work for years to develop a thriving business and not capitalize on its worth. Many entrepreneurs delay planning for the future, however, the sooner the transition process is explored, the better prepared the business owner will be to control their retirement and secure their financial future. ■

MAKING LOANS TO FAMILY MEMBERS PART II

By Deborah S. Barcham, J.D., L.L.M.

This is the continuation of an article from our Winter 2005 Newsletter concerning the tax consequences of family loans. The first installment cautioned the reader that if such loans are not properly documented they may be treated in whole or in part as gifts. This second installment focuses on the interest rate to be charged as well as the value of family loans for estate planning purposes.

To avoid imputed interest on family loans it is imperative that the loans be documented by a promissory note which provides for interest at a rate no less that the Applicable Federal Rate ("AFR"). The AFR utilized will depend on whether the loan is a term loan or demand loan.

Each month the Internal Revenue Service publishes the AFR for the following month. It lists rates for short term loans (loans of 3 years or less), mid-term loans (loans from 3 years to less than 9 years) and for long term loans (loans of over 9 years). The AFR also provides for compounding periods of annual, semi-annual, quarterly or monthly. In structuring a term note you must use the AFR that corresponds to the term of the note to be used.

A term note should be structured so that the interest is payable at least annually. Notes that provide that all interest will accrue and be payable at the end of the term will trigger income tax under the so-called original issue discount or "IOD" rules. These OID rules are fraught with problems, and to avoid OID issues it is recommended that the interest on the note be payable twice a year.

A term loan should use the appropriate AFR in effect on the date of the loan. However, care should be taken in drafting the promissory note because its provisions will affect the relevant AFR. For example, an 8 year promissory note that has an interest rate which resets after every two years is deemed to be a 2 year note. In such a case the short term AFR applies rather than the mid-term AFR. Similarly, a 5 year note that permits the lender to demand payment at any time prior to the end of the term would be considered a demand note and would require an interest rate that resets after every 6 months in order to completely avoid phantom income and gift tax consequences. Moreover, a 5 year note that allows the borrower the right to extend the term of the note for 5 years at the same interest rate is viewed by the IRS as a 10 year note, making the long term AFR the appropriate rate to be used.

With a demand note, the initial interest would be the short term AFR in effect for the month of the loan. If a demand note is made in the first half of the year the loan may initially bear the January interest rate if it is lower, and if the loan is made in the second half of the year the loan may initially bear interest at the July rate if it is lower. Thereafter, the note should provide that the interest rate will be reset semi-annually, such as every January and July to the short term AFR compounded semi-annually then in effect.

Family Loans As An Important Estate Planning Tool

Making loans to younger generation family members can be an important tool in estate planning. A grandparent or parent can utilize family loans to transfer wealth to younger generations, and if the child is over 14 have it taxed in a far lower tax bracket. With proper planning a grandparent or parent can make a loan to a grandchild or to a trust to a grandchild without the payment of any income tax or gift tax. If properly structured and handled, forgiveness of the interest on the loan can even be treated as coming within the purview of the annual gift tax exclusion which has increased to $12,000 in 2006. As discussed in the first installment, special care must be taken to make certain that the forgiveness of principal and especially interest does not provide the IRS with ammunition to argue that Grandpa never had any intention of having the loan repaid and allow them to attempt to re-characterize the loan as a gift.

If the assets are properly invested, hopefully they will earn income and appreciate at a greater rate then in the grandparent's hands and all of the income and appreciation of the assets would be attributed to the grandchild

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LIVING WILLS & HEALTH CARE PROXIES

FREQUENTLY ASKED QUESTIONS...

Mark S. Charwat, J.D., CPA and Deborah S. Barcham, J.D., L.L.M.

What is a Living Will and Health Care Proxy?

A Living Will is a legal document in which a person expresses his or her wishes regarding efforts to sustain life by mechanical or artificial means when treatment is futile and recovery is hopeless. A Health Care Proxy is a legal document by which an individual designates a health care agent who is authorized to make all health care decisions for that person if he or she is incompetent or unable to make such medical decisions. Usually a Living Will and Health Care Proxy is executed together as one document in New York State.

Why Do I Need a Living Will and Health Care Proxy?

As recent events have demonstrated, where a person fails to execute a Living Will, a spouse or other close relative cannot simply substitute his or her judgment for that of the patient, and the wishes of the patient regarding medical treatment must be established in a court proceeding by clear and convincing evidence, if there is such evidence. This can result in prolonged and costly litigation when family members disagree or where there is no evidence to prove how the patient feels about his or her medical treatment.

What are the Benefits of a Living Will and Health Care Proxy?

In addition to providing for or withholding medical treatment, the Living Will and Health Care Proxy can assist in settling extremely difficult family situations where family members may have differing religious or moral convictions, provide for relief from pain and suffering, avoid a costly guardianship proceeding and allow the health care agent to obtain vital medical information which is protected (even from a spouse) under the Health Insurance Portability and Accountability Act ("HIPAA") and from a practical perspective, can limit costs and expenses.

Who Should I Designate on the Health Care Proxy?

Usually people designate their spouse or an adult child as their agent on the Health Care Proxy. However, anyone can be designated as long as they are at least 18 years of age, reasonably available to make a decision should the need arise, willing and competent to serve, and aware of your feelings on life sustaining efforts where there is no hope for recovery.

Can I Designate More Than One Person on the Health Care Proxy?

A Health Care Proxy should only designate one person at a time as the health care agent, but you may designate successor agents to act, if the person named is unavailable or unable to act.

What If My Current Health Care Proxy Designates Two or More Persons Jointly as Health Care Agents, and Not Successively?

You should contact an attorney to have the Health Care Proxy modified to specify which person is the primary health care agent and which is the successor agent.

Is a Living Will and Health Care Proxy Known by Other Names?

In some jurisdictions a Health Care Proxy is known as a Medical Power of Attorney. Also, these documents are also known as "advanced directives".

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and not the grandparent. Of course, the borrower will be required to pay interest on the loan at the AFR, and only the balance due on the note would be included in the grandparent's estate on his death, as would any accrued interest due. Eventually, the note can either be satisfied by the borrower or the grandparent can forgive the outstanding balance at his death by his Will or can bequeath the entire balance of the note directly to the grandchild.

The IRS has taken the position, which has been supported by the courts, that transactions within a family group are subject to special scrutiny and, therefore, when making family loans it is crucial to pay attention to those details that will make the difference between family transactions that brings a grandparent and a grandchild happiness, joy and tax benefits or one that brings unwanted and unpleasant tax consequences.

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