

ACTEC®

**SHAREHOLDERS AGREEMENTS
FOR CLOSELY-HELD CORPORATIONS
OUTLINE**

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Disclaimer: The Outline is not intended as a definitive resource or primary research tool regarding the tax or legal issues discussed. Rather it is intended to highlight issues for consideration by knowledgeable attorneys.

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I. INTRODUCTION

A. General Purpose

Shareholder agreements, often referred to as “buy-sell” agreements, contain contractual rights and obligations between shareholders and the corporation to buy and sell stock, as well as other provisions dealing with matters such as governance and tax issues. This outline is intended to explain the use and characteristics of agreements between shareholders and the corporation. The focus is on corporations with active businesses (but does not include provisions unique to professionals) that are owned either by family members or unrelated owners (but not specifically ESOPs). Selected issues relevant to S and C corporations are covered, but this outline is not intended as a comprehensive treatment of corporate tax issues. Variations in state laws are not addressed, except in general reference, and so practitioners should check applicable state law.

The ACTEC Shareholders Agreements For Closely-Held Corporations Sample Agreement¹ contains sample provisions for a shareholders agreement discussed in this Outline.

The articles of incorporation can also contain restrictions on transfer, which would be binding on all shareholders. A shareholders agreement is a private contract between shareholders (all or less than all) and often the corporation as well, and thus may contain agreements to undertake future actions and more flexibility in the terms.

Since a shareholders agreement is a contract, it needs consideration to be enforceable. Generally the benefits and burdens of the agreement run to all parties and that is sufficient consideration. If the agreement is one-sided only, specific consideration may need to be included.

B. Non-Tax Objectives

- (i) Protect the shareholder/employees and/or their families from having to maintain an interest in a closely-held business, which may not provide a source of revenue, by creating a market for the stock.
- (ii) Preclude shareholders from selling or hypothecating their interests in the business without the consent of the other shareholders, thus limiting unrelated third-party access to ownership.
- (iii) Insure continuation of the business by providing for a smooth and orderly transfer of ownership, governance and control upon the occurrence of a “triggering event” (such as the death, disability, retirement, divorce, insolvency and/or termination of employment, whether voluntarily or involuntarily, of a shareholder).
- (iv) Provide a “known” buyer upon the occurrence of a triggering event.

¹ <http://meetings.abanet.org/webupload/commupload/RP519000/relatedresources/Actec2.pdf>

- (v) Avoid controversy, particularly among family members of a former shareholder.
- (vi) Avoid the need for negotiations with the family or a fiduciary representing the former shareholder's interest by (i) establishing a price or method of valuing the ownership interest which is to be transferred, such as by an appraisal or formula, (ii) establishing the terms of payment, and (iii) providing a method of funding for the payment of the purchase price.
- (vii) Consider the use of lack of marketability or minority interest discounts in determining value.
- (viii) Provide liquidity to the family of a deceased, disabled or terminated shareholder, particularly with sufficient cash to provide for the payment of estate taxes and other family needs, and eliminate exposure to future risks inherent in the business.
- (ix) Provide the remaining shareholders and/or the corporation with access to funds for the purchase of stock, often without adverse tax consequences.
- (x) Restrict the use of proprietary or confidential information and competition by a former shareholder.
- (xi) Provide voting agreements where necessary to protect various interests.
- (xii) Avoid disputes pertaining to any excess of insurance proceeds over the purchase price upon the death of a shareholder.
- (xiii) Determine what happens to insurance policies on the life of a terminated but surviving shareholder.
- (xiv) Establish a dispute resolution process such as arbitration, selection of one or more independent directors or possible injunctive relief.
- (xv) Allow for efficient and orderly estate administration when the triggering event is death.
- (xvi) Avoid conflict among shareholders who are not employed by or otherwise active in the operation of the business.
- (xvii) Establish a means to void transfers, whether voluntary or involuntary, which may be inconsistent with the succession to ownership rights agreed to by the shareholders.

C. Tax Objectives

- (i) Allocate the consideration paid for the transferred interest and other agreements in a manner that will result in capital gain (or loss), ordinary income or some combination thereof for income tax purposes.

- (ii) To the extent possible, cause interest paid on the indebtedness incurred to fund the purchase price to be fully deductible under the interest allocation rules.²
- (iii) In many instances, provide the remaining or surviving shareholders with an increase in the cost basis of their stock.
- (iv) Subject to the requirements of IRC §2703 and §2704(b) and Treas. Reg. §20.2031-2(h), establish a value for purposes of estate, gift and generation-skipping transfer (“GST”) tax planning that may be binding on the IRS and the applicable state.
- (v) Provide a source of funds with which to pay estate taxes or income taxes.
- (vi) Protect S status by prohibiting transfers which would result in disqualification.
- (vii) Avoid dividend (ordinary income) treatment by making sure the transaction qualifies under IRC §302 or §303 (applicable only to redemption agreements).
- (viii) Preserve the availability of loss carry forwards.³
- (ix) With respect to S corporations, be able to elect the appropriate allocation of income loss, credits and deductions between the terminated shareholder and the remaining shareholders.⁴
- (x) Allocate the consideration payable among buy-sell and other ancillary (related) agreements to achieve desired economic and tax results.
- (xi) Avoid application of the alternative minimum tax, which could, in effect, subject insurance proceeds to tax.⁵
- (xii) Make sure compliance with applicable state law is satisfied.

II. RESTRICTIONS ON TRANSFERS

Transfers can take many forms, involuntary or voluntary, by operation of law, due to death, an outright sale, a pledge of stock, transfers with or without consideration, or transfers in an estate planning context such as to avoid probate. One of the primary uses of a shareholders agreement is to limit transfers to individuals or entities acceptable to the other shareholders. Generally this is done by a restriction on transfers subject to various exceptions such as (i) the right to transfer upon obtaining a certain level of consent (such as by all of the other

² IRC §163(h) (U.S.C.S. 2006).

³ IRC §382 (U.S.C.S. 2006).

⁴ IRC §1362(e) (U.S.C.S. 2006).

⁵ IRC §56(g)(1)(6) (U.S.C.S. 2006).

shareholders, a majority, vote of the board); (ii) the right to transfer to a defined group of permitted transferees; and (iii) the right to transfer subject to a right of refusal.

A. Outright Prohibition on Transfers

Under the laws of most states, outright prohibitions on transfers of stock are unenforceable as a matter of public policy.⁶ Reasonable restrictions on transfers are generally permitted.⁷ Examples of reasonable restrictions include: (i) a general prohibition on transfer with exceptions for certain transfers such as those made with the consent of the remaining shareholders or those made after granting a right of refusal to the corporation and/or shareholders; and (ii) limiting the type of owner such as only individuals licensed in a particular profession for a professional corporation, employees or an ESOP for employee-owned corporations, family members for a family corporation, or only persons eligible to be an S shareholder in S corporations.

B. Right of Refusal

Generally shareholders agreements contain a provision that prohibits a shareholder from selling stock without first granting the other shareholders or the corporation the right to buy that stock. Therefore, if one of the owners wishes to sell his or her interest, he or she would be required to notify the corporation and other owners of his or her intention to sell. The corporation and other owners would then have a reasonable period of time to acquire the withdrawing owner's interest. The maximum purchase price under a right of refusal (whether or not exercised) should be determined pursuant to the terms of the shareholders agreement in order to preserve the agreement's ability to fix the value of the ownership interests for estate, GST and gift tax purposes. For example such a provision could provide that the purchase price would not be greater than the price determined by the agreement, i.e., the lesser of the price determined under the agreement or the price offered by a third party. Similarly, the terms of payment should not be more egregious than as set forth in the shareholders agreement. This protects the other shareholders from having to pay a higher value than what a third party would pay, and would not seem to affect the estate tax valuation.⁸

If a right of refusal provision is drafted too broadly, it may give a shareholder an open-ended "put." For example, if a shareholder can trigger the right of refusal simply by expressing a desire sell his or her stock, the other shareholders or the corporation will have to buy the stock or risk an outside owner. To avoid this scenario, the right of refusal should be triggered only by a "bona fide offer." A bona fide offer can be defined to include an actual copy of a binding agreement to buy and sell (subject only to the right of refusal) and perhaps even proof of a down payment from the potential purchaser. There may be few real potential

⁶ *Rafe v. Hindin*, 244 N.E.2d 469 (N.Y. 1968).

⁷ *See Lawrence v. Sudman*, 70 F. Supp. 387 (S.D.N.Y. 1945).

⁸ But see IRC §2703 (U.S.C.S. 2006).

purchasers who would spend the time and money to negotiate, draft, and sign a binding purchase agreement subject to such a broad contingency.

If a meaningful right to sell is desired, an alternative approach is to include a right of first offer. This allows the shareholder to make an offer to the other shareholders at a specified price and terms, and if the other shareholders do not buy then allows the shareholder to sell on those price and terms to a third party.

C. Exceptions (Permitted Transfers)

A shareholders agreement may provide for an exception to any transfer restriction or triggering event, such as permitting transfers to family members working in the business or trusts for the benefit of a spouse or other family member. If the agreement permits transfers such as these, generally the permission applies only if the transferee becomes subject to and bound by the shareholders agreement. If an entity or trust is the shareholder, then transfers of the ownership interests in that entity, or changes in the beneficial interests of the entity or trust, can be indirect transfers that the parties may want to restrict.

D. Transferee Subject to the Agreement

Since transfer restrictions in a shareholders agreement are a matter of private contract between the parties, they are not necessarily binding on a third party who or which may not be aware of such restrictions. This is contrasted with the inherent statutory restrictions on a membership interest in a limited liability company or partnership since a third party purchaser can only be an “assignee” without further approval. This is further contrasted with a restriction contained in the articles of incorporation that gives constructive notice to the world. The notice to the prospective transferee must be clear and unambiguous. The best way to do this is to print on the back of the stock certificates the restrictions themselves or a reference to restrictions contained in the shareholders agreement on record with the corporation.⁹

The agreement should require each transferee to execute a counterpart or addendum to the shareholders agreement. For further control, each shareholder could be required to sign a blank stock power and provide it and the original certificates to the secretary of the corporation to insure compliance with the obligations under the agreement.

There are potential securities law issues when stock is transferred. Although this may not be a significant issue in most private corporations with a small number of shareholders, it is a conservative approach to also legend the certificates with a securities legend.

The agreement should also address whether all transferees, including permitted transferees, take subject to the agreement or not.

⁹ Some state statutes require this. N.Y. BUS. CORP. LAW § 620(g) (McKinney 2003); TEX. BUS. & COM. CODE ANN. §8.204 (Vernon 2006); see also Uniform Commercial Code Article 8-204.

E. Recapitalization Upon Transfer Without Consent

If there is a transfer of shares to any party in violation of the agreement (i.e. without the required consent to anyone other than a permitted transferee), the parties may want that stock automatically converted to non-voting shares. This conversion will eliminate that shareholder's ability to vote for directors or to otherwise participate in the management or operation of the corporation. If the corporation is not authorized to issue non-voting stock, an amendment to the certificate of incorporation will be necessary. A plan of recapitalization will also be necessary to provide for the requirement to transfer of the voting stock of the shareholder in exchange for the non-voting stock.

This would be an alternative to the common provision that any such transfer would be void. This approach also more closely parallels a limited liability company "assignee" concept.

F. Issuance of Stock

Normally, under the corporate law of most states, directors of a corporation can issue stock without the consent of the shareholders.¹⁰ Pre-emptive rights permit a shareholder to acquire a proportionate amount of the corporation's unissued shares upon the decision of the board of directors to issue additional shares. Corporate law of some states have "opt-in" provisions, which means that shareholders do not have pre-emptive rights unless the articles of incorporation expressly provide that shareholders have pre-emptive rights.¹¹ Other states have "opt-out" provisions, which mean that the shareholders have pre-emptive rights unless the articles of incorporation deny the pre-emptive rights.¹²

Closely-held corporations may want to customize these provisions of corporate law. One example is allowing the directors to issue stock without pre-emptive rights, but only upon the consent of a majority of the shareholders. Another example is to give only certain shareholders (such as family members) preemptive rights. Any customization in this regard will need to be added to the shareholders agreement, and possibly also the articles of incorporation.

III. TYPES OF BUY-SELL AGREEMENTS

A. Corporate Redemption Agreements

Under a corporate redemption arrangement, the corporation is the purchaser of each shareholder's shares.

¹⁰ *E.g.*, N.Y. BUS. CORP. LAW §622 (McKinney 2003).

¹¹ N.Y. BUS. CORP. LAW §622(b)(2).

¹² N.Y. BUS. CORP. LAW §622(b)(1).

1. Advantages of a Corporate Redemption

There are several advantages to structuring a shareholders agreement as a corporate redemption. First, a corporate redemption can be more easily funded by insurance. If an agreement among multiple owners is funded by life insurance, multiple insurance policies on each business owner are avoided. For example, if there are four shareholders, a cross-purchase agreement funded with life insurance would require an aggregate of 12 policies, whereas a corporate redemption funded with life insurance would only require four policies. Also, nondeductible premium payments may be less expensive if paid by a C corporation that is in a lower income tax bracket than its shareholders.

The effect which death benefits received on corporate owned life insurance to fund a corporate redemption have on the estate tax valuation of stock of a deceased shareholder was litigated in *Estate of Blount v. Commissioner*¹³. While the Tax Court in that case ruled the insurance proceeds are to be considered a non-operating asset and included in the valuation of the corporation and its stock, on appeal, the Eleventh Circuit, citing *Estate of Huntsman v. Commissioner*,¹⁴ and *Estate of Cartwright v. Commissioner*¹⁵, indicated receipt of insurance proceeds subject to a buy-sell agreement was offset by the corporation's obligation to pay the proceeds to the estate of a deceased shareholder pursuant to the agreement. The Court further held that Reg. §20.2031-2(h) only requires that insurance be considered under "customary rules of valuation."

Second, the assets or income stream to fund the purchase and/or make insurance premium payments may be more available inside the corporation. For example, if a former shareholder was receiving a significant salary, those funds will now be available to help fund the stock redemption. The funds can be distributed out to the shareholders to let them make the purchase, but often only with an accompanying tax cost or disadvantage (dividend).

Third, a corporate redemption may be more "self-executing" in that the corporation itself is the purchaser of the stock of the selling shareholder and not one or more individual shareholders.

Fourth, a corporate redemption will result in all shareholders' ownership percentage increasing proportionately.

Fifth, it evens the playing field. Less affluent shareholders with limited resources are not precluded as from being a "purchaser" since the corporation, not the individual shareholders, must raise the cash to make the purchase.

¹³ 87 T.C.M. (CCH) 1303 (2004); rev'd. 428 F.3d 1338 (11th Cir. 2005).

¹⁴ 66 T.C. 861 (1976).

¹⁵ 183 F. 3d 1034 (9th Cir. 1999).

Sixth, redemptions have less of a negative impact on estate tax deferral under IRC §6166 than do cross purchases.¹⁶

Seventh, while insurance premium payments are not deductible by the policy owner, the corporate tax marginal bracket may be less than the individual shareholder's bracket.

2. Disadvantages of a Corporate Redemption

However, there are disadvantages to corporate redemption. Although the remaining shareholders will own a greater percentage of the corporation after the redemption, there will be no corresponding change in the income tax basis of the outstanding shares. In a C corporation redemption funded with life insurance, the policy's death benefits and cash values are subject to the corporate alternative minimum tax to the extent the proceeds or cash values exceed the corporation's basis in the insurance policy.¹⁷ The alternative minimum tax does not apply to S corporations. In most states, cash value and insurance proceeds are likely to be subject to the corporation's creditors. When insurance is not used to fund the corporation's redemption of its stock, there is a risk that the corporation will not have enough non-operating assets to distribute to satisfy the redemption price and that the corporation does not have sufficient capital surplus for state law purposes to complete its redemption purchase.

3. Tax Aspects

In a C corporation redemption, the remaining shareholders' cost basis is unchanged. Gain on all subsequent sales by the remaining shareholders will be measured by the difference between the original cost for their stock and the sale price. This is a disadvantage because the percent of the corporation owned by the remaining shareholders increases upon a redemption.

The terminating shareholder typically would have a capital transaction if the redemption qualifies under IRC §302 or §303. Otherwise, the corporation's payment of the purchase price will be a dividend to the selling shareholder.¹⁸ Although currently dividend and capital gain rates are the same, the taxable portion of a redemption distribution treated as an income taxable dividend is not reduced by the basis of the redeemed stock. Also, deferral of taxable income using the installment method is not available if the redemption is treated for income tax purposes as a dividend instead of a sale or exchange.¹⁹

Capital gain treatment for the redeemed shareholder is not always straightforward. IRC §301 provides that a stock redemption will be treated as a dividend unless one of the four

¹⁶ See IRC §6166(g) (U.S.C.S. 2011).

¹⁷ IRC §§55 to 56 (U.S.C.S. 2011).

¹⁸ IRC §301 (U.S.C.S. 2011).

¹⁹ IRC §301, §302(d) (U.S.C.S. 2011); *See* Treas. Reg. §1.301-1(d)(1)(ii), 1(h)(2)(i), -1(1) (as amended in 2006); IRC §312(a)(2), §453 (U.S.C.S. 2011).

exceptions set forth in IRC §302(b)(2) in which case the redemption will be treated as a capital transaction by the redeemed shareholder. To be treated as a capital transaction, the redemption distribution must be²⁰ (i) not essentially equivalent to a dividend;²¹ or (ii) substantially disproportionate with respect to the shareholder;²² or (iii) a complete termination of the redeemed shareholder's interest in the corporation;²³ or (iv) made as part of a partial liquidation of the corporation.²⁴ The facts must be carefully examined in each case to determine which, if any, of the exceptions to dividend treatment are applicable to the redemption distribution.

A complete termination of a shareholder's interest is the most common exception used.²⁵ Even though all of the selling shareholder's stock is actually redeemed, there may be no complete termination of the redeemed shareholder's interest after application of the constructive ownership rules of IRC §318²⁶ which attribute to the redeemed shareholder ownership of stock which is actually owned by others, such as family members, partnerships, other corporations, estates or trusts. Only in the case of a complete termination of a shareholder's interest may the rules attributing stock ownership from family members of the terminating shareholder be waived,²⁷ even then the waiver is allowed only if three requirements are satisfied: (i) during the prior ten years, the redeemed shareholder must not have transferred to or received from a related party any stock of the redeeming corporation; (ii) the terminated shareholder must agree not to acquire an interest in the corporation for the succeeding ten-year period;²⁸ and (iii) the redeemed shareholder must not have any continuing interest in the corporation such as that of an officer, director, consultant or employee.²⁹ Creditor status is permitted.³⁰ Other permitted relationships include: (i) that of a landlord; (ii) negotiated temporary consulting services; (iii) pension participation; (iv)

²⁰ IRC §302(b), §317(b) (U.S.C.S. 2011).

²¹ IRC §302(b)(1) (U.S.C.S. 2011).

²² IRC §302(b)(2), *But see* IRC §302(b)(2)(D) (a series of redemptions, each disproportionate, which when aggregated, failed the test).

²³ IRC §302(b)(3) (U.S.C.S. 2011).

²⁴ IRC §302(e) (U.S.C.S. 2011).

²⁵ IRC §302(b)(3) (U.S.C.S. 2011).

²⁶ IRC §318(a)(3)(A), (B) (U.S.C.S. 2011).

²⁷ IRC §302(c)(2)(e) (U.S.C.S. 2011); *See also* IRS Priv. Ltr. Rul. 94-08-018 (Nov. 29, 1993); Rev. Rul. 59-119, 1959-1 C.B. 68.

²⁸ IRC §302(c)(2)(A)(ii), (iii) (U.S.C.S. 2011) (notice to IRS of stock acquired within the ten-year period of redemption).

²⁹ IRC §302(c)(2)(A)(ii) (U.S.C.S. 2011); Treas. Reg. 1.302-4(c).

³⁰ *Lynch v. Comm'r.*, 801 F.2d 1176 (9th Cir. 1986), *See I.R.S. Priv. Ltr. Rul.* 89-44-075 (Aug. 14, 1989).

continued coverage under Medicaid plan; (v) creditor status; and (vi) payment to transferring shareholder by subordinated note.

When an estate has all of its stock redeemed, there is no family relationship between the estate and the individuals who were the family of the deceased shareholder, so there is no family attribution of stock ownership to be waived. Essentially, the waiver of the family attribution rules only applies to a complete termination of the interest of a living shareholder, and not a redemption from an individual shareholder's estate.

If the sale occurs by reason of death, typically there is no gain recognized by the selling shareholder's estate because the estate benefits from a step-up of the deceased's basis to the stock's fair market value as of the date of death (or alternate valuation date).³¹ However, if estate tax repeal comes to pass, carry-over basis may replace step-up, and there may be capital gain or loss realized on a stock sale at death, but the rules would remain the same.

IRC §303 permits a redemption to be treated as a capital transaction to the extent the redemption distribution does not exceed the amount certain estate-related expenses, such as estate taxes and certain administrative expenses. IRC §303 trumps IRC §302 and, therefore, can be a useful tool even when attribution from other shareholders may preclude capital gain treatment of the redemption under IRC §302. The requirements for IRC §303 are: (i) the decedent owned stock in a corporation that was included in the gross estate; (ii) the value of the shares must exceed 35% of the decedent's gross estate; (iii) the redemption amount is limited to estate taxes and administrative expenses; (iv) the stock redeemed must be from a shareholder liable for such taxes and expenses; and (v) the stock redemption must occur after decedent's death and within certain time periods. Gain is recognized only to the extent that the selling price exceeds the estate's basis in the shares. There is no requirement that the redemption proceeds received actually be used to pay estate taxes and administrative expenses

Accumulating earnings by not distributing them as a means of providing liquidity to fund a redemption is not without disadvantages. First, in the case of a C corporation, accumulating earnings prior to a redemption may subject the corporation to the accumulated earnings tax if the IRS considers the accumulation to be for a shareholder purpose rather than a bona fide corporate business purpose.³² Accumulation for the sole purpose of redeeming stock has been held not to be a valid business purposes; therefore, the excess accumulation tax was triggered.³³ Accumulations after a redemption has occurred are not a proscribed purpose.³⁴

³¹ IRC §1014 (U.S.C.S. 2011).

³² *Golconda Mining Corp v. Comm'r.*, 58 T.C. 139 (1972) *rev'd* 507 F.2d 594 (9th Cir. 1974), *See* IRC §532(c) (U.S.C.S. 2011).

³³ IRC §531 (U.S.C.S. 2011). *See Lamark Shipping Agency v. Comm'r.*, 42 T.C.M. (CCH) 38, 56 (1981); *But see Wilcox Mfg. Co., Inc. v. Comm'r.*, 38 T.C.M. 378 (1979) (where the court held that an accumulation to buy out dividend shareholders was a valid corporate business purpose).

³⁴ IRC §537(a)(2), (b)(1) (U.S.C.S. 2011).

An S corporation is free to accumulate its earnings since earnings are taxed at the shareholder level whether or not distributed and accounted for in the AAA account.

Paying for the stock by the distribution of appreciated corporate property will cause the corporation (whether a C or an S) to be taxed on the appreciation of such assets, even when the payment is treated as a dividend distribution to the withdrawing shareholder.³⁵ The gain will increase the AAA of an S corporation and E & P account of a C corporation.

IRC §6166 allows the installment payment of estate taxes if the tax is the result of the inclusion in the estate of closely-held business interests. Care must be taken when planning to use both the deferral under §6166 and a redemption qualifying under IRC §303. Basically, the tax payment is deferred for the statutorily provided period unless and until the underlying business assets are sold or redeemed within the period of the deferral, in which case the deferral is lost and the estate taxes would become immediately due. The rule is basically if a redemption qualifies under §303, the entire deferred estate tax is not accelerated, but only the estate tax that would be payable under the deferral agreement within one year of the redemption.³⁶

4. State Law Financial Requirements

State law may require that stock be redeemed only out of “surplus” and only to the extent the redemption payment does not cause the corporation to become insolvent.³⁷ This is often a technical barrier only, not an actual shortage of cash or other assets with which to make the purchase. This barrier can be avoided if (i) the shareholders are required to purchase those shares the corporation cannot; (ii) the shareholders are required to adjust the corporate surplus by recapitalizing the stock (reducing capital and increasing surplus), by reappraising the assets including goodwill (thus increasing surplus), or by reducing the par or stated value of the stock;³⁸ or (iii) the shareholders are required to contribute to the corporation. This last approach must be used wisely, since it could be viewed as a type of personal guarantee of the remaining shareholders to contribute whatever amount would be necessary to provide sufficient surplus for the redemption. Some states, such as New York, require that the redeeming corporation must meet the “surplus” rule, not only as of the date of closing, but as of each date on which a payment is required to amortize a note issued by the corporation as part of the consideration for the redemption.³⁹

³⁵ IRC §§311(b), 1239, 1245 (U.S.C.S. 2011).

³⁶ IRS Priv. Ltr. Rul. 85-06-004 (November 5, 1984) and IRS Priv. Ltr. Rul. 92-02-020 (October 10, 1991).

³⁷ *E.g.*, N.Y. BUS. CORP. LAW §§ 103, 513(a) (McKinney 2003).

³⁸ N.Y. BUS. CORP. LAW § 516(a) (McKinney 2003).

³⁹ IRC §302(b)(1) (U.S.C.S. 2011).

B. Cross-Purchase Agreements

Under a cross-purchase agreement the remaining shareholders buy the selling shareholder's shares.

1. Advantages of a Cross-Purchase Agreement

There are several advantages to structuring a shareholder agreement as a cross purchase agreement. First, the remaining shareholders will have a purchase price tax basis in the acquired shares. If there are three shareholders owning equal interests, a corporate redemption of a shareholder's entire interest would leave two shareholders each owning a 50% ownership interest in the corporation without a change in basis. On the other hand, a cross purchase would result in the same 50% ownership interest between the two shareholders with an increased tax basis equal to the amount paid for the additional shares of stock.

Second, the transaction cannot be reclassified as a dividend, so the selling shareholder should always have capital gains treatment.

Third, the alternative minimum tax (AMT) does not apply.

Fourth, there is not an incremental increase in the value of the entity by reason of the incremental increase in cash values or proceeds of a policy on the seller's life owned by the purchaser.

Fifth, the cash value buildups and insurance proceeds are not subject to the claims of the corporation's creditors. (However, they could be subject to the policy owner's creditors.)

Sixth, state law prohibitions against redemptions are not applicable.

Seventh, the constructive ownership rules of IRC §318 do not apply.

2. Disadvantages of a Cross-Purchase

There are also some disadvantages to a cross-purchase agreement. If there are more than two shareholders, multiple insurance policies will be necessary. For example, if there are three shareholders, six policies will be necessary. Those multiple policies will need to be transferred as shareholders come and go, thus transfer for value issues could occur.⁴⁰ This disadvantage can be lessened by the use of a partnership to hold the insurance policies. There will always be a question about whether the obligated party will have the resources and inclination to perform, and to the extent that a cross-purchase agreement is optional and unfunded, this may prejudice those shareholders who are not financially able to participate at the same level as the others.

⁴⁰ IRC §101(a) (U.S.C.S. 2011), *See infra* Discussion in Article X, (Insurance), Section F (Transfer for Value Rule) and Section H (Partnership to Own Insurance).

C. Hybrid Agreements

In certain circumstances, a combination of a corporate redemption agreement and a cross-purchase agreement may be best to accomplish the intended economic result. The corporation can have the first option to purchase, and if the corporation does not purchase, the other shareholders either have an option to purchase or must purchase. Conversely, the shareholders may have the initial option and the corporation a second option or be compelled to purchase the balance of the shares.

Constructive or actual dividend treatment must be avoided if the purchasing party is required (or has an option) to purchase a certain portion of the equity interest and the entity is required (or has an option) to purchase the balance. For example, if the shareholders of a C corporation were obligated under the agreement, but the corporation purchased the stock, a deemed dividend distribution of funds to the purchasing shareholders would result and be taxable as ordinary income to the purchasers.⁴¹

A hybrid arrangement is also useful when the economic deal is to have the remaining shareholders acquire a disproportionate amount of the seller's interest. For example, if the seller owned 50% of the equity interests and the remaining owners owned 25% each and the desired result is to have one of the remaining owners own 60% and the other 40%, one of the remaining shareholders could have the right to purchase that percentage of the interests to be sold which would result in his or her having a 60% interest and the other owner 40%. Any interests remaining would be redeemed and the 60/40% arrangement would be accomplished.

Choosing a corporate redemption or a cross purchase agreement from the start locks in the advantages and disadvantages of the type of agreement selected. Assuming everyone is cooperating, however, the hybrid allows the parties to decide which method works best at the time the purchase is triggered. Thus, it is a more flexible approach.

D. Sale to Purchaser Not a Current Owner

It is not unusual to identify prospective purchasers who are appropriate candidates for ownership. Examples would be employees or outsiders who possess needed skills or provide additional direct or indirect benefit to the entity, such as investment bankers, board members or professional advisors. In such instances, the shareholders agreement may provide that all or a portion of the equity position of a terminated owner will be acquired by such a person or entity, or provide the mechanism for determining when and who should be a new owner.

E. Mandatory Sale Versus Option

Regardless the type of agreement, a decision must be made on whether the sale is to be mandatory or optional, and if optional, at whose option (*i.e.*, either a "put" where the owner is given the option to require a purchase, or a "call" where the others are given the option to purchase).

⁴¹ IRC §§301, 302 (U.S.C.S. 2011).

Most agreements provide that upon the occurrence of a triggering event, a shareholder is required to sell, and the corporation (if a redemption) or the remaining shareholders (if a cross-purchase) are required to purchase. This mandatory purchase gives both the corporation and the shareholders certainty that the purchase will occur.

Some option agreements are in the form of a “put.” This means that upon an event that would trigger a sale the terminating shareholder could require the corporation or the other shareholders to buy the stock, but the terminating shareholder is not required to sell. For example, a family corporation may want to let the spouse and descendants continue to benefit from company ownership, but if they want “out” because of concern about how the business is being operated, family liquidity needs, or some other reason, they can “put” the stock to the corporation or other shareholders.

Some option agreements are in the form of a “call.” This is the reverse of a put. In other words, the corporation or remaining shareholders have the right to acquire the interest of a shareholder, but are not required to buy. There is no guarantee of liquidity for the terminating or deceased owner with which to pay estate taxes and other obligations due at death or to continue an income stream for the family. If the agreement only provides a call, the terminating owner or estate does not have a guaranteed market for the stock and therefore will not be able to “cash out.”

There might be circumstances in which both a “put” and a “call” are used. For example, if a shareholder dies, a put would protect the shareholder’s family by turning what may be illiquid stock into cash and/or promissory notes, whereas a call would protect the other shareholders from being in business with a decedent’s family. It may be simpler, however, to have a mandatory purchase in those circumstances.

F. Other Types of Agreements (Related Agreements)

In certain cases, it is appropriate to combine a noncompetition agreement, consulting agreement, death benefit only agreement, and/or a deferred compensation agreement with a redemption, cross-purchase or hybrid agreement. Payments made under the stock purchase agreements result in capital gain to the seller (and in some cases no recognized gain if the sale occurs by reason of death). The payments under the other agreements generally constitute ordinary income to the recipients and are deductible or amortizable by the obligor.⁴² Capital gain acquisitions generally are not deductible by the purchaser.

IV. BUY-SELL TRIGGERS

The nature of the relationship between business owners (unrelated business owners, employee owners, family members, etc.) will affect the selection of the events which create a right or obligation of a shareholder to sell his or her stock and the right or obligation of the corporation or the other shareholders to buy that stock. Some of the common events “triggering” the buy-sell transaction are discussed below.

⁴² IRC §§162, 197 (U.S.C.S. 2011).

A. Non-Permitted Transfers

Since a shareholders agreement contains restrictions on transfers of stock, a transfer or attempted transfer in violation of the agreement should trigger a right to buy that stock. Such a trigger would apply to both a voluntary transfer and an involuntary transfer.

B. Death

Almost all buy-sell agreements among active business owners are triggered upon death, since the remaining shareholders generally do not want to be in business with members of the deceased's family who are not active in the business. A stock sale at this time also provides liquidity to the deceased shareholder's estate, particularly since the family members are unlikely to draw a salary from the business, and closely held corporations seldom pay dividends.

Transfers to spouses on death that qualify for the marital deduction can defer or possibly escape estate taxes on the stock. A common exception, therefore, is to allow a transfer to a marital trust for the spouse, as long as there is some control over who serves as trustee with the power to vote the stock (or the stock becomes non-voting by providing for a mandatory recapitalization) and control over who owns the stock when the spouse dies. In these circumstances the corporation or other shareholders may wish to purchase insurance on the spouse to fund a purchase from the marital trust upon the death of the spouse. Frequently, insurance on a spouse or survivorship life insurance is considerably cheaper than what the premiums on the shareholder may be, and thus produce a less expensive means to fund a purchase on the spouse's death.

Similarly, it is not unusual to allow for transfers to a "permitted transferee" such as a trust for family members. In such an event it is preferable to use an independent trustee or possibly (being aware of fiduciary responsibility as a potential conflict) one or more of the other shareholders. This could be coupled with a put or call (or both) provision. For example, the shareholders may be willing to have family members continue to own stock, but only if the shareholders have a call upon that stock if the family members create problems. Alternatively, the shareholders may prefer to have their family members continue as shareholders, but family members may want to have a put that allows them to sell the stock as needed at a future time.

C. Disability

If a shareholder who is also an employee is no longer capable of performing his or her duties and thus unable to receive earnings income as an employee, it is often best for both that individual and the other shareholders to trigger a purchase of the individual's stock. The most difficult task in drafting this type of provision is defining "total and permanent disability." If a disability buy-sell insurance policy is in place, the definition in the agreement should be the same as the definition in the policy. This will ensure that there will be proceeds to pay (or partially pay) the purchase price if a shareholder becomes disabled. If there is a long-term disability income policy, then eligibility for or receipt of payment under that policy can be used as an objective trigger. Presumably there will be an incentive for the

shareholders to apply for the disability income payments, or buy-out proceeds, even though that would trigger a buy-out of the stock.

If neither type of policy is in place, disability can be determined by one or more physicians selected by consensus of the parties. Because of HIPAA⁴³ privacy rights, a provision that determines disability based on input from a physician can create problems if the shareholder is not willing or able to consent to release of the needed medical records. One way to get around this is to provide that the board of directors (or other shareholders) shall make the determination of disability after taking into account any relevant information available to them. To avoid a disgruntled shareholder disputing the board's (or the shareholders') determination, the determination may be made in the board's "sole discretion" or require super majority vote. Such language might be too broad for the shareholders to accept as the standard. A compromise approach is to base the determination of disability on a physician's opinion, but provide that if the shareholder does not make medical information available to the board, the board (or the other shareholders) will decide based on the information it has.

Determining whether someone is disabled is only the initial step. The next issue is whether the disability is total versus partial. A partially disabled person could continue as a part-time employee. Should becoming a part-time employee trigger a required sale of stock?

The final issue is whether the disability is permanent or temporary. Clearly, permanent disability should be included in any disability buy-out provision, but not short-term disability. This raises two questions: how long should disability last before it becomes "permanent"; and what if it is not known at the beginning of the disability whether it will last a short or long time? Sometimes a "grace period" will allow these determinations to be made with hindsight. For example, the agreement could provide that a purchase of stock is triggered only after six months of continuous total disability or continued disability for X days out of Y days.

Definitional issues can be avoided if the purchase is triggered when the shareholder is no longer a full-time employee. This is not always a solution, however, since sometimes a particular state's disability employment law makes reducing or terminating employment problematic upon a disability.

Another approach is for the shareholders agreement to provide that a majority or super-majority of the board of directors or shareholders have the discretionary right to purchase the stock of a shareholder at any time for any reason.

Note that IRC §409A(a)(2)(C) has its own definition of disability relating to deferred compensation agreements. If any provision relating to disability can affect compensatory payments to or for the benefit of the disabled person, it may be appropriate to adopt this definition.

⁴³ Health Insurance Portability and Accountability Act of 1996 (HIPAA), Pub.L. No. 104-191, 110 Stat. 1936.

D. Termination of Employment

If a corporation is intended to be solely “employed-owned,” or if an employee’s ownership is intended to be coupled with employment, the corporation will need an option to buy stock on termination of employment.

If a shareholder-employee voluntarily terminates his or her employment with the corporation, the resulting obligation to purchase stock may, depending on the circumstances, cause a hardship on the corporation and could affect the operation of the business. Termination could be a result of having to relocate for health reasons, job dissatisfaction, fear of a decline in stock value, or other reasons. To prevent the corporation from facing a hardship in the voluntary termination scenario, consider making the purchase of the stock on termination of employment optional rather than automatic and/or allow the purchaser(s) to pay for the stock over a longer period of time. These protections may also be useful if a shareholder-employee is terminated “for cause.” “For cause” should be carefully defined in the shareholders’ agreement or the shareholder-employee’s employment agreement if cause is to be grounds for termination.

If the corporation fires the employee without cause, it may be fair to give the employee a put. This allows the employee to get value for the stock and break all ties with the corporation.

E. Reaching a Certain Age

Agreements may provide for purchase of the stock of an employee upon attainment of a certain “retirement” age. The purpose of this type of provision is to transition ownership to the next generation, even though the individual may continue as an employee.

As an alternative, a shareholder-employee may be permitted to voluntarily “put” part or all of his or her stock after reaching a stated age. The benefit of this type of provision is to allow a shareholder reaching retirement age to start to liquidate stock ownership. A similar provision is found in most ESOPs.

If there is concern that the corporation will incur too large a financial obligation to purchase at a certain age, one option is to use a buy-down period such as 5% of the purchase price per year starting at age 60 and a “balloon” payment of the balance at age 65. However, make sure one or more of the exceptions under IRC §302 are applicable to avoid potential dividend treatment.

F. Bankruptcy, Insolvency, Creditor Attachment

Bankruptcy, insolvency, or creditor attachment should be included in the restrictions on involuntary transfer provisions. Any agreement that is “executory” can be voided by a bankruptcy trustee. Therefore to the extent a buy-sell agreement obligates the shareholders and the entity to buy and sell, it is more likely, though not certain, to survive a bankruptcy.

Most clients like the idea of “penalizing” a creditor by providing for a lower purchase price or longer period of time to purchase the stock. Under certain circumstances such provisions will not be binding on a bankruptcy trustee unless there is an objective rationale, such as a

longer period to pay for stock in all cases except a shorter period is offered only in situations where the corporation is in control of the trigger and thus can “plan ahead” for the repurchase obligation. Similarly, a default under a loan agreement may be a trigger.

Whether a bankruptcy court will enforce the terms of the buy-sell agreement as agreed upon by the parties is based on the determination of whether (i) the buy-sell agreement constitutes an executory contract, and (ii) the bankruptcy trustee accepts or rejects the agreement.

1. Is A Buy-Sell Agreement an Executory Contract?

Subject to court approval and subject to certain exceptions, Section 365(a) of the title 11 of the United States Code (“Bankruptcy Code”) permits a bankruptcy trustee to assume or reject any executory contract or unexpired lease of the debtor. Accordingly, a bankruptcy court must first determine whether the Buy-sell agreement constitutes an “executory contract”. Although the Bankruptcy Code does not define the term “executory contract”, the legislative history refers, with approval, to the commonly named Countryman definition, observing that the term “executory contract” generally includes contracts under which performance remains due to some extent on both sides.⁴⁴

Although the Countryman definition may be easy to recite, the myriad differences in particular contracts have made it somewhat difficult for courts to apply. Courts do not follow a per se rule as to whether buy-sell agreements are considered executory contracts under the Bankruptcy Code. The facts and circumstances of each case determine the executory nature of a particular agreement.⁴⁵ A majority of courts have held limited liability company operating agreements to be executory contracts, although there is contrary authority in Virginia.⁴⁶ Partnership agreements generally are also considered executory contracts by the courts.⁴⁷

If the court determines that the buy-sell agreement is not an executory contract, the trustee is subject to the terms of the buy-sell agreement notwithstanding any *ipso facto* clauses (explained below) contained therein. If the trustee breaches a monetary term of the buy-sell agreement, then the non-debtor parties to the buy-sell agreement may assert a claim against the bankruptcy estate for monetary damages. If the trustee fails to comply with the terms of the buy-sell agreement (i.e. fails to adhere to the predetermined buyout provision), then the

⁴⁴ H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977). Professor Countryman’s definition of executory contract was expressed as follows: “A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” Countryman, *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439, 446 (1973).

⁴⁵ *In re Tsiaoushis*, 383 B.R. 616 (Bankr. E.D. Va. 2007).

⁴⁶ *Id.*; *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000).

⁴⁷ *Stumpf v. McGee (In re O’Connor)*, 258 F.3d 392 (5th Cir. 2001).

non-debtor parties to the buy-sell agreement may seek to enforce their rights in the bankruptcy case or possibly in another forum after obtaining any required relief from the automatic stay.⁴⁸

2. May the Trustee Assume or Reject an Executory Contract?

Although there is no per se rule as to whether a particular agreement constitutes an executory contract, it is likely that a bankruptcy court would conclude that the buy-sell agreement falls within the concept of an executory contract because, by the nature of a buy-sell agreement, all parties, including the debtor and the non-debtor parties, to the agreement will have unperformed obligations to one another pursuant to the contractual terms.

If the court determines that the buy-sell agreement is an executory contract, the trustee may, subject to court approval, assume (and assign) or reject the buy-sell agreement pursuant to Section 365(a) of the Bankruptcy Code, subject to certain exceptions described herein.

If the trustee assumes the buy-sell agreement, pursuant to Section 365(b) of the Bankruptcy Code, it must first cure any existing default under the buy-sell agreement, compensate or provide adequate assurance that the trustee will promptly compensate the non-debtor parties for any actual pecuniary loss resulting from such default, and provide adequate assurance of future performance under the buy-sell agreement. Once the court approves the assumption of the buy-sell agreement, the trustee is obligated to adhere to the terms of the buy-sell agreement, including, without limitation, any predetermined buyout conditions or price, subject to certain exceptions described herein.

Section 365(c) of the Bankruptcy Code prevents the trustee from assuming and assigning an executory contract when “applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor . . . and such party does not consent to such assumption or assignment.”⁴⁹ The exception in Section 365(c) of the Bankruptcy Code is commonly applied when a contract is based on personal trust or confidence and it would violate public policy to allow for a third party to replace the debtor.⁵⁰ Other courts have applied the exception when applicable state law prohibits a non-debtor party from becoming a partner of the limited partnership without the remaining partners’ consent.⁵¹ Thus, if there is an executory contract based on personal services or skills, or upon personal trust or confidence, or if state law excuses the non-debtor parties from accepting performance from or rendering performance to a party other than the debtor, the trustee may not assume or assign the contract without the consent of the non-debtor parties. The trustee may still reject such executory contract.

⁴⁸ 11 U.S.C. §362(a).

⁴⁹ 11 U.S.C. § 365(c).

⁵⁰ See *In re Manor Place Dev. Assocs., L.P.*, 144 B.R. 679 (Bankr. D.N.J. 1992).

⁵¹ See *Breedon v. Catron (In re Catron)*, 158 B.R. 629 (E.D. Va. 1993).

Courts have ruled that the voting and managerial rights associated with ownership interests in a company are so personalized that a trustee is prohibited from assuming and assigning such rights without the consent of the non-debtor parties.⁵² On the other hand, the economic rights associated with the ownership interests in a company, such as the distributions of profits, do not fall under the exception pursuant to Section 365(c) of the Bankruptcy Code, and the trustee typically may assume and assign those rights.⁵³

If the trustee elects to assume the executory contract, any *ipso facto* clauses contained within the buy-sell agreement will be deemed unenforceable.⁵⁴ An *ipso facto* clause is a provision within an executory contract that conditions a termination or modification of the contract or its terms solely upon the insolvency or financial condition of the debtor, the commencement of a bankruptcy case by the debtor, or the appointment of or taking possession by a trustee in a bankruptcy case. Thus, if the buy-sell agreement contains a provision that restricts or requires the transfer of an owner's interests in the event of bankruptcy, such provision will most likely be deemed unenforceable pursuant to Section 365(e)(1) of the Bankruptcy Code.

There is, however, an exception to Section 365(e)(1) of the Bankruptcy Code. Section 365(e)(2) of the Bankruptcy Code states that Section 365(e)(1) does not apply to executory contracts (meaning that *ipso facto* clauses contained in the contract are not deemed unenforceable) if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor . . . and such party does not consent to such assumption or assignment." Therefore, if an *ipso facto* clause addresses a personal or confidential interest of the company or applicable state law excuses the non-debtor parties from accepting performance from or rendering performance to a party other than the debtor, the *ipso facto* provisions remain effective.

As stated above, the voting and managerial rights associated with the ownership interests of a company are deemed personal and generally fall within this Section 365(e)(2) exception to the rule that *ipso facto* clauses are unenforceable.⁵⁵ Therefore, the terms of the buy-sell agreement would most likely be permitted to terminate or condition the transfer of the voting and managerial rights of the debtor upon bankruptcy. The economic interests associated with such interests, however, are subject to Section 365(e)(1) of the Bankruptcy Code and may not be transferred or terminated solely pursuant to a bankruptcy-conditioned provision within the buy-sell agreement.

The trustee's rejection of the buy-sell agreement generally constitutes a breach of the agreement by the trustee/estate as if the breach occurred immediately before the date of the filing of the petition commencing the bankruptcy case.⁵⁶ Nonetheless, the estate retains its

⁵² *In re Manor Place Dev. Assocs., L.P.*, 144 B.R. at 686.

⁵³ *Id.*

⁵⁴ See 11 U.S.C. §365(e)(1).

⁵⁵ *In re Manor Place Dev. Assocs., L.P.*, 144 B.R. at 686.

⁵⁶ See *In re IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003). 11 U.S.C. § 365(g).

economic interest in the company, including its share of the company's profits and losses.⁵⁷ Notwithstanding its rejection of the buy-sell agreement, the trustee may seek authority to sell its economic interests in the company at a price distinct from the buyout terms contained in the contract. If the trustee attempts to sell its interest outside of the buy-sell agreement's buyout terms, the non-debtor parties may, among other things, (i) oppose the sale or the terms proposed by the trustee, (ii) seek to enforce the buy-sell agreement in state court, or (iii) seek to enjoin the sale of the trustee's interests in the company.

It is the goal of the owners of the company to prevent any unwanted third party from becoming a party to the buy-sell agreement, and in the event of a bankruptcy of any owner, the remaining owners desire to limit the trustee's rights and interests in the company. Assuming that the buy-sell agreement constitutes an executory contract under the Bankruptcy Code, the trustee may either assume or reject such agreement. Because the trustee may step into the shoes of debtor owner (similar to an assignee) by assuming the contract and then dispose of the debtor's interests, it is important to structure the buy-sell agreement in a way to minimize the rights and interests available to the trustee in such a situation.

Because *ipso facto* clauses are unenforceable as to the owner's economic interests in the company, any provision that restricts or requires the transfer of such economic interests of a bankrupt party to the buy-sell agreement likely will be deemed unenforceable. Section 365(e)(1) of the Bankruptcy Code should not prohibit the contract from requiring that any sale of a party's interests be unanimously approved by the remaining parties because the transfer would not be necessarily conditioned on the financial status of the transferring party and thus not fall under the concept of an *ipso facto* clause. It may be prudent to add a unanimous consent provision or a right of first refusal provision in the buy-sell agreement that requires any party to grant a right of first refusal to the other parties and the company when it desires to sell its interest, whether, economic, voting or managerial. It is important not to condition the unanimous consent or the right of first refusal on an event of bankruptcy because such a provision likely will be unenforceable as an *ipso facto* clause. If the unanimous consent requirement or right of first refusal is conditioned on an option to transfer by a party, then such clause should be upheld.⁵⁸

Another way to limit the risk of the non-debtor parties is to add a provision that states upon the bankruptcy of any party, its voting and managerial rights automatically terminate. Such a provision likely will not be deemed an unenforceable *ipso facto* clause because of the exception contained in Section 365(e)(2).

By adding these precautionary provisions to the buy-sell agreement, once an owner files for bankruptcy, its voting and managerial rights will automatically terminate, and the remaining

⁵⁷ See 11 U.S.C. § 541 (defining property of the estate).

⁵⁸ See *In re IT Group, Inc.*, 302 B.R. 483 (D.Del. 2003). There are a few minority cases that render a right of first refusal provision unenforceable pursuant to Section 365(f) of the Bankruptcy Code because such a provision "prohibits, restricts or conditions the assignment" of the contract interests. See *Ramco-Gershenson Properties, L.P. v. Service Merchandise Company, Inc.*, 293 B.R. 169 (M.D. Tenn. 2003).

economic rights associated with its interests will be subject to unanimous consent of the remaining owners or a right of first refusal in the event the trustee desires to monetize the debtor's economic interests.

If different valuations are used for involuntary transfers, such as bankruptcy, IRC §2703 could result in the IRS not accepting the valuation for gift or estate tax purposes, and thus result in a gift or an estate tax value in excess of the purchase price.

G. Divorce or Separation

A buy-sell agreement may be triggered on the divorce or separation of a shareholder in order to prevent a transfer of an ownership interest to a former spouse, and therefore avoid the possibility of having an owner who is not welcomed by the remaining owners or who may cause disruption in the conduct of business. If the corporation is family-owned, and stock is owned directly by a spouse of a family member, usually there is no intent to have that spouse continue to own stock after a divorce from the family member. Even in cases where a spouse does not own stock, or only has a community property interest, divorce between a shareholder and his or her spouse could result in shares of stock being awarded to the ex-spouse.

Divorce between existing shareholders would not be a "transfer," and so specific language needs to be drafted to make this a triggering event. An award of stock to an ex-spouse who is not currently an owner should be expressly stated as a triggering event since the courts have not interpreted general restrictions on lifetime transfers contained in a buy-sell agreement to cover the situation of divorce (or upon expectancy of a judgment or lien).⁵⁹

Care should be taken when using divorce as a triggering event, particularly to trigger a mandatory purchase, since the existence of the provision may be viewed by the divorce court as converting unmarketable stock into marketable (or divisible) stock, thus making the court more willing to award stock to the non-shareholder spouse. Such a provision may also be deemed to increase the value of the stock in the divorce because the stock will be more liquid. Also, a mandatory purchase provision may prejudice the corporation and the remaining shareholders by unexpected cash requirements. Therefore, an option or call in divorce situations should be considered instead.

If stock is purchased due to a divorce trigger, it is standard to allow the ex-spouse who continues involved in the business or family to purchase that stock rather than the corporation or other shareholders.

H. Community Property & Spousal Consents

It is important to determine whether the shareholder's shares are community property or separate property.⁶⁰ Since the community property rules vary in each state, local counsel

⁵⁹ *In re Marriage of Spoth* 2003 WL 21062132 (Cal. 3d Dist. Ct. App. 2003).

⁶⁰ Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.

should be consulted. Generally, however, property acquired by a married person during marriage while domiciled in one of these states is community property. A court will look to the domicile of the parties at the time the property was acquired to characterize the property as separate or community. It is important to understand that the character of property remains community when there is a change of residence to a common law state.⁶¹ It is possible for the same asset to be partially community and partially separate property of the spouses.

Generally property acquired before marriage or during marriage by gift, bequest or devise is separate property. Although property may be characterized as separate property, it may be transmuted during marriage into community property. This may occur when community and separate property are commingled intentionally or inadvertently or when capital contributions or money loaned to the corporation is made with community funds.

Under the Pereira rule, which favors a community property result, a court will assign a fair rate of return to the separate property contributed to the corporation (which is usually money or sometimes property) and the value in excess of this return will be treated as community property.⁶² This method is utilized where the increase in value of a business can be shown to be attributable to the time, effort and skill of the shareholder-employee. The Van Camp rule, which favors a separate property result is contrary.⁶³ Here the fair value of services performed by the shareholder-employee will be treated as community property and any excess in value is treated as separate property.

You cannot just “contract” away a spouse’s community property rights, therefore they need to be addressed through buy-sell triggers. In addition to having a divorce being a triggering event, you need to address the more subtle forms of transfer, such as if the spouse dies first and leaves his or her interest in the corporation to children by a prior marriage.

It is fairly standard practice in community property states to require each shareholder’s spouse to “consent” to the provisions of the shareholders agreement.⁶⁴ Depending on nuances of state law, the spouse’s interest may already be subject to all the restrictions that the shareholder of record is, but the consent should make it clear that the restrictions are enforceable against the spouse. Having the spouse to agree to bequeath any interest in the shares to the shareholder if the spouse dies first is also helpful.⁶⁵ You may also want the spouse to forgo the right to attend and vote at a shareholder meeting.

There are a number of dilemmas regarding a spousal consent. Even if the corporation is located in a common law state, there is no guarantee that a shareholder’s interest might be

⁶¹ *Tomaier v. Tomaier*, 146 P.2d 905, 908 (Cal. 1944).

⁶² *Pereira v. Pereira*, 103 P. 488, 492 (Cal. 1909).

⁶³ *Van Camp v. Van Camp*, 199 P. 885, 889-90 (Cal. Dist. Ct. App. 1921).

⁶⁴ See John O. Hargrove, *Business Buy-Out Agreements* (Cal. Continuing education of the Bar 1976).

⁶⁵ See Fuller. *Buy-Sell Arrangements of Community Property Business Interest*, 117 Tr. & Est. 186, 187 (1978).

subject to community property rules by virtue of a prior residency. If getting a spousal consent is required by the terms of the shareholder agreement, what happens if the spouse does not consent to or execute the agreement? How does the corporation keep track of subsequent shareholder marriages? How does the corporation determine whether any spouse or ex-spouse has rights when it is time to pay for the stock?

I. Breach of Agreement

The shareholders agreement may require a shareholder to sell his or her stock in the event the shareholder breaches the terms of the agreement. This will typically be an optional purchase by the remaining shareholders and/or the corporation since a mandatory purchase would, in effect, give the breaching shareholder a “put” right. Shareholders may wish to include notice and a cure period for any breach of the terms of the agreement. It is important to determine if the trigger is a final legal adjudication of a breach, or just a determination by the board of directors in their sole discretion that a breach occurred, and draft accordingly.

J. Call Upon Specified Vote

The shareholder agreement may provide for a forced sale of a shareholder’s stock upon the vote of a stated percentage of the remaining shareholders or the board of directors. This will enable the shareholders to remove an unwanted shareholder under any circumstances, without having to define each specifically or deal with the definitional issues addressed above. This type of provision works best if there are multiple shareholders rather than just a few.

K. Protecting Loss of S Election

See the discussion below under Article V Special Issues for S Corporations.

L. Tag-Along & Drag-Along Rights

Corporations can be sold basically two ways: first by selling the corporate assets, second by the shareholders selling the stock. Generally state corporate laws require that a sale of all (or substantially all) the assets of a corporation be authorized by a vote of the board of directors which is then approved by a majority or possibly as high as two-thirds of the shareholders.⁶⁶ The same general effect can be accomplished with an all-cash merger. Thus, it is possible to sell a corporation without getting consent of all the shareholders. On the other hand, if most of the shareholders want to sell their stock in a stock sale, but cannot deliver 100 percent of the shares, the ability to sell could be illusory.

In order to allow a majority of the shareholders to sell the corporation, regardless of whether the form of the transaction would be an asset or stock sale, shareholder agreements often contain a “drag-along” right. This provision allows a majority of the shareholders to force the minority to sell their stock to a prospective purchaser, generally at the same price and terms as the majority. In addition, it is often helpful to include a provision waiving

⁶⁶ N.Y. BUS. CORP. LAW §909 (McKinney 2003).

disclosure and appraisals rights which otherwise might apply if the transaction is done as a traditional merger, or be deemed to apply in a sale of stock with a drag-along.

In order to protect the minority from a sale of stock by the majority to a third party, shareholder agreements often contain a “tag-along” right. This provision allows minority shareholders to sell to the third party at the same price and terms as those at which the majority is selling. A tag-along right can have an impact on the valuation of minority stock.

Consideration should be given to the mechanics of both a drag-along and a tag-along. All shareholders who are included in the sale would presumably be parties to the sale agreement, which would normally contain numerous representation and warranties, and those parties should bear a pro-rata share of the costs associated with the transaction such as the sellers’ attorneys’ fees. This will be easier to accomplish in a tag-along as the shareholders would be required to sign the agreement and pay a share of the costs for the privilege of participating in the sale.

If there are additional aspects to the sale, such as payments for non-competes to certain individuals, employment agreements for key employees with earn-outs, etc., and/or more than one class of stock, it will be more difficult to determine “at the same price and terms.”

The existence of these provisions may make it more awkward for the buyer to enter into a transaction for the purchase of stock (versus a purchase of assets or a merger). Even if a sale is not structured this way, however, the potential of exercising these rights should still provide protection for the majority and minority shareholders.

V. SPECIAL ISSUES FOR S CORPORATIONS

A. Termination of S Election

If S status is terminated, the corporation will generally be ineligible to elect S status for the succeeding five-year period.⁶⁷ Profits distributed to shareholders during the interim period will be exposed to a double tax⁶⁸ and the pass-through of losses for shareholder-level reporting would be denied. Termination of the S election will result from:

- (i) A transfer that results in more than 100 shareholders.⁶⁹

⁶⁷ IRC §1362(g).

⁶⁸ Income taxes imposed on a C corporation’s earnings plus income tax on dividends, *see* IRC §1(h)(11), where qualified dividend income is taxed at the capital gains rates for certain years.

⁶⁹ Under IRC §1361(c)(1), interests owned by a husband and wife are counted as one shareholder and all members of a family (defined as common ancestor, lineal descendant, and spouse or former spouse of such ancestors or descendants, but limited to six generations) are counted as one shareholder. Under IRC §1361(c)(2)(B), a grantor trust and a QSST are each counted as one, but an ESBT looks through and counts each current potential beneficiary.

- (ii) A transfer or issuance of stock to an ineligible shareholder. Eligible shareholders under IRC §1361(b)(1)(B), include: individuals (other than nonresident aliens); estates (for a period of time); certain trusts (as discussed below), and certain exempt organizations. Ineligible shareholders include nonresident aliens.
- (iii) Ownership by a corporation or other entity, unless the subsidiary is a wholly-owned corporation that meets certain requirements or a single-member limited liability company.
- (iv) The corporation has more than one class of stock.

B. Single Class of Stock Requirement

An S corporation cannot have more than one class of stock, and for this purposes, liquidation and distribution rights of all shares must be identical.⁷⁰ Stock with mere differences in voting rights such as common voting and common nonvoting, are allowed.⁷¹ Whether an S corporation's stock confers identical rights to distribution and liquidation proceeds is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds;⁷² thus, a written shareholder agreement can violate the single class of stock rule without any violating provision being in the articles or bylaws.

Debt satisfying the definition of "straight debt" is not treated as a second class of stock for this purpose. Straight debt is a written unconditional promise to pay in money a sum certain on demand or on a specified date provided (i) that the interest rate and the interest payment dates are not conditioned on the corporation's profits or discretion; (ii) the debt is not convertible into stock; and (iii) the creditor is an individual other than a nonresident alien, an estate, a trust that could be a shareholder in an S corporation, or a person actively and regularly engaged in the money lending business.⁷³ The parties might consider whether to limit transfers of debt instruments to persons whose ownership would fit within the straight debt safe harbor.

A bona fide agreement to redeem or purchase stock upon death or divorce, disability or termination of employment will not be construed as creating a second class of stock.⁷⁴ Similarly, restrictions on transfer are disregarded in determining a second class of stock. A buy-sell agreement will not result in a second class of stock unless a principal purpose is to circumvent the one class of stock requirement and the agreement establishes a purchase price at, at the time the agreement is entered into, is significantly in excess of or below current fair

⁷⁰ IRC §1361(b)(1)(D).

⁷¹ IRC §1361(c)(4).

⁷² Treas. Reg. §1.1361-1(1)(2)(i).

⁷³ IRC §1361(c)(5).

⁷⁴ Treas. Reg. §1.1361-1(1)(2)(iii)(B).

market value.⁷⁵ Although in some ways this is similar to IRC §2703, a price between book value and fair market value is permissible for the single-class-of-stock rules,⁷⁶ but a price between book value and fair market value does not satisfy IRC §2703(b)(2).

Generally, a second class of stock exists if the outstanding shares do not have the same right to receive distributions and liquidation proceeds.⁷⁷ However, the regulations further state that buy-sell agreements among shareholders and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights *unless* – (i) a principal purpose of the agreement is to circumvent the single class of stock rule *and* (ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.⁷⁸ Additionally, Treas. Reg. §1.1361-1(l)(2)(iii)(B) states that “bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights.” Example 9 of Treas. Reg. §1.1361-1(l)(2)(vi) states that J, K and L are shareholders of S and that L is also an employee of S. By agreement, S is to redeem L's shares for an amount significantly below their fair market value on the termination of L's employment or if S's sales fall below certain levels, and the portion of the agreement providing for the redemption of L's stock on termination of employment is disregarded. Furthermore, the portion of the agreement providing for the redemption of L's stock if S's sales fell below a certain level is disregarded unless a principal purpose of that portion of the agreement was to circumvent the single class of stock requirement.⁷⁹

Based on this, query whether a corporation can enter into the shareholders agreement providing for different purchase prices for different shareholders' shares so long as (i) the buy-sell provisions are only triggered in certain circumstances and the purchase price for the shares is equal to or exceeds fair market value or (ii) the principal purpose of the different purchase prices is not to circumvent the single class of stock rule? Arguably, a shareholders agreement which sets the price of certain employee-shareholders' shares at one multiple of EBITDA and other shareholders' shares at another multiple of EBITDA, does not violate the second class of stock rule, provided that the principal purpose of the agreement is not to

⁷⁵ Treas. Reg. §1.1361-1(l)(2)(iii)(A).

⁷⁶ Treas. Reg. §1.1361-1(l)(2)(iii)(C) respects book value that is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments) or is used for any substantial nontax purpose.

⁷⁷ Treas. Reg. §1.1361-1(l)(1).

⁷⁸ Treas. Reg. §1.1361-1(l)(2)(iii)(A).

⁷⁹ *Id.*

circumvent the single class of stock rule, but practitioners are advised to tread carefully in this area as the risk of S corporation disqualification can be disastrous.⁸⁰

It may be advisable to limit the corporation's ability to issue warrants or options to buy stock. Although warrants and options might not constitute a second class of stock, be sure not only to check the regulations⁸¹ but also to consider that, if such warrants or options were exercised at a time when the corporation already had the maximum number of permitted shareholders or if they were exercised by a person who would be an ineligible shareholder, an inadvertent termination could result.

A collateral assignment split dollar agreement does not constitute a second class of stock.⁸² Payment for stock pursuant to a buy-sell agreement by issuing a subordinated note does not constitute a second class of stock.⁸³

In a shareholders agreement it is often beneficial to create classes of shareholders solely for purposes of making decisions and options to buy stock on transfers. For example, each child would have a separate class, and (i) voting for matters under the shareholder agreement (but not shareholder decisions under corporate law) would require a majority of each class to approve certain acts, as opposed to requiring all shareholders to approve, and (ii) if shares in one class are subject to a prohibited transfer then the other members of that class get the first option to purchase. The former solely relates to a difference in voting rights, which is clearly allowable, and in any case the "voting" here relates to decisions under a contract not a corporate vote. The latter is not related to distributions or liquidation and would be irrelevant under the single class of stock rules.

C. Resident Aliens

Resident aliens as shareholders of S corporations present special problems. For example, if a resident alien leaves the United States for an extended period of time, he or she may fail the substantial presence test of IRC §7701(b)(3) and become a nonresident alien without the change in status being immediately recognized and addressed by the corporation. Thus, it may be desirable to provide that S corporation stock cannot be transferred to a person who is not a United States citizen.

⁸⁰ See, e.g., PLR 200632004 in which the IRS ruled that a buy-sell agreement that required directors to resell their shares to the corporation for a fixed price created a second class of stock for S corporation purposes; the Service granted inadvertent termination relief under IRC §1362(f).

⁸¹ Treas. Reg. § 1.1361-1(l)(4)(iii).

⁸² IRS Priv. Ltr. Ruls. 9735006, 9803008.

⁸³ Treas. Reg. §1.1361-1(l)(5)(ii).

D. Trusts as Shareholders

Only certain domestic trusts can acquire stock in an S corporation without causing the corporation to lose its S election. The types of trusts permitted to own stock in an S Corporation are:⁸⁴

- (i) Trusts that are grantor trusts, deemed owned by only individual who is a U.S. citizen or resident.⁸⁵
- (ii) Trusts that acquire stock from a grantor trust if the deemed owner of the grantor trust dies and the trust continues in existence, but this exception only applies during the first two years following the death of the deemed owner.⁸⁶
- (iii) Trusts that acquire stock from an estate, but this exception applies only during the two-year period beginning on the day the stock is transferred to the trust.⁸⁷
- (iv) Voting trusts.⁸⁸
- (v) Trusts that meet the requirements of an Electing Small Business Trust (“ESBT”).⁸⁹
- (vi) An IRA that held stock in a qualified bank as of October 22, 2004.⁹⁰
- (vii) Qualified revocable trusts that elect taxation as estates.⁹¹
- (viii) Trusts that meet the requirements of a Qualified Subchapter S Trust (“QSST”).⁹²

⁸⁴ IRC §1361(c)(2).

⁸⁵ IRC §1361(c)(2)(A)(i).

⁸⁶ IRC §1361(c)(2)(A)(ii).

⁸⁷ IRC §1361(c)(2)(A)(iii). Treas. Reg. §1.1361-1(h)(1)(iv)(B) extends this to include trusts that acquire stock from a revocable trust that elected to be taxed as an estate.

⁸⁸ IRC §1361(c)(2)(A)(iv).

⁸⁹ IRC §§1361(c)(2)(A)(v), 1361(e)(1)(A).

⁹⁰ IRC §1361(C)(2)(A)(iv). Treas. Reg. §1.1361-1(h)(1)(v ii) applies this only to the extent of the stock held by such trust in such bank or company as of October 22, 2004 and points out that in no other case is an IRA qualified to own S stock.

⁹¹ Treas. Reg. §1.1361-1(k)(1), Ex. (3)(ii) provides that taxation as an estate qualifies the trust until the IRC § 645 election terminates.

⁹² Treas. Reg. §1.1361-(1)(j)(6)(i) states that a QSST election under IRC §1361(d)(2) causes the trust to qualify as a grantor trust under IRC §1361(c)(2)(A)(i).

To be a QSST, the beneficiary or the beneficiary's legal representative must file an election.⁹³ A separate election is made for each S corporation owned by the trust.⁹⁴ The election applies to successor beneficiaries unless a successor beneficiary refuses to consent to the election.⁹⁵ The election, however, does not apply to successor trusts; if the trust terminates and the stock passes to a new trust, a new election must be made.⁹⁶ There must be only one income beneficiary during the life of the current income beneficiary, and the income beneficiary cannot change prior to the death of the current income beneficiary.⁹⁷ The corpus of the trust must be distributable to the income beneficiary only during the life of the current income beneficiary.⁹⁸ All trust income must be actually distributed (or required to be distributed) currently to the income beneficiary;⁹⁹ if the trust agreement does not require all income to be distributed, consider obtaining from the trustee a direction for the corporation to pay the trust's share of income directly to the beneficiary so that the corporation has proof of distribution to the beneficiary. The current income beneficiary's income interest must terminate upon the earlier of the beneficiary's death or the termination of the trust, and trust assets must be distributed to the current income beneficiary if the trust terminates during the beneficiary's lifetime.¹⁰⁰

To be an ESBT, the trustee must file an election.¹⁰¹ Unlike QSSTs, the election is made for the trust, and separate elections are not required for each S corporation owned by the trust.¹⁰² The election does not apply to successor trusts. If the trust terminates, and the stock passes to a new trust, a new election must be made. The trust's beneficiaries must be individuals, estates, or certain charitable organizations.¹⁰³ Interests in the trust must not have been acquired by purchase.¹⁰⁴ The trust cannot be a QSST.¹⁰⁵ A QSST can elect to change into an

⁹³ Treas. Reg. §1.1361-1(j)(6)(i), (ii).

⁹⁴ IRC §1361(d)(2)(B)(i).

⁹⁵ IRC §1361(d)(2)(B)(ii); Treas. Reg. §1.1361-1(j)(9).

⁹⁶ Treas. Reg. §1.1361-1(j)(9), Ex. (2). Between the income beneficiary's death and actual transfer of the stock to a new trust, the trust qualifies to hold stock as a former grantor trust for two years after the beneficiary's death. Treas. Reg. §1.1361-1(j)(7)(ii).

⁹⁷ IRC §1361(d)(3)(A)(i), (iii).

⁹⁸ IRC §1361(d)(3)(A)(ii).

⁹⁹ IRC §1361(d)(3)(B).

¹⁰⁰ IRC §1361(d)(2)(A)(iii), (iv).

¹⁰¹ IRC §1361(e)(3).

¹⁰² Treas. Reg. §1.1361-1(m)(2)(i).

¹⁰³ IRC §1361(e)(1)(A).

¹⁰⁴ IRC §1361(e)(1)(A)(ii).

¹⁰⁵ IRC §1361(e)(1)(B)(i).

ESBT if the trust has not converted from an ESBT to a QSST within the prior 36 months.¹⁰⁶ The trust cannot be a charitable remainder unitrust, a charitable remainder annuity trust, or any other trust that is tax-exempt.¹⁰⁷ Certain charitable organizations can hold contingent remainder interests in the trust.

If you are preparing an estate plan for a shareholder in an S corporation, consider an S corporation savings clause. This can add provisions that will allow a trust to qualify as a QSST if the trust holds any S corporation stock. Alternatively, a trust with a single beneficiary that provides for discretionary distributions to the beneficiary may want to segregate any S corporation stock into a separate share and provide that the net income from the separate share be paid to the beneficiary at least annually. In drafting these provisions, consider whether:

- Restricting the number of beneficiaries of the trust is desirable to avoid exceeding the 100-shareholder limit. This is less of an issue after 2004 since in many cases all members of a family are treated as just one shareholder – the common ancestor.
- The beneficiary's income tax bracket is low (favoring the beneficiary's deemed ownership of a QSST's S corporation K-1 income) or high (favoring the flexibility of an ESBT). One of the authors reformed a trust from an ESBT to a QSST because the primary beneficiary had no taxable income beyond the S corporation's K-1, saving an estimated \$10,000-\$12,000 per year, according to the beneficiary's income tax preparer. The lawyer who had drafted the trust used boilerplate language that created a QSST only if the trust was not otherwise eligible to be a shareholder, but the trust was in fact eligible to be an ESBT, so the form language did not kick in, making the reformation necessary.
- Whether the trust will need to buy S corporation stock on an installment basis. As described further below, the interest deduction is more certain for an ESBT than for a QSST.
- Whether the remaindermen of a trust are the natural objects of the beneficiary's bounty. If not, tension can arise in a QSST when the beneficiary is taxed on the S corporation's undistributed income, especially in the year of death when post-mortem distributions to pay tax on pre-mortem income go other than to the decedent's beneficiaries.

Also, upon the grantor's death, the trustee of a qualified revocable trust should consider making an election¹⁰⁸ to be taxed as an estate.¹⁰⁹ As described further above, this election

¹⁰⁶ Treas. Reg. §1.1361-1(j)(12) (iii).

¹⁰⁷ IRC §1361(e)(1)(B)(ii), (iii).

¹⁰⁸ IRS Form 8855.

¹⁰⁹ IRC §645.

generally allows the revocable trust to hold S stock for more than two years and also causes testamentary trusts created under the revocable trust to be treated as created under the decedent's will.

E. Avoiding Transfers that Would Cause Termination

The mere prohibition against transfers to persons or entities that are not qualified to be shareholders of S corporations is not an absolute bar against the acquisition of the stock by an impermissible shareholder. For example, no prohibition against transfer will prevent the transfer of stock as a result of the death of the shareholder or the transfer upon a shareholder's bankruptcy, divorce or incompetence. Shareholder agreements typically protect against transfers to impermissible shareholders at death by mandating the purchase of the stock of a deceased shareholder, unless the stock is to be transferred to a permitted transferee. Other potential transfers to impermissible shareholders often are addressed by separate provisions.

The determination of ownership is based on beneficial ownership, not on who is the registered owner.¹¹⁰ In one case, the owner of record had an agreement with his brother that all business interests in either individual's name were split evenly, regardless of actual title; the S election was invalid because the silent initial owner did not sign it.¹¹¹

There is a grace period on transfer of stock when a death occurs, which allows time to get the stock to a qualified shareholder. There is no grace period in other circumstances. Therefore, the agreement should provide that a transfer to an ineligible shareholder be "void ab initio" so that an impermissible shareholder never acquires title. This can be addressed several ways, which may have varying effect depending on state law.

- (i) Prohibit any transfer or attempted transfer which would terminate the S election and provide that any such transfer is void ab initio.
- (ii) Have an automatic, mandatory repurchase of shares upon the occurrence of any event that would result in those shares not being owned by a qualified S shareholder. Because this is much broader than the traditional concept of a "transfer," consider expanding the concept of "transfer" in the buy-sell agreement.
- (iii) Give the corporation the option to purchase any stock if the board of directors believes that this would help safeguard the S election (for example, this can be used to buy out shareholders if the limit of 100 owners is close), but this doesn't help if the transfer has already been made and thus the election "lost," which is why the first provision is an important safeguard.

¹¹⁰ Rev. Rul. 75-261. See Treas. Reg. §1-1361-1(e) ("The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation").

¹¹¹ *Kean v. Comm'r.*, 469 F.2d 1183, 1186 (9th Cir. 1972).

- (iv) Require a buy-out right upon death to be exercisable within a specified time period, not to exceed two years, if feasible. This will eliminate any issue as to whether the shares have passed to a testamentary trust that may be a shareholder for only a two-year period.¹¹²
- (v) Prevent the transfer of stock from a shareholder to a creditor, either by prohibiting a shareholder from pledging his stock as security for the repayment of a loan, or, alternatively, by requiring (with a clause in the pledge agreement) the lender to limit enforcement upon default to the proceeds resulting from the sale under the buy-sell agreement.
- (vi) Provide in the corporation's articles and/or bylaws that no transfer of stock is effective until recorded on the books of the corporation, and that the corporation may refuse to change the title of stock unless proof is provided that the successor owner is a qualified S shareholder. (Among other things, "proof" can include any elections required for a trust to be a qualified S shareholder or a legal opinion provided by the corporation's or prospective shareholder's counsel.)
- (vii) Have the corporation or an escrow agent hold the original certificates so that they cannot be transferred to a creditor or pledged to secure a shareholder's debt. If you cannot arrange that, at least put a legend restricting transfer on all stock certificates. Even better, if the entity is an LLC taxed as an S corporation, then do not issue any certificates, making it impossible for an owner to transfer an interest in the entity without those managing the entity knowing about the transfer.

Triggering buy-sell procedures immediately upon a disqualifying transfer facilitates the corporation's ability to ask the IRS for a waiver for an inadvertent termination,¹¹³ or alternatively request consent for an early re-election¹¹⁴ as soon as the purchase is consummated. When one shareholder intentionally violates the buy-sell agreement, does that mean that the termination was intentional and not inadvertent? That the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination or invalidity of the election was inadvertent.¹¹⁵ Although the corporation has the burden of proving inadvertence, the IRS has established procedures for automatic relief¹¹⁶ and understands the mandate that the legislative history gave it to be liberal in granting relief,¹¹⁷ so long as it

¹¹² IRC §1361(c)(2)(A)(iii).

¹¹³ IRC §1362(f).

¹¹⁴ IRC §1362(g).

¹¹⁵ Treas. Reg. §1.1362-4(b).

¹¹⁶ Rev. Proc. 2003-43 (modified by Rev. Proc. 2007-62).

¹¹⁷ S. Fin. Comm. Rep. No. 6400, 97th Cong., 2d Sess. 12-13 (1982).

obtains consents sufficient to avoid any attempt shareholders might make to whipsaw it.¹¹⁸ To avoid difficulty in obtaining consents required to obtain automatic relief, each shareholder should grant to the corporation an irrevocable power of attorney to sign consents on the shareholder's behalf.

F. Other Provisions to Protect S Election

An election to be an S corporation is not valid unless all persons who are shareholders of the day the election is made consent to the election.¹¹⁹ If the election is made during the first two months and fifteen days of the taxable year and is to be effective retroactively to the first day of the taxable year, all persons who were shareholders during the taxable year and at any time before the election must consent to the election.¹²⁰

An S election is revoked by obtaining the consent of more than one-half of the shares of stock in the corporation.¹²¹ If the election is made by the 15th day of the third month of a tax year, it can be effective retroactive to the first day of the current tax year. Otherwise, the revocation generally is effective on the first day of the following year. Notwithstanding, the revocation can provide that it is effective on or after the date on which the revocation is filed. The shareholders agreement can require a greater voting requirement for the revocation of the S election.

It is often desirable to include a provision requiring the shareholders to cooperate in making S elections, including granting an irrevocable power of attorney to the president, secretary or an agent escrow agent to sign all consents necessary. The parties to the shareholders agreement should also agree that, as directors and officers, they will not take any action which could terminate the S election, such as authorizing a second class of stock.

G. Damages for Causing Loss of S Election

It may be appropriate to provide that any party violating the "S protection" provisions of the shareholder agreement will be liable to the other shareholders for damages from the loss of the S election, including loss of pass-through tax treatment (which could be a very significant amount of money).

The method for computing damages could be identified in the agreement. For example, where the loss of the corporation's election denies the pass-through of operating losses for a particular taxable year within the agreed measuring period, the appropriate measure of damages would include each non-breaching shareholder's lost tax benefit from claiming such deductions (pass-through of losses times maximum or assumed marginal rate of tax), plus any additions to tax attributable to such losses that may have been previously claimed by the

¹¹⁸ IRC §1362(f)(4).

¹¹⁹ IRC §1362(a)(2).

¹²⁰ IRC §1362(b)(2)(B)(ii).

¹²¹ IRC §1362(d)(1)(B).

non-breaching shareholders. When the corporation is making a profit, damages would include not only a differential tax rates but also the tax and other financial cost of declaring a dividend cleansing the corporation¹²² of all earnings and profits earned during the five year period when the corporation may not reelect S status.¹²³

The parties may prefer to arbitrarily select a specific dollar amount as liquidated damages. Not only would this be a far simpler process, but it would avoid application of the forward-looking damage provisions, which may inspire the breaching party to raise various technical and legal challenges. The liquidated damages amount must be a reasonable estimate of probable damages or be reasonably proportionate to actual damages. However, since predicting profits is precarious at best, estimating such damages might not be practicable.

It will also be helpful to allow for the remedy of specific performance. Preventing the loss of the election may be a more effective remedy than suing a shareholder for damages (with perhaps no meaningful hope of recovery) after the fact. In this regard the shareholders agreement should provide that (i) the parties consider the interests of the entity to be of substantial and unique value to them (with supporting facts); (ii) irreparable harm incapable of being cured by money damages would occur if the agreement is not honored; and, therefore, (iii) the parties agree specific performance is available as a remedy. As a practical matter, however, using an irrevocable power of attorney to secure inadvertent termination relief might be the most direct remedy – one that minimizes all parties' costs.

H. Declare Dividends Equal to Tax Burden

Although the result of an S election is that the shareholders are required to pay the income tax on the corporation's income, there is no statutory rule mandating that the corporation pay dividends or make other distributions to the shareholders in the amounts required for them to pay the taxes. This can cause hardship and disadvantage for those shareholders who lack the resources to pay such taxes unless the corporation is required to make distributions this purpose. Therefore it is customary for a shareholders agreement to require distributions (subject to state law restrictions on paying dividends) on a pro rata basis (based on share ownership). Since each shareholder could be in a different federal bracket, and have differing state taxes, usually there will be a formula based on the highest combined state and federal bracket or a percentage of income (such as 45%).¹²⁴ Generally, the corporation should make these distributions each quarter to cover its owners' estimated tax payments.

¹²² Treas. Reg. §1.1368-1(f)(3).

¹²³ IRC §1362(g).

¹²⁴ In PLR 200934021, the IRS ruled that a provision in a shareholders' agreement that directed that the corporation pay the state income taxes of the shareholders, who resided in several different states with differing tax rates, created a second class of stock, because it caused the corporation to make non pro rata distributions to its shareholders. This, the IRS stated, involuntarily terminated the corporation's subchapter S election. The IRS noted that this was an unintentional termination, not motivated by tax avoidance or retroactive planning and that the corporation took adequate corrective actions. The IRS, therefore, treated the S election as continuing without termination under Section 1362(f).

If shareholders, or their percent of ownership, do not vary from year to year, a tax dividend can be declared and paid (to the extent not already paid to cover its owners' estimated tax payments) in the following March when the taxable income can be determined. If, for example, there is a significant change at year-end in the stock ownership, it will be necessary to declare a tax dividend to shareholders of record on December 31 based on a formula, such as 45% of the taxable income reported on that year's tax return. Depending on state law, the dividend may be required to be paid within 60 days, which may be sooner than the taxable income is determined. One way to avoid this dilemma is to add to the purchase price any shortfall between the tax dividend the shareholder received and 45% of the taxable income. Due to the fact that a distribution reduces basis, there is no tax difference between purchase price and distribution in an S corporation.

I. Income Allocation for Year of Sale

A shareholder's share of an S corporation's items of income, loss, deduction or credit is determined by assigning an equal portion of the items to each day of the tax year and then allocating each day's portion of each item to the shares outstanding on that day.¹²⁵ This method is referred to as a "pro rata allocation."

If a shareholder's entire interest in the corporation is terminated, however, the corporation and all affected shareholders can agree that the affected shareholders will be treated as if the corporation's taxable year consisted of two taxable years, the first of which ends on the date the shareholder's interest in the corporation is terminated.¹²⁶ This method is referred to as an "interim closing of the books." The effect is that the terminated shareholder is apportioned the items of income, loss, deduction or credit realized during the part of the tax year that he or she was a shareholder instead of a pro rata portion of the items for the entire year.

There can be a number of reasons to use one method over the other. If the business is cyclical, or it is difficult to accurately close the books in the middle of the year, the pro rata method may be perceived as "fair." The interim closing of the books may better match the purchase price if the purchase price of the stock is based on the value of the corporation as of the date the shareholder's interest in the corporation terminates.

It is usually best to agree on which method to use and specify that in the shareholders agreement, since the election to do an interim closing of the books cannot be made unless the corporation and all affected shareholders agree to the election.

¹²⁵ IRC §1377(a)(1).

¹²⁶ IRC §1377(a)(2)(A).

J. Insurance Proceeds Effect on Basis

Insurance proceeds received by the corporation are reflected as book income, but will not increase any shareholder's accumulated adjustments account ("AAA").¹²⁷ This book income increases each shareholder's basis proportionately.¹²⁸ However, since the deceased shareholder's basis is automatically adjusted to fair market value upon death,¹²⁹ any basis increase due to an allocation of insurance proceeds to the deceased shareholder's stock is wasted.

With respect to an accrual basis S corporation, Letter Ruling 200409010 held that insurance proceeds are allocated to the shareholders as of date of death; therefore you cannot avoid an allocation of some of the basis increase to the deceased shareholder's stock. If an interim closing of the books is elected as the allocation method, the election will cause all of the insurance proceeds to be included in the short year ending on the date of death and therefore allocable on a per share basis to both the remaining and the deceased shareholder's interest. You can at least minimize the allocation to the deceased shareholder's stock by not making that election. If the election is not made, a portion of the proceeds will be treated as income arising after the date of death, since the year does not close and the proceeds are allocated based on the number of days of the years prior to the date of death. Example: If death occurs on January 2nd, only two days are allocated to the deceased shareholder's basis.¹³⁰ Generally, therefore, an accrual basis S corporation with a corporate redemption agreement funded by insurance will find it advantageous to have a shareholders agreement that provides for the pro rata method of allocation.

With respect to a cash basis S corporation, you should be able to avoid the waste of basis by electing the interim closing of the books method. Generally, therefore, a cash basis S corporation with a corporate redemption agreement funded by insurance will find it advantageous to have a shareholders agreement that (i) provides for an interim closing of the books allocation upon death, (ii) provides that the receipt of insurance proceeds be allocated to those owning stock after the effective date of the purchase, (iii) the effective date of the purchase occurs on the date of death, with a promissory note payable on collection of the insurance proceeds, and (iv) the claim for insurance proceeds is made after the date of death and the proceeds used to repay the note. However, if you are concerned that the IRS might extend Letter Ruling 200409010 to cash basis taxpayers, you might consider a cross purchase instead.

If an S Corporation has accumulated earnings and profits (E&P) from then it was a C corporation, any distribution of life insurance proceeds comes first from AAA, then E&P,

¹²⁷ IRC §1368(e)(1)(A). To the extent that the corporation has accumulated C corporation earnings and profits and has used its AAA on other distributions, distributions of such proceeds that are not taxed as redemptions might be taxed as dividends.

¹²⁸ IRC §1367(a)(1)(A), §1366(a)(1)(A).

¹²⁹ IRC §1014.

¹³⁰ IRC §1362(e)(2)(B).

and then from basis,¹³¹ essentially turning tax-free life insurance proceeds into taxable dividends.

It would be better for the shareholders to own the policy, be the beneficiaries, and receive distributions from the corporation to pay premiums. Furthermore, the shareholders could contribute their investment of the life insurance proceeds to a new limited liability company taxed as a partnership. Then either:

- The new LLC loans the proceeds to the S corporation as needed, documenting the loan with interest at the applicable federal rate.
- The S corporation then contributes all of its business assets to the LLC. Later, when the LLC does not need part or all of the investment any more, it can distribute that excess money to the shareholders as a tax-free return of their capital contribution. This might or might not be a practical alternative, depending on the non-tax issues caused by transferring the S corporation's assets, as well as the annual expense of filing two business income tax returns instead of one. This is more cumbersome than the loan alternative, but it might have the positive effect of shifting a significant portion of the business operations to a partnership income tax model, which is more tax-efficient when changing the composition of the business' equity ownership.

Finally, to protect the life insurance from various business exigencies inherent in the shareholders owning life insurance under the alternative, the shareholders should consider forming a limited liability company to hold the life insurance.

These issues could be avoided if the corporation had an S election in place from inception or to the extent it had distributed all of its E&P in the past. Owners of S corporations with E&P should consider cleansing the corporation's E&P while dividend rates are low. IRC §1368(e)(3) allows taxpayers to elect to reverse the normal distribution rules and have distributions come first from E&P and then from AAA to implement this strategy.

K. Basis at Death

The basis of the deceased shareholder's stock is adjusted to fair market value as of the date of death (or as of the alternate valuation date).¹³² The basis adjustment could avoid gain upon a sale of the stock by the estate in a transaction that qualifies under IRC §302 or §303 as a capital event.

Except to the extent of the limitations pertaining to the at risk rules of IRC §465 and the passive activity rules of IRC §469, losses incurred by an S corporation pass through to shareholders but are only deductible to the extent of basis.¹³³ Unused losses are carried

¹³¹ Revenue Ruling 2008-42.

¹³² IRC §1014.

¹³³ IRC §1361(d)(1).

forward until the basis requirement is met.¹³⁴ However, suspended losses may not be carried forward to the estate and, to the extent not deductible on the decedent's final tax return, are lost.¹³⁵ Any unused (suspended) passive activity losses on the decedent's final tax return are disallowed and added to basis.¹³⁶

The estate's new basis controls the deductibility of losses incurred during the period of administration. Any net operating losses not usable as of the termination of administration are deductible on the estate's final fiduciary return and therefore benefit the beneficiaries.¹³⁷ Further, all suspended passive activity losses on termination are lost forever but increase basis upon distribution of the stock from the estate to the beneficiaries.¹³⁸

The stock of a deceased S shareholder may not receive a full step up (or step down) in basis under IRC §1014 to the fair market value of the stock. That value has to be reduced by the deceased shareholder's deemed share of the corporation's unrealized receivables or other items of income in respect of a decedent.¹³⁹

L. Tax Effects of Redemptions

Redemptions of S corporation stock is treated similarly to C corporation stock. If IRC §302 or §303 is satisfied and the transaction qualifies as a sale or exchange, the AAA account is reduced in proportion to the shares redeemed.¹⁴⁰ Gain is recognized by the terminated shareholder to the extent of the receipt of proceeds in excess of basis.¹⁴¹

If the transaction does not qualify as a capital transaction under IRC §302(b) or §303, the redemption first reduces the AAA account to zero, and then is taxed as a dividend if and to the extent attributed to any E&P (if the corporation is a former C corporation that has not distributed all of its E&P).¹⁴² If there is no E&P account, the shareholder will only recognize gain to the extent the distribution¹⁴³ exceeds the AAA account and basis.¹⁴⁴ In either event,

¹³⁴ Treas. Reg. §1.1366-2(a)(2).

¹³⁵ Treas. Reg. §1.1366-2(a)(5).

¹³⁶ IRC §469(j)(12).

¹³⁷ IRC §642(h).

¹³⁸ IRC §469(j)(12).

¹³⁹ IRC §691 (c), §1367(b)(4).

¹⁴⁰ IRC §1368(e)(1)(B); Treas. Reg. §1.1368-2(d)(1)(i).

¹⁴¹ IRC §1368(b).

¹⁴² IRC §1368(c).

¹⁴³ IRC §1368(b).

¹⁴⁴ Rev. Rul. 95-14, 1995-1, C.B. 169.

the shareholder does not need to pro-rate basis to the sold shares; rather, to the extent of the lesser of AAA and basis in *all* of the shareholder's stock, the shareholder recognizes no gain. Thus, if a redemption can be treated as a distribution that is not from E&P, that redemption might result in less short-term tax (because basis from all shares is applied against the proceeds) than in a redemption that is taxed as a sale (because basis from only the sold shares is applied against the proceeds).

A cross-purchase agreement does not affect the AAA account or the remaining partner's basis.¹⁴⁵ Thus, in a cross-purchase agreement, the buying shareholders get an immediate advantage because their cost basis is the purchase price. (The selling shareholder would typically receive capital gain except to the extent of his or her proportionate share of receivables.)

M. Other Income Tax Issues

If a promissory note is used to acquire the stock of a deceased or withdrawing shareholder, the interest paid on the note is deductible, subject to certain qualifications. The IRC §469 passive activity rules might defer net loss (including interest deductions allocable to passive activities) for the year.¹⁴⁶ Also, whether the interest paid by a QSST is deemed paid by the beneficiary or by the trust for income tax purposes is unclear.

Premiums paid by an S corporation on behalf of a shareholder under a cross-purchase agreement might be viewed as creating taxable income to the shareholders. This is because the shareholders are treated as the taxpayers and premium payments are not deductible.¹⁴⁷ Further, non-deductible expenses not chargeable to the capital accounts reduce basis.¹⁴⁸

VI. PURCHASE PRICE

A. Identifying the Goal

In deciding how to set the price for the buy-sell provision of a shareholders' agreement, you need first to identify the goal. If the agreement is between family members and you want to attempt to set the value for gift, estate and GST tax purposes, you obviously are constrained by tax considerations, as discussed below in Article VII. Even if you do not expect to "set" the value, the value used in the shareholders' agreement can clearly have an impact on what is considered "fair value" for state law purposes.

There are many other goals. If the context is a grandparent making gifts to children and grandchildren, a defensible lower value may be preferred. If the price will be used to buy out a grandchild who is being sued by creditors, a low value using all available discounts

¹⁴⁵ It is not listed as an item that adjusts basis under IRC §1367(a).

¹⁴⁶ IRC §163(d), §469 (U.S.C.S. 2006). *See also* IRS Notice 89-35, 1989-1 C.B. 675.

¹⁴⁷ IRC §264.

¹⁴⁸ IRC §1367(a)(2)(D).

may be the goal. If the context is three sisters who each own one-third of the corporation, and the price will be used to buy out the family of a sister who dies, then a value based on one-third of the entire value of the company may be the goal. If the context is a medical practice with doctors buying-in and then buying-out, and goodwill is considered an asset of the corporation and accounts receivable attributable to the doctor are paid as deferred compensation, then a value based on cash book value may be the goal. If the context is a business of unrelated owners, then fair market value of the interest being purchased or sold may be the goal.

The purchase price may also vary depending on the triggering purchase event. An objective may be to discourage certain share transfers but not prejudice a shareholder with respect to other transfers. For example, fair market value may be the appropriate purchase price in the event of death, disability or termination of employment (due to retirement) of a shareholder. Conversely, if the objective is to discourage a transfer of shares to an unknown third party, such as a creditor, a formula price of book value could be selected together with all available discounts.

The business issues underlying each triggering event must be considered in determining the purchase price formula. You must consider other implications of having different prices for different triggers, however, such as enforceability under bankruptcy law, S corporation second class of stock concerns, value set for estate tax purposes, etc. (see discussions herein).

B. Certificate of Value

Under this method, the parties initially fix the price to be paid for an ownership interest in a certificate attached to the agreement as an exhibit. The agreement typically requires an annual review and determination of fair market value which is set forth on subsequent certificates. If the parties fail to timely renegotiate a new certificate of value, the purchase price should be subject to determination by a stated formula or by appraisal. Failure to provide a method for updating the certificate price could result in a price which is inconsistent with the true value (whether higher or lower). This may not result in a “fair” result in business situation, and in family situations, it could result in a value which may not be controlling on IRS.¹⁴⁹

For example, if the certificate sets the value for the shares of a deceased shareholder at \$50,000, and at the time of death, the fair market value of the shares was \$200,000, the IRS may determine successfully that the \$50,000 purchase price does not accurately reflect the fair market value. In such an instance, the deceased shareholder’s estate will receive \$50,000 for the shares yet the IRS will value the shares at \$200,000, leaving the estate with an estate tax burden which exceeds the purchase price. Further, a marital bequest formula clause may not be satisfied resulting in the loss of the marital deduction.¹⁵⁰

¹⁴⁹ IRC §2703, §2704(b) (U.S.C.S. 2006).

¹⁵⁰ *Estate of Lauder v. Comm’r.*, 68 T.C.M. (CCH) 985, 77-78 (1994); see *Estate of Friedberg v. Comm’r.*, 63 T.C.M. (CCH) 3080 (1992).

C. Set By Appraiser

If fair market value is the goal of the purchase price, a professional appraisal may be required. Do both parties mutually select an appraiser? Does each party select a separate appraiser? What if the appraisals are materially different? Is there a third appraisal and by whom? A concern with multiple appraisers is the added cost and additional time to reach an agreement among them. If there are a number of shareholders, it may be most practical to let the board of directors select the appraiser. It is also important to address who pays for the appraisers. If the procedure allows for multiple appraisers, and if the cost is to be split, the parties have an incentive to agree on one appraiser. If the value of the stock is low, it may not be worth the cost of paying an outside appraiser at all and another method should be used. The shareholders agreement could use a certificate of designation, where the parties agree on an initial appraiser. The certificate would have an expiration date similar to a certificate of value.

If the parties cannot agree on one appraiser, you may decide to provide for each picking their own appraiser. Frequently, if the appraisals are within a certain value, say a 10% difference, the two appraisals can be averaged. Another approach is to have those two appraisers select a third appraiser. If you have three appraisals done, you can average the three or use the one in the middle. Alternatively, you can have the first two select the third, and so only have one appraiser. There are potential problems with this approach. Appraisers may not be willing to be hired merely to select a third appraiser, or they may not be able to agree on one.

A potentially cost-effective and speedy option with respect to a relatively small corporation is an appraisal by the corporation's CPA who has experience in establishing value. Since the CPA is already familiar with the business, he or she may be best suited to determine value. However, it may also be less of an "independent" appraisal, particularly if there is a controlling stockholder and the price is used to buy out a minority owner. An appraisal by the corporation's CPA will have low credibility with the IRS, however, and so should be avoided where setting the value for estate, gift and/or GST tax purposes is an issue.

D. Valuation Formula¹⁵¹

The agreement may call for value to be determined by one or more valuation formula. Rev. Rul. 59-60, 1959-1 C.B. 237. Where two or more valuation formula are to be considered, the effective price for the interest may be determined by an average or weighted average of all values resulting from the application of the various formula. However, IRS has both questioned and accepted this concept.

The *Lauder* case made it clear that a price formula in itself does not satisfy the basic requirements, i.e., the device test and bona fide business purpose test. *Lauder* specifically

¹⁵¹ RAYMOND C. MILES, *BASIC BUSINESS APPRAISAL* (John Wiley & Sons, Inc., 1984); THOMAS L. WEST & JEFFREY D. JONES, *HANDBOOK OF BUSINESS VALUATION* (John Wiley & Sons, Inc, 1992). *See also*, SHANNON P. PRATT ET AL., *VALUING A BUSINESS* (4th Ed. 2000); SHANNON P. PRATT, *BUSINESS VALUATION – DISCOUNTS AND PREMIUMS* (John Wiley & Sons, Inc. 2001) (each is an excellent treatise on valuation).

asked a number of questions, such as health of the parties, consistent enforcement of the agreement, negotiated professional advice, was there a periodic review of price, etc.¹⁵²

1. Industry Formula

In certain industries there is an industry standard for valuing a business, such as two times gross annual revenue. Usually an industry standard is a measure of the going concern value of the business only, not the value of the corporation. Since in a stock purchase the corporation needs to be valued, the industry standard needs to be further modified by adding in unusual assets and subtracting debt. In many industries (such as the insurance brokerage business) trade publications publish current formulae for determining value of a business in that industry (e.g., one or two times earnings). If the agreement is to use an industry formula, the source of the formula's determination should be stated in the agreement.

2. Cap Earnings Using P/E¹⁵³

Another approach is a capitalization of annual net earnings using a price/earnings ("P/E") multiple approach. The first step in using this formula is to determine the P/E multiple. Typically this is done by identifying the P/E ratios of several comparable public companies in the same industry and developing a composite ratio to be used in the formula. Averaging the net annual earnings on a straight or weighted basis may be used in appropriate circumstances to more fully reflect the ongoing earnings stream of the company and therefore avoid "peaks" or "valleys" which could taint the formula.

3. Cap Net Cash Flow¹⁵⁴

Another approach is the capitalization of annual net cash flow. The first step in using this formula is to define in the agreement the meaning of "net cash flow." The capitalization rate specified in the agreement should represent a fair rate of return on invested capital. However, that rate changes from year to year.

4. Cap Excess Earnings Plus Hard Assets

Another approach is the capitalization of excess earning, plus the value of "hard" assets. First, the fair market value of "hard" assets is determined, then it is multiplied by a reasonable rate of return on such assets (this number represents the reasonable return on an investment in a closely held business, i.e., typically considerably higher than market rate). The actual return experienced by the business on its assets, in excess of the expected reasonable return, constitutes "excess earnings." Excess earnings are considered the return

¹⁵² See also, *St. Louis County Bank v. Comm'r.*, 674 F.2d 1207 (8th Cir. 1982).

¹⁵³ See *Borg v. Int'l Silver Co.*, 11 F.2d 147 (2d Cir. 1925); Rev. Rul. 59-60, 1959-1 C.B. 237, 240; *Estate of Watts v. Comm'r.*, 51 T.C.M (CCH) 60 (1985); *aff'd*, 823 F.2d 483 (11th Cir. 1987); *Estate of Clark v. Comm'r.*, 35 T.C.M. (CCH) 1482 (1976).

¹⁵⁴ See, e.g., Martin & Votta. *Accounting and Non Accounting Factors in Valuing Stock of Closed Corporations*, 42 C.P.A. J. 901 (1972).

on intangible assets such as goodwill or going concern value. The excess earnings are capitalized at an appropriate rate, usually some industry standard or marketable interest-bearing security plus a risk premium (market rate). The risk premium represents the additional risk inherent in ownership of a closely-held business without a readily available market to determine the value of the intangible assets. The value of the intangible assets is then added to the value of the “hard” assets.¹⁵⁵

5. Debt Capacity Approach (EBITDA)

This approach quantifies funds available to meet debt service payments for a chosen fiscal period. These “funds” are typically defined as net operating income (i.e., earnings before interest, taxes, depreciation, and amortization - EBITDA). This amount then is capitalized by the entity’s current incremental cost of long-term debt capital. This approach is frequently used in valuing companies that are available for sale to unrelated parties. EBITDA means earnings before interest on corporate indebtedness, taxes, depreciation and amortization. Typically, an average or weighted average of the last three to five years is used as the base and that base is multiplied by a factor, which is typically supported by other comparable transactions. For example, the EBITDA base multiplied by, say, four or five, of course adjustments to the financials for extraordinary events or other financial items, such as low or excessive salaries, are also applied.

6. Comparable Pricing¹⁵⁶

Though difficult, the preferred valuation method is to compare the earnings, asset values and debt structure to comparable publicly-held companies. For example, if a comparable public company’s market price is fifteen times earnings before taxes, the value of the privately-held company could be mutually considered to be fifteen times its earnings before taxes before adjustment. Since the privately-held company does not have a public market for its stock it is necessary to “adjust” the initial determination by non-marketability discounts, as well as minority interest discounts. Finding comparable publicly-held companies may be difficult.

7. Book Value¹⁵⁷

Net book value is an accounting value. While it is used, it seldom produces true fair market value. Cash book value is usually less relevant than accrual book value. Some formulas use adjusted book value, which increases or decreases the book value of tangible assets by the difference between “book” and “fair market” value. Other adjustments may include unaccrued income and expenses, contingent on remote liabilities and insurance proceeds.

¹⁵⁵ A.R.M. 34, 2 C.B. (1920).

¹⁵⁶ See, *Estate of Hall v. Comm’r.*, 92 T.C. 312 (1989) (adjusted book value provided a reasonable estimate of the fair market value of the shares at the valuation date); Treas. Reg. §20.2031-3 (1992); *U.S. v. Parker*, 376 F.2d 402 (5th Cir. 1967); *Estate of Miller v. Comm’r.*, 36 T.C.M. (CCH) 169 (1977) (a publicly traded company should be used as a comparable if similar); *Estate of Proios v. Comm’r.*, 68 T.C.M. (CCH) 645 (1994).

¹⁵⁷ See, Roger R. Fross. *Estate Tax Valuation Based on Book Value Buy-Sell Agreement*, 49 TAX LAW 319 (Winter 1996).

Though questioned by IRS, adjusted book value may require “booking” the potential tax cost resulting from a sale or assets at the corporate level. It is also appropriate to consider the value of intangible assets such as goodwill, which may not have been booked. If you use a book value formula, be sure and specify that the value will be at least \$1, since book value can be negative.

E. Life Insurance

An alternative provision used in conjunction with other methods of valuation when the triggering event is death or permanent disability is the greater of the fair market value or the life insurance (or disability buy-out) proceeds received by the corporation on the shareholder’s life. The business thinking is that if the parties have agreed to a certain level of insurance for buy-sell purposes, the sales price should be at least that amount. This alternative will create problems regarding setting the value for estate, gift and GST tax purposes, however, since the value during life and at death will be different. We have never been able to accept the rationale for this approach, but see it frequently used with respect to buy-sell agreements for stock of a professional practice.

F. Price Offered by Bona Fide Purchaser

If the price is pursuant to an option to purchase upon a bona fide offer, then the price paid under the shareholders’ agreement can be the price in the offer. This allows the individual shareholder to realize full “market value.” If the desire is to protect the corporation and other shareholders from being forced to pay a higher price than what they have agreed to, however, the bona fide offer should not be used, or the purchaser should be allowed to pick either the bona fide offer or the price set by the shareholders’ agreement. Since price and terms are interrelated, it is generally best to substitute the payment terms of the bona fide offer for the payment terms in the shareholders’ agreement if the bona fide offer is used to set the price.

G. Reciprocal Purchase Options (Australian Lottery)

The agreement may provide that any owner’s offer to buy another owner’s interest or to sell his or her interest to another owner is deemed to be both an offer to buy and an offer to sell at the price and on the terms on which the initial offer is made. The effect is that an offer to buy if refused by the would-be seller becomes a “put” option for the would-be buyer, or an offer to sell if refused by the would-be buyer becomes a “call” option for the would-be seller.

Use of reciprocal purchase options can favor wealthy owners if they can make an offer without fear of a counterproposal from owners with less wealth or credit resources. Use of reciprocal purchase options may also favor owners who have the advantage of more business contacts and skill who are willing to pay a premium in order to acquire ownership.

Reciprocal purchase options do not prevent lifetime sales of interest at a price higher than that established for estate tax purposes and, therefore, may mitigate the agreement’s ability to fix a value for estate tax purposes under the IRS requirements.

H. Discounts & Premiums

Care should be taken to clearly specify whether (i) the entire corporation is being valued and then multiplied times the percent of stock being purchased, or (ii) only the stock being purchased is valued. Although lack of marketability discounts may be appropriate for the entire corporation, those will likely be more significant for a partial interest. If the stock being purchased is a minority interest, then there would be appropriate discounts for minority interests if only that stock is being valued. Conversely, there may be a premium for control if the purchased interest is a majority. If there are several people buying a controlling interest, is it fair to have them each pay a control premium? A buy-sell agreement should provide that discount or premium factors are to be considered in determining the purchase price of an interest.

I. Adjustment Upon Subsequent Sale of Corporation

In some cases, a selling shareholder is concerned that he or she may sell stock in the corporation to the other shareholders (in a cross-purchase transaction) or the corporation (in a redemption transaction) and the entire company may, shortly thereafter, be sold by the surviving shareholders to an unrelated third party. In this instance, it may be appropriate to consider a provision in the buy-sell agreement that provides purchase price protection to the selling shareholder.

A provision can be included that gives the selling shareholder the right to share, on a declining basis, a portion of any additional consideration received in excess of what the selling shareholder received in the original sale transaction. The amount of purchase price protection will typically be reduced the longer the interval from the original sale. For example, a clause could provide that if the company is re-sold within 12 months of the original sale, the original seller will receive 100% of her pro rata share of the incremental, but after 12 months, it is reduced to 50%, and after 24 months it is reduced to 25%. In addition, it is important for the clause to recognize that the form of the transaction could be an asset sale or merger and not just a sale of the stock of the company. Finally, the clause should take into consideration all of the alternative forms of consideration that is included in a transaction (such as a non-competition agreement, goodwill purchase, or employment agreement), in addition to the purchase price.

For example, X sells her 50% interest in the stock of the corporation for \$1 million to Y on December 31, 2011. After acquiring the stock owned by X, Y owns 100% of the stock of XYZ corporation. On July 1, 2013 (18 months later), Y sells 100% of the stock of XYZ to ABC for \$5 million. If X had held onto the stock to July 2013, she would have received \$2.5 million, or an additional \$1.5 million. If the agreement contains a purchase price protection clause, with a 50% share of the incremental amount between 12 and 24 months, X would receive an additional \$750,000.

An example of a purchase price protection clause is set forth below:

Purchase Price Protection. If a Change of Control (as hereinafter defined) occurs on or before the third anniversary of the settlement of any purchase of a Shareholder's

shares pursuant to this Agreement (a “Clawback Shareholder”) and as a result of such Change of Control the Corporation or the remaining Shareholders receive per share consideration (“Change of Control Consideration”) greater than the Closing Valuation (as hereinafter defined), the Corporation or the remaining Shareholders, as applicable, shall pay to the Clawback Shareholder an amount equal to the product of (i) the excess of the Change of Control Consideration over the Closing Valuation, times (ii) the number of shares purchased from the Clawback Shareholder, times (iii) the Discount Factor. For purposes of this Agreement, a “Change of Control” shall mean (a) a disposition of assets requiring shareholder approval pursuant to Section 13.1-724 of the Virginia Stock Corporation Act; (b) a merger requiring the approval of shareholders pursuant to Section 13.1-718 of the Virginia Stock Corporation Act; or (c) any other event whether a sale of stock, merger, consolidation, share exchange, reorganization, combination or other transaction, that results in the ownership by the current Shareholders of less than fifty percent (50%) of all shares of capital stock of the Corporation, or less than fifty percent (50%) of all shares of voting stock of the Corporation, following such event. For purposes of this Section 7.3, the “Closing Valuation” shall mean the Agreement Price paid to the Clawback Shareholder divided by the number of shares purchased from the Clawback Shareholder. For purposes of this Section 7.3, the “Discount Factor” shall mean (i) 75% from the settlement date of the purchase of shares from a Clawback Shareholder up until the day prior to the first anniversary of such settlement date, (ii) 50% from the first anniversary of the settlement date of the purchase of shares from a Clawback Shareholder up until the day prior to the second anniversary of such settlement date, and (iii) 25% from the second anniversary of the settlement date of the purchase of shares from a Clawback Shareholder up until the day prior to the third anniversary of such settlement date. For the sake of clarity, the consideration received by the Corporation or Shareholders, as applicable, as a result of a Change of Control includes without limitation any and all amounts payable to the Shareholders, the Corporation or Affiliates of any of them (x) in the form of an earn-out or other deferred payment, valued as the parties thereto agree (and in any event not less than the amounts actually received), and (y) for non-competition, non-solicitation, employment or similar agreements to the extent that the amounts payable thereunder are in excess of reasonable compensation for the services or agreements set forth therein. On the third anniversary of the settlement date of a purchase from a Clawback Shareholder, such Clawback Shareholder shall have no further rights under this Section 7.3. In addition, the “Change of Control Consideration” arising from an asset sale that qualifies as a Change of Control shall be the aggregate distribution per share that a Shareholder of the Corporation would receive from such a Change of Control if the Corporation were to dissolve shortly after receiving payment for such Change of Control after the Corporation provides for reasonable reserves for the Corporation’s liabilities and pays all applicable taxes payable by the Corporation in connection with such Change of Control and dissolution.

J. Adjustment Due to Different Estate Tax Value

A buy-sell agreement that fails to fix estate tax values may create significant tax problems if it still compels a sale at a price lower than that at which the estate tax is imposed. The

taxpayer in *Estate of Dickinson, Jr. v. Commissioner*¹⁵⁸ successfully limited the risk of such adverse results by providing that if the estate tax value of the shares sold was ultimately found to be higher than the agreement price, the agreement would not bind the parties to buy and sell at that price, and the sale would be made at the estate tax values. The IRS argued that this provision was invalid as a matter of public policy. The IRS relied on the decision of the Fourth Circuit in *Commissioner v. Proctor*¹⁵⁹, which had rejected a clause revoking a purported sale to the extent it was found to be a taxable gift. The Fourth Circuit had held that this clause was an attempt to render the tax examination and judicial processes ineffective and struck it down as an attempt at “trifling with the judicial process.” Nonetheless, the Tax Court upheld the Dickinson revaluation clause. The court found that the clause did not attempt to rescind an act already taken by the parties but merely to deny the application of the valuation provisions of the agreement in certain circumstances. The court stated that this was not an attempt to negate the government’s determination of the value of the stock but rather an attempt to make that determination binding for nontax purposes as well as tax purposes.

In *King v. United States*¹⁶⁰, a revaluation clause was also sustained in a context similar to that of *Dickinson*. In *King*, a father sold stock to trusts he had created for his children at a price believed to be its fair market value. The trusts paid for the stock with promissory notes. The notes contained a clause stating that if the IRS determined that the market value differed from the price set in the agreement, an adjustment would be made in the face amount of the notes. When the IRS ultimately determined that the stock was worth more than the parties had believed, the corporation had become bankrupt and the stock was worthless. Again, the IRS, citing *Proctor*, contended that the revaluation clause violated public policy. The Tenth Circuit upheld the clause, finding that it did not seek to alter the nature of the transaction but merely to make the transaction follow the intent of the parties.

The following sample clause, similar to the one used in *Dickinson*, could be used in the shareholder agreement to guard against this risk:

The Agreement Price is intended to be the fair market value of the Offered Stock, but if the Agreement Price under subsection 2.1 is ever determined by the U.S. Internal Revenue Service to be greater or less than its fair market value, the Agreement Price shall be adjusted to the fair market value determined by the U.S. Internal Revenue Service.

Another option would be to provide for the payment of the additional estate tax liability attributable to the difference between the agreement price and the final valuation for estate tax purposes in the deceased shareholder’s estate planning documents. A sample clause could provide as follows:

¹⁵⁸ *Estate of Dickinson, Jr. v. Comm’r*, 63 TC 771 (1975).

¹⁵⁹ *Commissioner v. Proctor*, 142 F2d 824 (4th Cir. 1944) cert. denied, 323 US 756 (1944).

¹⁶⁰ *King v. United States*, 545 F2d 700 (10th Cir. 1976).

I currently own interests in certain closely held businesses that are subject to buy-sell agreements that will require my estate to sell its interest in those businesses at my death at a purchase price and on purchase terms set forth in those agreements. In the event that the value of one or more of the closely held business interests subject to the buy-sell agreements is finally determined for estate tax purposes (“final value”) to be higher than the value provided for in the buy-sell agreement (“agreement value”), any additional estate and generation skipping transfer tax, interest, and penalties attributable to the difference between the final value and the agreement value shall be apportioned to the purchaser or purchasers of such closely held business interests.

K. Defined Value Clauses

The Internal Revenue Service often scrutinizes significant transfers of “hard-to-value” assets, such as an interest in a closely-held business. One approach that may reduce the chance of an audit of a transfer of a hard-to-value asset is to utilize a formula defined value transfer. For example, a transfer may provide that an undivided part of a “hard-to-value” asset, which exceeds a defined value of the transferred entity interest, will pass either to a grantor retained annuity trust, the transferor’s spouse, a charity, or a trust in which the grantor has retained an interest that makes the gift incomplete.

The IRS argues that such clauses should not be respected because they would make fair administration of the gift tax difficult, given the Service’s limited resources available for gift tax audits, especially considering the finality that now can be obtained through gift reporting with adequate disclosure under IRC § 6501(c)(9).

“Formula defined value” clauses should be distinguished from “price adjustment” clauses like the ones discussed in Revenue Ruling 86-41¹⁶¹, and in *Commissioner v. Procter*¹⁶². In Rev. Rul. 86-41, the IRS said that a clause that increased the consideration to be paid for the transferred property or that caused a portion of the transferred property to revert to the transferor were conditions subsequent that are not effective to avoid a taxable gift from being made on the transfer of the property. By contrast, formula clauses defining the amount of the transfer or the identity of the transferee are ubiquitous in the transfer tax context. In fact, such arrangements are specifically permitted in the tax law. If an adjustment occurs in a formula defined value clause, a change in the identity of the transferee may occur (e.g., the credit shelter trust owns less of the asset and the marital trust owns more of the asset). If an adjustment occurs in a price adjustment clause, the initial transfer is partially unwound and the identity of the transferee does not change (e.g., the transferee pays an additional amount for the asset). Price adjustment clauses were found to be against public policy in *Procter* because, if such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency. Although the same public policy argument applies to formula defined value clauses, they are so commonly used that an argument that they are void is not persuasive. Moreover, the public policy argument could be addressed by deliberately structuring the formula to produce a small deficiency on audit.

¹⁶¹ 1986-1 C.B. 442.

¹⁶² 142 F.2d 824 (4th Cir. 1944).

In FSA 200122011, the IRS attacks a defined value clause that it assumes was executed without “[any] evidence of arm’s length negotiations” and the transactional documents were accepted by charity as presented. The IRS concludes the possibility of “any additional transfer to charity under the formula clause was illusory.” The IRS also states that “Though *Procter* involved a savings clause as opposed to a formula clause, the principles of *Procter* are applicable to this case. If formula clauses like the one at issue actually function to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they re-characterize the transaction in a manner that would render any adjustment nontaxable. A valuation increase resulting from an examination would serve only to increase the charitable deduction, but would not otherwise generate any gift tax deficiency. Moreover, the adjustment would substantiate a claim for an increase in the income tax charitable deduction claimed by the donor. The sole justification for the Commissioner’s examination would be to insure that charity received all that it was entitled to under the transfer documents. This would place federal tax administrators in the position of policing charitable transactions, a role more appropriately performed by the states’ attorneys general.”

Commentators have argued that the IRS analysis misses several key points, including: (i) the IRS does have a “revenue incentive” to examine a charity’s actions in agreeing to the amount of a formula gift, because the charity and the “offending” individual will be subject to IRS sanctions (which potentially increases Treasury revenue), if there is any excess benefit to that individual; (ii) state attorney generals do have a duty to enforce the formula; (iii) the charity has a fiduciary duty under state property law to enforce the formula (and, as noted above, it is clear law that federal gift tax consequences follow state property law); (iv) assuming the charity does engage in arms length negotiations, it is irrelevant whether the formula clause “works,” because under gift tax valuation cases and the IRS’s own regulations, it is clear arms length negotiations are the best evidence of value; (v) as noted above, the IRS itself mandates formula clauses for charitable split interest trusts and grantor retained annuity trusts, both of which involve the same public policy considerations; (vi) as noted above, the IRS has long accepted formula marital deduction clauses and formula pecuniary disclaimers, which have no more (or less) public policy considerations than formula gifts to charity; and (vii) there is a key distinction between price adjustment clauses such as the one discussed in *Procter* and defined value formula clauses (e.g. marital deduction clauses). One distinction is that the price adjustment clause involves a condition subsequent. In addition, in some defined value formula clauses, the identity of the recipient could change (which is clearly not in the donor’s best interest.).¹⁶³

In recent years, the courts have generally come to accept the use of properly drafted defined value clauses, especially in the charitable context, where the excess value passes to a charitable beneficiary. In *McCord v. Commissioner*¹⁶⁴, a defined value clause was upheld where the taxpayer transferred interests in a limited partnership to (i) GST trusts, (ii) their

¹⁶³ See Porter and Dyer, *Defined-Value Transfer Planning After McCord and Christiansen*, 22 *Probate & Property* No. 5 (September/October 2008).

¹⁶⁴ 461 F.3d 614 (2006), *rev'g* 120 TC 358 (2003).

sons, (iii) the Shreveport Symphony, with any excess value passing to (iv) the Community Foundation of Texas.

*Christiansen v. Commissioner*¹⁶⁵ concerned a defined-value disclaimer. The decedent left her estate to her daughter. Under the will, 75% of any disclaimed assets would pass to a charitable lead annuity trust (CLAT) and 25% to a private foundation. The principal assets of the estate were 99% limited partnership interests in two partnerships. The daughter disclaimed a fractional share of the estate exceeding \$6.35 million, based on values “as finally determined” for estate tax purposes. The Christiansen decision was affirmed by the Eighth Circuit and confirmed that use of a formula disclaimer, based on values as finally determined for federal estate tax purposes, neither renders the amount of the federal estate tax charitable deduction subject to an impermissible contingency nor violates public policy. The result is to allow the estate tax charitable deduction for the portion of the disclaimed property passing directly to a qualified charity as a result of a valuation increase on audit.

In *Hendrix v. Commissioner*¹⁶⁶, the Tax Court examined a part gift and part sale transaction in which the taxpayers transferred non-voting common shares in a closely held company to two trusts for the benefit of their children, with the excess passing to a donor advised fund under a defined value clause. The defined value clause provided that (i) each taxpayer would transfer a total of 403,342 company shares, (ii) the trusts would take company shares with a fair market value equal to \$14,732,846, and (iii) the donor advised fund would receive any remaining shares in the event the value of the shares were increased for federal gift tax purposes. The taxpayers obtained an appraisal of the shares prior to the gift. The trusts also obtained an independent appraisal of the shares, and the donor advised fund retained independent counsel to review the trusts’ appraisal. The donor advised fund concluded that the appraisal was fair and reasonable. After the taxpayers filed their gift tax return claiming a \$50,000 charitable deduction and a \$1,414,581 taxable gift, the IRS claimed that the defined value clause should be disregarded because it was not negotiated in an arm’s length transaction and was void as against public policy. The Tax Court found that a familial relationship, by itself, was not sufficient to create a non-arm’s length transaction as a matter of fact. The Tax Court explained that the donor advised fund assumed a real economic risk of loss as recipients of the stock and that it performed due diligence by independently examining the stock’s appraisal. Moreover, the Tax Court found that defined value clauses do not frustrate national or state policy, and, in fact, actually encourage charitable giving. Consequently, the Tax Court held for the taxpayers.

In facts similar to *Hendrix*, *Petter v. Commissioner*¹⁶⁷, rejected the IRS’s public policy attack on defined value clauses. *Petter* involved the transfer of separate blocks of LLC units in gift and sale transactions. A portion of the transferred assets passed to grantor trusts for the donor’s children equal to the donor’s remaining gift exemption amount (for the gift transactions) and the amount of notes given by the trusts (in the sale transactions), using

¹⁶⁵ 586 F.3d 1061 (8th Cir. 2009), *aff’d* 130 T.C. No. 1 (2008).

¹⁶⁶ T.C. Memo. 2011-133.

¹⁶⁷ T.C. Memo. 2009-820, *aff’d* ___ F.3rd ___ (9th Cir. 2011).

values as finally determined for federal gift tax purposes. The balance passes to charities. The result is that an agreement by the IRS with the taxpayer on the valuation of the LLC units (using a 35% discount) resulted in a shift of more units to the charities, but did not result in any additional gift taxes. The court discussed four major reasons that the defined value clauses in this case do not violate public policy: (1) there is a general public policy encouraging charitable gifts; (2) there are other potential sources of enforcement of the gift and sale transactions other than gift tax audits; (3) the mootness and declaratory judgment concerns mentioned in *Procter* are not appropriate; and (4) the existence of other formula clauses authorized in regulations suggest that there is no general public policy against lifetime transfers by formula clauses. The IRS appealed the Tax Court's decision in *Petter* to the Ninth Circuit on the grounds that the taxpayer's increased charitable deduction should be disallowed because it was subject to a condition precedent, i.e., that the IRS audit the taxpayer's return and increase the per-unit value of the transferred LLC units. The Ninth Circuit upheld the defined value clause, finding that the taxpayer unconditionally transferred the LLC units to the charities involved. The only open question, the Ninth Circuit explained, was the value of the units transferred, and not the transfers themselves. Interestingly, the IRS withdrew its appeal of the Tax Court's public policy rationale, perhaps signaling an end to the IRS's attack of defined value clauses on public policy grounds.

L. Taxable Income as Liability in Valuation

If the purchase price is determined by fair market value, the parties should recognize that a recent split decision of the Sixth Circuit affirming the Tax Court (where the issue was resolved based on the concurring opinion), and a second Tax Court decision, did not allow a discount or other adjustment for the tax on the earnings of the S corporations. The Tax Court explained that “the principal benefit that shareholders expect from an S corporation election is a reduction in the total tax burden imposed on the enterprise. The owners expect to save money, and we see no reason why that savings ought to be ignored as a matter of course in valuing the S corporation.”¹⁶⁸ Citing *Gross*, the Tax Court held that in applying the income capitalization method to value stock of an S corporation, “it is appropriate to use a zero corporate tax rate to estimate net cash flow when the stock being valued is stock of an S corporation.” This conclusion was based on the court's finding that the taxpayer's “estimated capitalization rate (before he converted it to before corporate tax) is an after corporate tax rate.”¹⁶⁹

In *Estate of Litchfield v. Commissioner*¹⁷⁰, the Tax Court upheld valuation discounts of 17.4% and 23.6%, respectively, in determining the fair market value for estate tax purposes of stock in S Corporations that owned assets with considerable built in capital gains tax liabilities for the underlying assets of the companies. The Court held that a willing buyer of stock in the corporations would consider the built in capital gain tax liabilities for the underlying assets of the corporations. The Court adopted the estate's valuation approach on the built in capital

¹⁶⁸ *Gross v. Comm'r*, 272 F.3d 333, 353 (6th Cir. 2001), *aff'g*, 78 T.C.M. (CCH) 201 (1999).

¹⁶⁹ *Estate of Adams v. Comm'r.*, 83 T.C.M (CCH) 1421, 1425 (2002).

¹⁷⁰ T.C. Memo 2009-21.

gains tax, indicating that the estate's expert used more accurate data than did the Service's expert. Both experts assumed that the corporations would sell a percentage of their assets over time. However, in calculating the impact of the sale of assets over time, the Court held that the Service's expert failed to consider appreciation that could occur during the ten-year waiting period following the S election, which would be subject to tax at the corporate level.

VII. ESTATE TAX ISSUES REGARDING VALUATION

A. Fixing Value For Estate Purposes

To make sure the IRS will accept the price and terms of payment established under a buy-sell agreement as the value of the ownership interest for estate tax purposes, specific statutory and regulatory rules must be followed. Questions prevail on whether the same rules apply in establishing valuation for gift and generation-skipping transfer tax planning.¹⁷¹

Under a long line of cases, regulations and rulings, the valuation set forth in a buy-sell, cross purchase or redemption agreement will fix estate tax valuation only if a number of requirements are met.¹⁷² Therefore, to guarantee IRS acceptance, a number of factors should be considered. They include, but are not limited to: (i) the nature of the business; (ii) the economic status of the industry within the nation as of the valuation date; (iii) asset value; (iv) earnings; (v) dividend history and dividend paying capacity; (vi) the existence or the lack of existence of intangible assets such as goodwill, going concern value, etc.; (vii) any sales of stock and the size or block of shares or other equity interest having been previously sold or valued; and (viii) comparison of the valuation for the target company as compared to comparable securities on a relative basis to earnings, dividends and asset values.¹⁷³

Rev. Rul. 59-60¹⁷⁴ specifically required that the buy-sell agreement be entered into as a "voluntary action by the shareholders binding during the life as well as at the death of the stockholder." The ruling, however, does not state that compliance with only this provision would automatically bar the Internal Revenue Service from challenging the valuation set

¹⁷¹ See *Hess v. Comm'r.*, T.C.Memo 2003-251; *Estate of Reynolds v. Comm'r.*, 55 T.C. 172 (1970), acq. 1971-2 C.B. 3; *Ward v. Comm'r.*, 86 T.C. 78 (1986).

¹⁷² See *May v. McGowan*, 194 F.2d 396 (2d Cir. 1952); *Estate of Littick v. Comm'r.*, 31 T.C. 181 (1958); *Broderick v. Gore*, 224 F.2d. 892 (10th Cir. 1955); Rev. Rul. 59-60, 1959-1 C.B. 237, *modified*, Rev. Rul. 65-193, 1965-2 C.B. 370, Rev. Rul. 65-192, 1965-2 C.B. 259 *superseded*, Rev. Rul. 68-609, 1968-2 C.B. 327; Rev. Rul. 77-287, 1977-2 C.B. 319 (which list the multitude of factors the Internal Revenue Service will consider in valuing a closely held business).

¹⁷³ Rev. Rul. 59-60, 1959-1 C.B. 237, *modified*, Rev. Rul. 65-193, 1965-2 C.B. 370, See Rev. Rul. 65-192, 1965-2 C.B. 259, *superseded*, Rev. Rul. 68-609, 1968-2 C.B. 327 and Rev. Rul. 77-287, 1977-2 C.B. 319 (listing the multitude of factors the Internal Revenue Service will consider in valuing a closely held business); Treas. Reg. § 20.2031-2(f) (as amended in 1992); Treas. Reg. § 20.2031-3 (as amended in 1992) (estate tax); Treas. Reg. § 25.2512-3 (1958) (gift tax).

¹⁷⁴ Rev. Rul. 59-60, 1959-1 C.B. 237, *modified*, Rev. Rul. 65-193, 1965-2 C.B. 370, See Rev. Rul. 65-192, 1965-2 C.B. 259, *superseded*, Rev. Rul. 68-609, 1968-2 C.B. 327 and Rev. Rul. 77-287, 1977-2 C.B. 319 (listing the multitude of factors the Internal Revenue Service will consider in valuing a closely held business).

forth in the agreement. It was merely a factor to be considered, along with other relevant factors, which the ruling continued to identify by stating that the agreement must represent “a bona fide business arrangement” and must not be “a device to pass the decedent’s shares to the natural objects of his bounty for less than adequate and full consideration in money or monies worth.”¹⁷⁵

Most importantly, in Treas. Reg. §20.2031-2(h) (as amended in 1992), the Treasury set forth a series of standards that must be complied with in order for the valuation to be controlling. The Regulation requires that the agreement must:

- (i) be a bona fide business arrangement;
- (ii) not be a device to transfer the decedent’s shares to the natural objects of his bounty for less than full and adequate consideration¹⁷⁶;
- (iii) establish a reasonable and ascertainable price to be paid. The price must be fixed by the terms of the agreement or the agreement must contain a formula or other method for determining the price;
- (iv) obligate the owner and his or her estate to sell upon death as well as during life;
- (v) prohibit lifetime transfers at a price which is higher than the price established under the agreement when transfers occur by reason of death¹⁷⁷;
- (vi) be consistent adherence to the agreement throughout the history of the agreement and the relationship of the parties.¹⁷⁸

The standards set forth in Treas. Reg. §20.2031-2(h) are also not exclusive. The following standards must also be considered: (i) a fixed or formula price that uses generally recognized valuation techniques; (ii) the method applied should be reasonably expected to produce a fair

¹⁷⁵ See Rev. Rul. 65-193, 1965-2 C.B. 370 *modifying* Rev. Rul. 59-60, 1959-1 C.B. 237; Rev. Rul. 65-192, 1965-2 C.B. 259, *superseded*, Rev. Rul. 68-609, 1968-2 C.B. 327 and Rev. Rul. 77-287, 1977-2 C.B. 319 (listing the multitude of factors the Internal Revenue Service will consider in valuing a closely held business); Rev. Rul. 83-120, 1983-2 C.B. 170; Treas. Reg. § 25.2703-1(b)(1)(ii) (1992); *Fiorito v. Comm’r.*, 33 T.C. 440 (1959); *Estate of Hall v. Comm’r.*, 92 T.C. 312 (1989); *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982); *Estate of Lauder v. Comm’r.*, 60 T.C.M. (CCH) 977 (1990); *Estate of Bischoff v. Comm’r.*, 69 T.C. 32 (1977); *Estate of Carpenter v. Comm’r.*, 64 T.C.M. (CCH) 1274 (1992); IRS Priv. Ltr. Rul 86-34-004 (May 1, 1986); *Estate of Littick v. Comm’r.*, 31 T.C. 181 (1958); *Estate of Reynolds*, 55 T.C. 172 (1970); *Estate of Slocum v. U.S.*, 256 F. Supp. 753 (S.D.N.Y. 1966). For an excellent review of the numerous cases and Revenue Rulings which establish the historical requirements which must be met in order to bind the Internal Revenue Service, see Keith Schiller, *Buy-Sell and Other Restrictive Agreements: Weaving the Fine Line Between Business Objectives and Estate Tax and the Importance of Consistency*. TAX MGMT. EST. GIFT & TR. J. 1998).

¹⁷⁶ *Rudolph v. United States*, 1993 U.S. Dis. LEXIS 1921, 93-1 U.S. Tax. Cas. (CCH) ¶ 60130 (S.D. Ind. 1993).

¹⁷⁷ *Estate of Weil v. Comm’r.*, 22 T.C. 1267 (1954).

¹⁷⁸ See *Estate of Davis*, 37 T.C.M. (CCH) 341-346 (1978).

market value as of the time of the sale; (iii) but the validity of the determination of the purchase price either by formula or other method is to be determined as of the time the agreement is executed.

All of the standards set forth above, and particularly as specifically described in Treas. Reg. § 20.2031-2(h) (as amended), apply to all agreements entered into on or before October 8, 1990, and with respect to post-October 8, 1990 agreements which have been substantially modified subsequent to such date.¹⁷⁹ In addition, the above requirements continue to be fully applicable with respect to agreements by and among shareholders that are not “natural objects of each other’s bounty.”

B. Rules Subsequent to October 8, 1990

The Omnibus Budget Reconciliation Act of 1990 added Chapter 14 to the Internal Revenue IRC. Under IRC §2703, the IRS is not required to respect the valuation set forth in an agreement between buyers and sellers that are “natural objects of each other’s bounty” (related parties) unless the agreement satisfies all three of the following requirements. The agreement must be:

- (i) a bona fide business arrangement;¹⁸⁰
- (ii) not a device to transfer such property to natural objects of the transferor’s bounty for less than full and adequate consideration in money or money’s worth;¹⁸¹ and
- (iii) by its terms comparable to similar arrangements entered into by persons in an arm’s length transaction.¹⁸²

IRC §2703 applies for estate, gift and generation-skipping transfer tax purposes. It applies only with respect to agreements entered into¹⁸³ or substantially modified¹⁸⁴ after its effective

¹⁷⁹ *Estate of Amlie v. Comm’r.* T.C. Memo. 2006-76, 91 T.C. (CCH) 1017. See also *Smith v. United States*, 2005 U.S. Dist. LEXIS 2471, 2005-2 U.S. Tax Cas. (CCH) ¶ 60508 (W.D. Pa. 2005). Treas. Reg. § 25.2703-1(c)(1), (d) (1992); IRS Priv. Ltr. Rul. 92-48-026 (Sept. 1, 1992); IRS 91-41-043 (July 16, 1991) *modified*, IRS Priv. Ltr. Rul. 92-21-042 (Feb. 24, 1992), See Boyd D. Hudson, *Substantial Modifications of Buy-Sell Agreements*, 27 TAX ADVISOR 598-99 (Oct. 1996).

¹⁸⁰ Treas. Reg. §25.2703-1(b)(1)(i).

¹⁸¹ Treas. Reg. §25.2703-1(b)(1)(ii).

¹⁸² Treas. Reg. §25.2703-1(b)(1)(iii). See discussion of the comparability test in *Estate of Amlie* (TC Memo 2206-76): “By its terms, the statute requires only a showing that the agreement’s terms are “comparable” to similar arrangements entered at arm’s length. While the regulations caution against using “isolated comparables”, we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.”

¹⁸³ See Hudson, *supra* note 128.

¹⁸⁴ See Treas. Reg. §25.2703-1(c) and §25.2703-1(d) (for examples of what is and what is not a substantial modification); IRS Priv. Ltr. Rul. 92-48-026 (Sept. 1, 1992); IRS Priv. Ltr. Rul. 91-41-043 (July 16, 1991).

date of October 8, 1990. Thus, we must be careful of amending pre-October 9, 1990, buy-sell agreements.¹⁸⁵

There are two significant regulations under IRC §2703 which are critical. These regulations provide that all three conditions set forth in IRC §2703 are deemed to be met if (i) 50% or more of the value of the stock is owned directly or indirectly by persons who are not members of the transferor's family.¹⁸⁶ For this purpose, family is defined as the transferor, the transferor's spouse, ancestors of the transferor and the transferor's spouse, and spouses of such transferor and all lineal descendants of the transferor's parents and the transferor's spouse's parents; as well as the natural objects of the transferor's bounty. While attribution does apply, it cannot be applied twice;¹⁸⁷ and (ii) the comparability requirement¹⁸⁸ is met if the agreement could have been obtained in a fair bargain between unrelated parties in the same or similar business, dealing with each other at arms-length and conforming with general business practice resulting in the purchase price and the payment structure to be consistent with anticipated changes in value throughout the life of the agreement.¹⁸⁹

Because of IRC §2703, some commentators suggest that a formula or specific price should not be set forth in the agreement. Instead, the price should be determined by independent appraisal.

C. Summary of Current Test to Fix Value

The shareholder agreement will fix the federal estate, gift and GST tax value of a closely held business interest if all the following requirements are met:

- (i) Ascertainable value: The price must be determinable from the agreement.
- (ii) Restrictions at death: The estate of the business owner must be required to sell; the buyer may be obligated to buy or have an option to buy.
- (iii) Lifetime restrictions: The obligation to sell at the contract price must be binding during lifetime as well as upon death. An option to purchase at the contract price will

¹⁸⁵ In PLR 200625011 (June 23, 2006), the IRS ruled privately that an amendment that clarified that a buy-sell agreement applied only to the nonvoting stock of an S corporation, and not to a separate class of voting stock, was not a substantial modification that would impair the effective date protection afforded the agreement under Code Sec. 2703. The voting stock was owned by a married couple, and the nonvoting stock by their children, and the parties had always intended that the parents have the unrestricted right to transfer their voting stock as they pleased. The IRS stated that the modification was clarifying in nature and that it did not affect the "quality, value or timing of any rights under the Agreement." Therefore, it was not a substantial modification.

¹⁸⁶ Treas. Reg. §25.2703-1(b)(3).

¹⁸⁷ Treas. Reg. §25.2701-2(b)(5)(i) (1992), §25.2703-1(b)(3) (1992).

¹⁸⁸ Treas. Reg. §25.2703-1(b)(4)(iii).

¹⁸⁹ Treas. Reg. §25.2703-1(b); *See Estate of Gloeckner v. Comm'r.*, 71 T.C. M. (CCH) 2548 (1996), *rev'd*, 152 F.3d 208 (2d. Cir. 1998).

meet this requirement, but a right of first refusal to meet an offered price will not. The terms of payment may differ, however, provided they are commercially reasonable. For example, a sale triggered by death may be fully funded with life insurance and would not therefore require additional payments. Therefore a promissory note would not be necessary.

- (iv) Bona fide business arrangement: There is a valid business purpose for the agreement (e.g., continuity of management where a child is in the business). Required before and by IRC §2703.
- (v) Not a device: “[N]ot a device to pass decedent’s [interest] to the natural objects of his bounty for less than an adequate and full consideration in money or money’s worth.”¹⁹⁰ (Required before and by IRC §2703.) This should be satisfied in a family business if the method of determining the contract price was reasonable when the agreement was signed, the agreement provides for a periodic review if a fixed price is used, and the parties abide by the agreement.
- (vi) Comparable to similar arrangements entered into at arm’s length: Added by IRC §2703. Perhaps this standard may only be satisfied by expert testimony. Likely to create great uncertainty as to whether a buy-sell agreement fixes the federal estate tax value of the business interest. As a practical matter, has led to the increased use of the appraisal method for determining the contract price.¹⁹¹

The first taxpayer victory in a case decided under Section 2703 came in *Estate of Amlie v. Comm’r*.¹⁹² In *Amlie* decedent had become unable to manage her own affairs, including her stock in a closely-held bank corporation, and a conservator was appointed. The conservator entered into a 1991 buy-sell agreement with the bank corporation and the controlling shareholder, prohibiting the decedent from transferring her stock without first offering it to the other parties or obtaining their consent, and giving the decedent put options to require the corporation to buy all of decedent’s common shares for its book value. In 1994, the majority shareholder sold his shares to another bank corporation, for book value, plus an employment contract, a signing bonus, retirement of certain capital notes, and an option to exchange his stock of the acquiring corporation for stock of a loan subsidiary corporation after five years. The decedent’s conservator was allowed to exchange the decedent’s stock for the acquiring corporation’s shares, based on their respective book values. The conservator also entered into a new buy-sell agreement that set the price of the decedent’s shares at 1.25 times book value, reflecting the value of the majority ancillary rights under the merger agreement.

The decedent’s son contested the agreement, and a local court rejected it as providing an inadequate price. The conservator settled these disputes by entering into a 1995 Family

¹⁹⁰ Treas. Reg. §20.2031-2(h) (as amended in 1992).

¹⁹¹ *Structuring Buy-Sell Agreements to Fix the Estate Tax Value of a Closely-Held Business Interest*, in XLIX ADVANCED UNDERWRITER (CONN. MUTUAL) No. 4 (Apr. 1995).

¹⁹² T.C. Memo. 2006-76.

Settlement Agreement (the “1995 FSA”), which, in part, restricted the decedent’s lifetime transfers of stock, required that all bequests to the decedent’s son (or his trust) be satisfied with shares of the stock at a fixed dollar value, and gave the trust the right to buy the rest of the stock at that same price. The Tax Court held that the 1995 FSA established the fair market value of the decedent’s shares, and that its terms were comparable to similar arrangements entered into by persons in an arm’s length transaction. The estate’s expert, an attorney with extensive experience in the purchase and sale of closely held equity interests, testified that the 1995 FSA was comparable to arrangements entered into by persons in arm’s length transactions, because the price and structure for the sale of the bank stock in the 1995 FSA was virtually identical to the terms of the earlier agreement that had been reached in arm’s length negotiations between the conservator and the corporation.

The IRS stated that this was insufficient for purposes of Section 2703(b)(3), because it relied on an “isolated comparable.” The Tax Court noted that the Code requires only a showing that the agreement’s terms are comparable to similar arrangements entered at arm’s length. The regulations caution against using isolated comparables, but the court stated that this really creates only a safe harbor, rather than a requirement that multiple comparables be shown. The court added that the price terms included in the 1995 FSA was based on a survey of comparable corporations. The court also cited several other factors as supporting the conclusion that the terms of the 1995 FSA were comparable to arrangements entered into at arm’s length. First, the court noted that identical price terms in the rejected 1994 agreement and the 1995 FSA were reached by negotiations between the conservator, who had a fiduciary duty to safeguard the decedent’s interests, and the corporation. Second, the negotiations among the prospective heirs to reach the 1995 FSA were at arm’s length, because the interests of the prospective heirs other than the decedent’s son were adverse to his interests with respect to the price terms for the stock. Third, an understated price in the 1995 FSA would have penalized the other prospective heirs.

In *Holman v. Commissioner*¹⁹³, the Tax Court held that Section 2703 applied for valuation purposes when valuing interests in a family limited partnership. The Court increased the value of the amount reported as gifts by the taxpayers based on its finding that the partnership had no business purpose and was merely a device to transfer assets to the family. The Tax Court found that the arrangement was a testamentary device and not a bona fide business, since it held only one asset, Dell Computer stock. The Court then went on to value the gifts using the substantially lower discount of 24% rather than the 49% discount reported by the Holmans. In *Fisher v. United States*¹⁹⁴, a District Court held that buy-sell restrictions in an LLC operating agreement could not be taken into account in valuing interests in the LLC for gift tax purposes, because the LLC did not have a bona fide business purpose. The LLC held a parcel of undeveloped lakefront property that was used occasionally by the family members who owned LLC interests.

¹⁹³ 103 T.C. 12 (2008).

¹⁹⁴ No. 1:08-cv-00908, (S.D. Ind. Sept. 1, 2010).

D. Chapter 14 Also Contains §2704

IRC §2704 fundamentally precludes valuation discounts arising by reason of a lapse of certain rights, such as the right to liquidate or dissolve the corporation by reason of death of one of the shareholders. Typically, IRC §2704 only applies to voting rights (for example, voting stock automatically becoming non-voting stock upon a triggering event). The lapse of such a right is treated as a gift, if before and after the last member of the holder's family still controls the corporation.¹⁹⁵ The applicable restriction is disregarded for purposes of determining the valuation of the interest transferred, unless the restriction is commercially reasonable, or the restriction is imposed or required to be imposed by state or federal law.¹⁹⁶

E. Controlling Date

The controlling date is the date at which the valuation must meet the standard. It is relatively clear that the critical date for determining whether the price will be respected by the IRS for transactions not controlled by IRC §2703 is the date on which the agreement was entered into.¹⁹⁷ In *Estate of Blount v. Commissioner*,¹⁹⁸ the Court reaffirmed the need for the agreement to meet the requirements of pre-IRC §2703 law to fix the federal estate tax value of the closely held business interest even when IRC §2703 applies. However, with respect to those agreements entered into after October 8, 1990 (or substantially modified after such date), the agreement must anticipate that the price or method of determining the price will reasonably represent fair market value at the time of the sale.¹⁹⁹

F. Gift Upon Execution of Agreement

No taxable gift occurs upon the execution of a buy-sell agreement, nor should any sales required under the agreement be taxable gifts if adequate consideration is given to all parties and because the agreement and sales are transactions in the ordinary course of business.

G. Undesired Results (Traps)

A shareholders agreement may not fix the gift tax value of stock if the agreement does not prohibit gifts without the written consent of the other shareholders or a right of refusal to the other shareholders.

¹⁹⁵ IRC §2704.

¹⁹⁶ IRC §2704(b); Treas. Reg. §25.2704-1(b) (1992); IRS Priv. Ltr. Rul. 97-10-021 (Dec. 6, 1996); Treas. Reg. §25.2704-1(f) example 1; IRS Priv. Ltr. Rul. 97-35-003 (May 8, 1997); *Estate of Boykin v. Comm'r.*, 53 T.C.M. (CCH) 345 (1987), *See also* Schiller, *supra* note 126.

¹⁹⁷ 64 T.C.M. (CCH) 1643, 1643-61. *See Estate of True v. Comm'r.*, 390 F.3d 1210 (10th Cir. 2004); Schiller, *supra* note 126.

¹⁹⁸ 87 T.C.M. (CCH) 1303 (2004); *rev'd*. 428 F.3d 1338 (11th Cir. 2005).

¹⁹⁹ *See Rudolph v. U. S.*, 93-1 U.S. Tax Cas. (CCH) P60, 130 (S.D. Ind. 1993); *Estate of Gloeckner*, at 2548, *rev'd*, 152 F.3d 208 (2d. Cir. 1998). Treas. Reg. §25.2703-1(b) (1992).

Gift tax implications may arise upon the failure to exercise a favorable purchase right under a shareholder agreement. If an option price is less than the fair market value of the interest, the failure to exercise the option may result in a taxable economic benefit to the other holders.

The estate tax value could exceed the contract purchase price. Thus, the decedent's estate would be required to include in the estate tax return (or at audit) an amount greater than what the estate would receive upon enforcement of the shareholders agreement. This is a particular problem with respect to family-related programs where IRC §2703 applies. For example, if the children could buy the stock at less than true value, the stock would not qualify for the marital deduction, because part of it can be used for the benefit of a person other than the surviving spouse.²⁰⁰

VIII. MARITAL DEDUCTION CONSIDERATIONS

A. Sale of Stock At Less Than Fair Market Value Destroys Marital Deduction.

The use of a buy-sell agreement can, in several ways, affect the availability of the estate tax marital deduction. Business interests transferred to a spouse who is obligated, under a buy-sell agreement, to sell it for a price below its estate tax value, should be treated as terminable interests, even if the estate is only obligated to offer the stock or partnership interests for sale and it is never in fact so sold. Therefore, the marital deduction should not be allowed for the difference between these two figures.

In PLR 9147065, the decedent, D owned 95 percent of the stock of Company and one of his sons owned the remaining 5 percent. D's will left his widow a marital deduction trust in an amount sufficient to reduce his estate taxes to zero. D's will granted each of his sons the right for 2 years to buy from D's executor or trustee a specified percentage (totalling 100 percent) of the Company shares at the price of \$1,000 per share, with payment over 60 months at 9 percent interest. The stock was worth approximately \$11,000 per share. The IRS ruled that, by giving his sons an option to buy the stock at \$1,000 a share, D effectively divided the value of the stock between his sons and the marital trust, reducing the value of the shares in the marital trust to a maximum of \$1,000 per share. As the interest rate on the date of sale was fixed at 9 percent, the actual value could be even lower. The IRS ruled that each son's right was, in effect, a right to appoint a portion of the marital trust to himself, also disqualifying it for the marital deduction. Thus, this ruling reflects the IRS view that if stock or partnership interests must be offered at a bargain price under a buy-sell agreement, the marital deduction, to the extent funded with such interests, will be limited to the buy-sell price.

The existence of a buy-sell type restriction on transfer was held to disqualify the entire marital deduction trust in *Estate of Rinaldi v. U.S.*²⁰¹ where the decedent owned 52.06 percent

²⁰⁰ *Rinaldi*, 38 Fed. Cl. 341 (1997), *aff'd per curiam* 82 AFTR 2d 98-7127 (Fed. Cir. 1998); *McCabe*, 475 F.2d 1142 (Ct. Cl. 1973); IRS Priv. Ltr. Rul. 91-39-001; TAM 91-47-065.

²⁰¹ 38 Fed. Cl. 341 (Ct. Fed. Cl. 1997), *aff'd per curiam* by unpub'd opinion, 178 F.3d 1308 (Fed. Cir. 1998), cert. denied, 526 U.S. 1006 (1999); see also, *Estate of McCabe v. US*, 475 F.2d 1142 (Ct. Cl. 1973); TAM 8843004.

of the common stock of a corporation that operated a printing business. The decedent left his stock to a QTIP marital trust for the benefit of his widow. The decedent's son was named trustee, but the decedent's will stated that the son could serve as trustee only as long as he was actively engaged in managing the corporation. If the son ever became unwilling or unable to continue managing the corporation, he would cease to be trustee and the decedent's widow would become trustee of the QTIP. If the son ceased to serve as trustee, he would be given the right to buy the stock from the QTIP trust for its book value. On the date of the decedent's death, the book value of the decedent's stock was \$1.39 million and the fair market value of those shares was \$1.52 million. If the son declined to buy the stock, the decedent's widow was to look for other buyers and to offer them the stock on reasonable terms. The company elected S corporation status before the decedent's death, and the trustee sought to sell the shares in order to avoid terminating the S election. The corporation's directors agreed to redeem the shares for their fair market value, with \$100,000 paid at closing and the balance paid in installments over a twenty-year period with 8.5 percent interest. The redemption of the shares from the trust was effected not long after the decedent's death. The IRS denied the estate tax marital deduction for the value of the stock passing to the QTIP, and the Court of Federal Claims held that the estate's QTIP election was ineffective to obtain the marital deduction under IRC §2056(b)(7). The court held that the trust did not give the widow a "qualifying income interest for life," because the son could buy the stock at its book value merely by ceasing active management of the company. Such an event would reduce the value of the trust's corpus, creating the equivalent of a "power to appoint any part of the property to any person other than the surviving spouse." IRC §2056(b)(7)(B)(ii). The estate argued that on the date the QTIP election was filed, the estate no longer owned the stock and, therefore, the marital deduction should be allowed. The IRS argued that eligibility for the marital deduction must be based solely on the facts in existence at the time of the testator's death, and that the later sale of the stock was immaterial.

The Court of Federal Claims rejected the IRS contention, based on the cases that have upheld the marital deduction for a QTIP interest that was conditioned upon the executor's selection of QTIP treatment.²⁰² The court still held for the IRS, however, distinguishing *Spencer* and the other cited cases because in *Spencer*, the terms of the testator's will clearly established a valid QTIP trust. In *Rinaldi*, on the other hand, the testamentary trust was ineligible for QTIP treatment—the will explicitly subjected the trust's value to diminution through the potential sale of its assets at a bargain price to someone other than the surviving spouse. Even though the trust owned none of the stock on the date of the QTIP election, it could reacquire shares, which would again give rise to the bargain purchase rights of the decedent's son. The marital deduction was therefore denied. The Court of Appeals for the Federal Circuit affirmed the lower court decision per curiam, in a one-paragraph opinion, and the U.S. Supreme Court denied certiorari.

Rinaldi involved a purchase option created in the decedent's will, but the result would be the same had the option been included in an independent buy-sell agreement. One should be very careful about allowing a discount purchase price for stock that is to be held by a marital trust

²⁰² *Estate of Spencer v. Comm'r*, 43 F.3d 226, 231 (6th Cir. 1995); *Estate of Clayton v. Comm'r*, 976 F.2d 1486, 1490 (5th Cir. 1992); *Estate of Robertson v. Comm'r*, 15 F.3d 779, 71 (8th Cir. 1994).

for the surviving spouse. The purchase option in *Rinaldi* resulted in the complete disallowance of the marital deduction for the stock passing to the QTIP trust. The same result would have occurred had the trust been a general power of appointment marital trust or an estate trust. However, had the stock passed outright to the surviving spouse subject to a purchase option in a buy-sell agreement, the deductible value of the stock should be reduced, but the entire marital deduction should not be eliminated.

The effect of this reduction in the marital deduction can be especially severe if there are few or no other assets from which to pay the additional estate taxes. When these estate taxes must themselves be paid from the assets otherwise qualifying for the marital deduction, the amount passing to the spouse is further reduced, the deductions further diminished, the tax further increased, and then the process is repeated. The net result can often be an estate tax of well over 100 percent of the amounts passing to family members other than the surviving spouse.

B. Non-Productive Assets in Marital Trusts.

The transfer of a business interest to a QTIP or power of appointment marital trust can also raise problems if a buy-sell agreement effectively precludes the spouse from converting the asset into one that produces current income. This was demonstrated in PLR 9147065, discussed above, where the will of the decedent named Son 2 as trustee of the marital trust, and gave the widow the required right to insist that “[u]nproductive property shall not be held as an asset of the Trust for more than a reasonable time during the lifetime of [the surviving spouse]...” The will specifically provided that the trust was to be funded with the Company stock only to the extent that other assets were unavailable, and that Son 1 was to manage Company, vote its stock, and determine the price or any other conditions concerning any sale of its shares. D’s will also stated that “[t]he Trustee shall sell the securities only as and when [Son 1] shall direct and shall follow his direction as to price and other terms and conditions of sale.” The IRS stated that the specific authority to Son 1 overrode the widow’s general right to compel the conversion of nonproductive assets to productive ones, under the ordinary rules of will construction that favor specific clauses over general ones. The widow, therefore, had an income interest in nonproductive assets, and the IRS rightly disqualified that portion of the marital trust that was comprised of Company stock.

C. Sale of Stock For Terminable Interest.

Another situation in which the marital deduction can be affected by a buy-sell agreement is when the agreement provides for a mandatory sale in exchange for a private annuity. IRC §2056(b)(1)(C) denies the marital deduction for a bequest of a non-terminable interest, such as stock or a partnership interest, if a terminable interest “is to be acquired for the surviving spouse; pursuant to direction of the decedent, by his executor or by the trustee of a trust.” Therefore, if stock or a partnership interest is left outright or in trust to a surviving spouse, but the decedent’s personal representative is required to sell the stock or partnership interests to the other parties, under a buy-sell agreement, in exchange for a private annuity, the marital deduction will be lost.

D. Marital Deduction for Undervalued Stock.

*Estate of Lauder v. Commissioner*²⁰³ was the first case to discuss the eligibility for the marital deduction of the difference between the value of the stock and the agreement price. After holding that the buy-sell agreement price was not fair market value because the agreement was a device, the Tax Court allowed the decedent's estate to deduct that part of the differential between the estate tax value of the shares and the agreement price that would inure to the benefit of the decedent's widow, who owned 39.26% of the corporation's shares. The court stated that she received 39.26% of the benefit inuring to the corporation from its discount repurchase of the decedent's shares, and the estate was entitled to another \$8,246,000 marital deduction (39.26% of \$21 million valuation differential). The IRS argued that the marital deduction should not be available because the widow's shares remained subject to the buy-sell agreement and she or her estate would have to sell them for their adjusted book value. The Tax Court disagreed, noting that any such sale by the widow or her estate would be subject to gift or estate tax if the shares were then worth more than their adjusted book value.²⁰⁴ The IRS also argued that the widow's interest in the stock would be a nondeductible terminable interest because she or her estate would ultimately have to resell the shares for the agreement price, had significant technical appeal. However, the Tax Court's holding is consistent with the purpose of the marital deduction, and avoids the possibility of a double tax on the same discount between the agreement price and the unrestricted value of the stock.

E. Valuation for Inclusion Purposes v. Deduction Purposes.

Assets are valued for estate tax inclusion purposes based upon the value of the assets included in the decedent's estate. Assets are valued for estate tax deductibility purposes based upon the value of the property interest passing in a manner that qualifies for the estate tax marital or charitable deduction. The often cited example of this principle is the decedent who owns 100% of the stock of a closely held business worth \$10,000,000. The decedent leaves 50% of her estate to her husband in a manner that qualifies for the estate tax marital deduction under IRC §2056 and 50% of her estate to a charity which qualifies for the estate tax charitable deduction under IRC §2055. The stock is included in the decedent's estate at \$10,000,000; however, for estate tax deduction purposes, each 50% interest may be discounted for lack of marketability and lack of control. Assuming a combined 35% discount, the value of the marital deduction is determined as follows: $(50\% \times \$10,000,000) \times (1 - 35\%) = \$3,250,000$; the charitable deduction is determined similarly. Therefore, with a gross estate of \$10,000,000 and combined estate tax marital and charitable deductions of \$6,500,000 ($\$3,250,000 + \$3,250,000$), there is a taxable estate of \$3,500,000.²⁰⁵

²⁰³ T.C. Memo. 1994-527.

²⁰⁴ Cf. PLR 9147065.

²⁰⁵ See, Pennell, "Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice", 1996 U. Miami Philip E. Heckerling Inst. Est. Planning § 9.02.

In *Ahmanson Foundation v. United States*²⁰⁶, the decedent owned 100% of the stock of a holding company with 1 voting share and 99 non-voting shares. The decedent left the 1 voting share to his son and the 99 non-voting shares to a charity. The Court refused to value the voting and non-voting stock separately in the gross estate. The Court found that 100% of the stock should be valued for inclusion purposes, and then a 3% reduction should be applied to the value of the non-voting shares passing to charity. The reduction in the value of the assets passing to charity had the effect of reducing the charitable deduction and increasing the taxable estate.

In *Chenoweth v. Commissioner*,²⁰⁷ the decedent owned 100% of the stock of a closely held corporation. The decedent specifically bequeathed 51% of the stock to his wife, with the balance passing to his daughter from a prior marriage. The decedent's estate claimed a 38.1% control premium applied to the 51% block of stock, which under Florida law, gave the surviving spouse complete control over the corporation. The Court was persuaded by the reasoning in *Ahmanson* and concluded that a control premium should be applied to the value of the 51% block of stock passing to Mrs. Chenoweth. Interestingly the court noted the following: "While we would tend to agree that the sum of the parts cannot equal more than the whole -- that is, that the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100% interest of the decedent, as reported for purposes of section 2031 -- it might well turn out that the sum of the parts can equal less than the whole -- that is, that the control premium which is added to the majority block passing to decedent's surviving spouse might be less than the proper minority discount to be attributed to the shares passing to decedent's daughter."

Additional cases and ruling have followed the progeny of *Ahmanson Foundation* and *Chenoweth*.

- (i) Tech. Adv. Mem. 9005004 is essentially the reverse of *Chenoweth*. In this case, the decedent left 49% in trust for his wife and 51% in trust for his son. The Service ruled that the value of the interest passing to the marital trust should be valued as a separate interest in property and could, therefore, be subject to a minority interest discount. This will have the effect of reducing the marital deduction and increasing the value of the taxable estate.
- (ii) Tech. Adv. Mem. 9403005. At the time of his death, the decedent owned a block of 400 preferred shares in a closely held corporation and a block of 37,728 common shares. Together, the two blocks of stock represented control of the corporation; separately they represented non-controlling interests. The decedent left the preferred stock to his wife and the common to his children. The Service ruled that "[i]f, as in the present case, a minority interest block of stock passes to the surviving spouse, a marital deduction may be taken for only for the value of the block as such. However, in accordance with the holdings in the *Ahmanson* and *Chenoweth* cases, the value of

²⁰⁶ 706 F.2d 1424 (7th Cir. 1983).

²⁰⁷ 88 T.C. 1577 (1987).

the same property for purposes of inclusion in the gross estate under IRC §2031 may be different if the decedent, at the time of death, possessed a controlling interest block of stock.

- (iii) *Estate of DiSanto v. Commissioner.*²⁰⁸ The decedent owned a controlling interest in a closely held corporation that he left to his wife. His wife disclaimed her right to inherit a certain amount of the stock, the result being that the only asset in the decedent's residuary estate that the wife could inherit was a minority interest in the stock. The Tax Court, relying on *Chenoweth*, held that the estate must compute the value of the marital deduction based on the minority interest the spouse was entitled to receive after she executed the disclaimer, not based on the value of the controlling interest he willed to her.
- (iv) *Schwan v. Commissioner.*²⁰⁹ Alfred Schwan, founder of a frozen food company, left 2/3rds of the voting and non-voting stock to a private foundation. The shares were subject to a redemption agreement with the Company. The Tax Court held, at a summary judgment hearing, that while the interests may be aggregated for inclusion purposes, for deduction purposes, the interests may be valued separately. Consequently, there may be a mismatch between valuation for inclusion and deduction purposes and additional tax may be due.

IX. TERMS OF PURCHASE & CLOSING

A. Dates

1. Effective Date of Transfer

The effective date of transfer should be stated in the agreement. Normally this would be as of the date on which the event occurred. Thus, for example, with death or disability, the effective date of transfer would be the date of death or the date on which the disability first occurred, notwithstanding that the disability period and the determination of permanency may extend beyond that date.

2. Valuation Date

The valuation date should also be stated. It may be useful to state that this is the last day of a fiscal quarter immediately preceding the effective date. In some cases, depending on the nature of business, the valuation date may be the last day of the preceding month or the last day of the preceding accounting period. Care should be taken, however, in fixing the value for gift, estate and GST tax purposes to make sure that no significant events which would

²⁰⁸ T.C. Memo 1999-421.

²⁰⁹ T.C. Memo 2001-174.

result in an invalid valuation have occurred between the valuation date and the effective date.²¹⁰

3. Closing

The closing and effective date of the sale and exchange of shares may be simultaneous, although normally the effective date is the date of the triggering event, and the closing date is typically subsequent to that date, once the valuation can be determined. A customary condition precedent to closing the sale triggered by the death of a shareholder will require that court approval of the sale must be obtained. As stated earlier in this outline, frequently, it is important to have the effective date significantly precede the closing. For example, with an S corporation you might want the sale to occur effective on the date of death or other triggering date, even though it might be impossible to actually close on such a date. Closing in escrow is generally available. This is particularly important with respect to a trigger based on disability when the disability is deemed to have occurred after the lapse of a significant period of time. In that case, it is again important to require that the transaction be deemed to have occurred as of the onset of disability.

B. Debt Financing

To the extent that insurance proceeds, if any, are not sufficient to pay the full purchase price at closing, the balance is typically evidenced by a promissory note.

1. Interest

The note should bear a reasonable and adequate rate of interest. The IRS publishes monthly tables indicating adequate rates of interest for debt obligations. Where interest is below the rate required by the IRS, or if an adequate rate of interest is stated but interest is not paid currently, a portion of the principal amount of the note will be recharacterized as interest. The rate of interest may be fixed or variable and payments of principal and interest under the note could be required on a monthly or annual basis.

2. Payment Terms

If it is not possible to determine what the purchase price (or the balance of the purchase price in excess of insurance proceeds) will be as of the time the note is executed, the amount of each installment would also not be ascertainable. To add some degree of certainty and to allow for appropriate budgeting and forecasting, the note may set forth a specific amount for each payment. The term of the note would not be ascertainable but the payment would be. The note could contain a provision which states that interest and principal will be paid in equal monthly installments over a set period of months. However, no monthly payment of

²¹⁰ See Louis A. Mezzullo, *Buy-Sell Agreements and Related Tax Issues for the Closely Held Business* (July 21-24, 2004, Santa Fe, N.M.) in ALI-ABA Course of Study: Estate Planning for the Family Business Owner at 81; Myron E. Sildon, *Buy/Sell Agreements: Alternate Approaches and Practical Solutions, Including Sample Provisions* (July 5-7, 2001, Boston, Mass.) in ALI-ABA Course of Study; Estate Planning for the Family Business Owner.

principal will be more than X or less than Y. To the extent required, the term of this note will be reduced or extended. The note may also provide for payment of not less than a certain dollar amount in order to avoid financing a nominal amount over a long period.

3. Subordination

When a promissory note is given as payment for the purchase price established under a shareholder agreement and the note is secured by a pledge of the business assets, the note should state whether it is or will be subordinate to any subsequent debt incurred with respect to the pledged assets. If the note is not to be subordinated, the ability of the business to borrow against those assets to finance working capital may be severally restricted. As an alternative to unlimited subordination, the note may provide that it is subordinate only on the borrowers' default on certain bank loans or only to certain loans from institutional lenders. Subordination does not create a second class of stock for determining S status.

4. Default & Acceleration

The circumstances under which the obligor may be considered in default may include failure to make a timely payment under the terms of a note, but might also include impairments to the collateral securing the note or the breach of an affirmative covenant. Similarly, it is generally appropriate to require acceleration should the obligor "sell out" by the sale of substantially all the corporate assets, merger, or the same of more than 50% of the stock of the corporation by the remaining shareholders.

Default might cause payments made prior to the default to be treated as dividend distributions if the default causes the stock pledged as security to be returned to the withdrawn shareholder. It may be possible to prevent dividend treatment by prohibiting the purchase by the secured party, thus requiring the "foreclosures" sale to be made to a third party.

A default, as well as certain other occurrences, generally triggers acceleration of the remaining balance of the note, as well as the interest thereon.

5. Bank Financing

Another alternative to financing payment of a lifetime or death sale is for the purchaser to borrow the funds from a bank or other lending institution and pay the purchase price in full. To facilitate financing for this purpose a shareholders agreement's general prohibition to pledging the ownership interest as collateral should provide an exception for financing the purchase price under the agreement, but require that in the event of a default, the collateral is to be purchased by the remaining owners in order to satisfy the bank debt. In this way, foreclosure will not cause the interests to be sold to individuals not connected with the business or family.

6. Deduction of Interest

The deductibility of interest paid on debt incurred or given to pay for the purchase of an ownership interest is subject to the interest allocation and passive loss rules.²¹¹ The allocations rules are complex and there are currently many unanswered questions as to how the rules work when a redemption agreement is used by an S corporation. While a complete discussion of these rules is beyond the scope of this outline, presently existing regulations and guidance generally provide that interest:²¹²

- (i) Paid or accrued by closely-held corporation (50% or more of the stock is owned by five or fewer shareholders) in a redemption agreement will generally be deductible against active trade or business income or passive activity income.
- (ii) Paid or accrued by an S shareholder in a cross-purchase agreement will generally be treated as non-passive interest deductible against all types of income if the assets of the S corporation are used in a trade or business (other than a rental activity) and the S shareholder materially participates in such trade or business as an employee. If he (they) do not materially participate, or only a rental business is conducted, then the interest will be passive interest, generally deductible only against passive income.

If the assets of the corporation or partnership are not rental property but are only held for investment and not used to conduct a trade or business, then the interest will be investment interest and deductible only to the extent of investment income. Further, if the corporation is an S corporation, S status may be lost if the corporation has accumulated C corporation earnings and profits.²¹³

7. Security for Note

A pledge of stock or other collateral by the buyer is often used to secure payment of the purchase price. The pledged interest may be held in escrow or in trust. The note may also be secured by the business assets of the corporation or partnership, or other assets of the obligor.

The seller may retain a board seat, or an alternate director may be appointed by the deceased shareholder's representative, and the seller may reserve voting rights on the shares sold until the buyer has paid the purchase price in full. The promissory note and security agreement may contain covenants regarding the financial condition of the corporation and limitations on dividends and compensation paid to the remaining shareholders/employees. If there is concern that the other shareholders (who are presumably parties to the same agreement) might "siphon" assets from the corporation (such as in excess compensation, dividends, or more indirect means), the agreement can require them to personally guarantee the note and contain a "due on sale" clause if there is a change in control at the ownership level.

²¹¹ IRC §163(h) (personal interest); IRC §163(j)(1) (related party limitation).

²¹² *Id.*

²¹³ IRC §162(d)3.

However, if the intent is to qualify as a “capital” transaction, compliance with IRC §302(b)(3) may be difficult. IRC §302(b)(3) – the complete termination of interest rules – may preclude a continuing relationship with the corporation. Compliance is not necessary for a cross-purchase agreement.

The note may also be secured by a personal or corporate guarantee. However, a corporate guaranty or the collaboration of corporate assets to secure personal shareholders indebtedness (cross purchase) could be a constructive dividend. If required, consider a payment by the shareholders to the corporation for the pledge of its assets or guaranty. This is similar to purchasing a letter of credit or a bond. In a cross-purchase agreement where one note is given to the deceased or withdrawing owner, the obligation to pay the note may involve several remaining owners. In such a circumstance, it may be appropriate that the obligation be both joint and several among the remaining owners or merely several.

The note may also contain affirmative covenants which prevent: (i) the creation of any security interest in favor of other owners; (ii) the declaration of dividends or increases in key employee salaries unless a specific amount is maintained as a reserve; or (iii) require the maintenance of certain financial ratios (i.e., debt to equity).

8. Multiple Purchases

The financial ability of a purchaser under either a redemption or cross-purchase agreement to pay the purchase price is usually limited. If multiple purchases are required in a relatively short period of time, such as the death of an owner followed by retirement of another, the financial hardship of the purchases may cause a default. To prevent such a burden on the purchaser and to help assure sufficient cash flow, a shareholders agreement may provide that in the event more than one owner is to be bought-out: (i) payment of the purchase price is to proceed in the order the triggering events occurred, or (ii) regardless of how many purchases are to be made within a short time under the agreement, the maximum amount paid towards all purchases is capped at some annual amount, with this amount split among the deceased or withdrawing owners equally, or pro rata based on price.

C. Self-Executing

The agreement may contain a provision that each shareholder subject thereto shall execute an assignment separate from certificate (stock power) in blank and deliver it to the secretary of the corporation. Thus upon a triggering event, the sale can be finalized by the corporation without action by the selling shareholder. Alternatively, the agreement may require that the shareholder grant the corporate secretary a limited power of attorney to execute and deliver all documents necessary to effectuate the agreement. This may be helpful in the case of a non-permitted transfer where the corporation and/or remaining shareholders acquire a right of first refusal and the selling shareholder resists delivering an executed stock power or negotiated certificate. Many advisors prefer that executed stock powers be held by an escrow agent, together with a collateral assignment of insurance proceeds or, in the alternative, naming the escrow agent as the designated beneficiary of the policy. Be sensitive to transfer

for value rules under IRC §101(a)(2) and any incidents of ownership being held by the secretary or the escrow agent.²¹⁴

D. Paying the Purchase Price into Escrow

If the seller cannot be found, cannot be identified (such as upon a death when no estate has been opened or there is a will contest), and the seller is not cooperating, it may be important for the purchaser to be able to pay for the stock and thus avoid issues regarding whether the stock has actually been transferred. A pre-determined escrow closing can solve this problem, provided the shares (endorsed in blank), insurance (if any), and notes (if required) are also escrowed.

X. INSURANCE

A. Need for Insurance

Insurance is the most popular method of funding all or part of the payment of the purchase price under a shareholder agreement when the triggering event is death or disability. Insurance provides the following advantages:

- (i) Cash is available upon death or disability of an insured equity owner to pay to the seller all or a substantial part of the purchase price.
- (ii) Cash is available upon death or disability of an insured equity owner to help the business recover from the financial effect on business operations, including loss of business, expenditures to regain the business, and expenses of hiring a suitable replacement.
- (iii) Depending on ages and insurability, life insurance and disability buy-out insurance could be a reasonably inexpensive means for a buyer to raise to funds to purchase a deceased or disabled equity owner's interest.
- (iv) Except to the extent of the premiums, insurance maintains the capital for the entity or the individuals for other purposes. Payment of the purchase price out of earnings or surplus of a corporation or other entity may adversely affect continued profitability.
- (v) As cash values build up, cash values can be used to provide a down payment for a terminating (but not deceased) equity owner's interest.
- (vi) Policy proceeds may be a source of funds to purchase an equity owner's interest when loan documents with banks prohibit or severely limit the ability of an entity to pay the purchase price out of earnings (although the bank may require insurance policies owned by the purchaser to be pledged to the bank for collateral.)

²¹⁴ IRC §2042.

The type of life insurance contract purchased will have major consequences. If the shareholders are relatively young and insurable, it is not a significant cash outlay to purchase insurance on their lives. Although use of convertible (or non-convertible) term policies can lock in insurability and rates for some period of time, as the shareholders age or become ill it may no longer be possible to purchase affordable term insurance. Alternatively, the purchase of permanent insurance will be a significant cash outlay and may create tax issues.

Life insurance can be a windfall to the surviving shareholder. For example, if the corporation is worth \$2 million and has two equal shareholders (A and B, and B is 20 years older than A), and each shareholder owns a \$1 million policy on the other's life, on A's death B will own a \$2 million company and A's estate will have \$1 million in cash that will be subject to estate tax. After a period of years, A will have paid much more in premiums on a term policy on B's life than the premiums paid by B on A's policy, since B is older. A's family would have been better off acquiring a \$1 million policy on A's life through an irrevocable insurance trust and thus receive that cash estate-tax free, and then be paid \$1 million by B for half of the company. This will not necessarily be a hardship on B, particularly if B now has double the cash flow from the compensation and profits that previously went to A.

If disability is one of the triggers, then the shareholders may be able to purchase disability buy-out insurance, which provides cash to fund a buy-sell agreement if an owner becomes disabled.²¹⁵ It may not be as available or cost-effective as life insurance, however, and the definition of disability in the policy may not match the definition the shareholders want to use for the buy-sell trigger. Further, a careful review of the policy must be made. Many disability buy-out policies do not provide for payment until after a specific period of time. In some cases, the payments are made over a rather extensive period of time. Recollection of two particular cases we were involved in points this up rather well:

(i) One policy specifically stated that disability insurance would become payable upon the expiration of six months following the termination of employment by reason of disability. The policy further stated that the payment of \$1 million would be payable then over a period of 10 years without interest. Discounting the \$1 million to present interest indicate that the corporation was paying the sole premium for effectively less than \$650,000, though the policy's face clearly indicated \$1 million in coverage.

(ii) In another case, the full proceeds were payable 18 months after the finding of total and permanent disability, again applying a discount indicated that the face value was not the true economic result.

There are often non-insurable triggers for the buy-sell, like termination of employment, which may be more likely to occur than death or disability. If the corporation or other shareholders cannot afford to purchase the stock on death or disability without insurance to fund it, how can they afford to purchase it in these other circumstances? Conversely, if they

²¹⁵ For an excellent review, see Brad M. Kaplan, *Disability Insurance Fills a Need for Buy-Sell Agreements*, 62 PRAC. TAX STRATEGIES 341 (June 1999).

can afford to purchase on termination of employment, why should they go to the expense of purchasing insurance?

B. How Much

In determining how much insurance to purchase, the first question is whether the goal is to provide insurance proceeds for the entire purchase price or just for the initial down payment. Many shareholder agreements require that insurance be purchased in a minimum amount on the lives of the shareholders to guarantee that at least some cash will be available to buy out the interest of a deceased shareholder. If the price can be paid over time out of cash flow, there is less reason to insure the full amount. Obviously the affordability of the insurance will be a practical factor in the amount of coverage purchased.

As time passes, the amount of insurance needed will constantly change regardless of the method chosen for determining the purchase price of the shares. Even a “set dollar amount” valuation method is usually determined annually by the board of directors or shareholders. Once the amount is initially established, it is important to periodically review the amount of insurance coverage.

If the purchase price is calculable without an appraisal (such as a set dollar amount), the amount of insurance needed will be more easily determined. If, however, the price of the shares is to be based on an appraisal, ascertaining the amount of coverage needed becomes more complex.

If the shareholders agreement provides that the shares will be valued at the higher of the fair market value or insurance proceeds received, and the shareholders are young, the shareholders or corporation may be inclined to purchase term insurance well in excess of the current value of the shares to allow for future increases in value.

A shareholders agreement should prevent disputes regarding proceeds in excess of the purchase price by expressly providing how any excess proceeds are to be handled. A possible use for the excess proceeds may be to fund a deferred compensation agreement for the benefit of a deceased owner’s spouse or family. If nothing is stated to the contrary in the agreement, the “excess” proceeds will belong to the beneficiary of the policy.

C. Income Tax Issues

Under a cross-purchase, redemption or hybrid agreement, the amount paid as premiums is not income tax deductible.²¹⁶ Therefore, the comparative tax brackets of the individuals and the entity involved should be considered in deciding whether to use the redemption or cross-purchase approach. This distinction is really only applicable if the entity is a C corporation. S corporations, partnerships and LLCs are pass-through entities and, therefore, the “taxpayers” are the shareholders in either case.

²¹⁶ IRC §264(a)(1) (U.S.C.S. 2011).

Premiums paid by an S corporation on policies owned by shareholders to fund a purchase under a cross-purchase agreement may create phantom taxable income to the shareholders. An S Corporation distribution to its shareholders to pay cross-purchase insurance premiums is income tax-free but also reduces the shareholders' stock basis. If the shareholder has little or no basis, a distribution in excess of basis will be taxed as capital gain.²¹⁷ If the amount of premiums paid by an S corporation on policies owned by its shareholders is treated as dividend distribution and is not in the same proportion as the relative ownership percentages of the shareholders, there is a risk that the non-prorata dividend distribution may be viewed as a creating second class of stock which will involuntarily terminate the corporation's S election.²¹⁸

If a C corporation has accumulated earnings and profits and converts to an S corporation ("tainted S corporation"), a distribution to its shareholders may be treated as ordinary income if the distribution exceeds the accumulated adjustments account ("AAA").²¹⁹ When a C corporation as policy owner/beneficiary pays premiums on a policy insuring the life of a shareholder and is the purchaser pursuant to the agreement, those premiums will not be taxed to the shareholder as either a constructive dividend or as salary.

Receipt of the insurance proceeds by a C corporation under a redemption agreement may cause the corporation to be subject to, or increase the corporation's liability for, the alternative minimum tax.²²⁰ Insurance proceeds increase "book income" which is treated as a tax preference. The corporate AMT is not a problem where the proceeds are received by an S corporation, partnership, LLC, individual co-shareholders or partners of the insured. Thus, there is no AMT concern with a cross-purchase agreement.

In addition, insurance proceeds, though not subject to income tax (except with respect to transfer for value rules and the alternative minimum tax) do increase earnings. Thus, if the proceeds are substantial and, when added to the previously existing earnings and profits, exceed the threshold under IRC §535 pertaining to the accumulated earnings tax, and the proceeds received exceed the corporation's obligation under the agreement, a constructive dividend may occur.

D. Policy Owner

Whether the corporation or the shareholders purchases the insurance will depend on the type of agreement. The insurance should be owned by and payable to the party obligated to purchase the deceased shareholder's shares. If the agreement is a corporate redemption, the corporation should purchase, own, and be the beneficiary of the insurance. If the shareholders agreement is a cross purchase, each shareholder will be responsible for

²¹⁷ IRC §1367(a)(2), §1368(b)(2) (U.S.C.S. 2011).

²¹⁸ IRC §1361(b)(1)(D), §1362(d)(2) (U.S.C.S. 2011).

²¹⁹ IRC §1368(c)(2) (U.S.C.S. 2011).

²²⁰ IRC §55, §56 (U.S.C.S. 2011).

purchasing the insurance to fund the purchase price. With a cross-purchase agreement, if there are more than two owners, multiple policies will be necessary. Thus, the use of a partnership described at Article X Section H may be more appropriate.

E. Insurance as Part of Gross Estate

In order to avoid the inclusion of insurance proceeds as well as the value of the shares in the gross estate of the deceased shareholder, the insurance policy should not be owned by the deceased nor should the proceeds be directly payable to the estate of the deceased owner.²²¹

If a cross-purchase agreement is used, the proceeds of policies on the life of a deceased shareholder which are owned by other shareholders will not be includable in the decedent's gross estate. However, cash values (plus premiums paid but unearned as of the date of death) with respect to the policies the decedent personally owned on the surviving shareholders' lives will be included. When life insurance is owned and is payable outside of the corporation, the policy death benefits will also be excluded for purposes of valuing the insured's stock to be purchased.

In a corporate redemption agreement, the cash value of all policies owned by the corporation constitutes an asset of that corporation and would therefore be considered in valuing that corporation's stock which may increase the value in the deceased shareholder's estate.²²² If corporate owned insurance proceeds are to be excluded for valuation purposes, the valuation date should be fixed as of the end of the month preceding the date of the shareholder's death or onset of disability. In addition, the shareholders agreement should specifically provide that the value of proceeds from any insurance owned by the corporation, over the cash value on the date of death, should not be taken into account for valuation purposes.

To ensure exclusion of the policy proceeds from the insured's gross estate, it is important to limit the insured from having the types of control over the policy which would result in him or her being deemed to have an incidents of ownership, such as the ability to borrow. Insurance proceeds paid by reason of the death of a "controlling" shareholder, partner or member pose special problems under IRC §2042. The IRS has attempted on numerous occasions to include the insurance proceeds as well as the value of the stock of the decedent as assets of the estate in those situations where the insured decedent was a controlling shareholder of the corporation. However, if the life insurance is owned by and payable to the corporation, the insurance is not included in the controlling shareholder's estate separately but is "considered" in valuing the shareholder's interest in the corporation.²²³

A shareholders agreement should not provide that if an owner sells an interest in the entity to the other owners, he or she may purchase the life insurance policy on his or her life. A mere

²²¹ IRC §2042 (U.S.C.S. 2011).

²²² *Estate of Blount*, 428 F.3d at 1346.

²²³ See Treas. Reg. §20.2042-1(c)(6) and §20.2031-2(f); Estate John T. H. Mitchell, 37 BTA 1, 5-6 (1938); Estate of Alexander, 25 T.C. 600 (1955).

option to allow the insured to purchase the policy for its fair market value may constitute an “incident of ownership” which would result in the inclusion of the insurance proceeds in the insured’s gross estate if he or she dies still owning an interest in the corporation.²²⁴ It is probably safer to be silent on this and leave it for negotiation at the time. If you are including such a provision, however, make sure that any rights an insured might have to purchase a policy others hold on his/her life arise only as a collateral consequence of acts or events of independent significance, so that they do not constitute an incident of ownership.²²⁵

F. Transfer for Value Rule

IRC §101(a)(1) states the general rule that life insurance proceeds are income tax free. IRC §101(a)(2), however, provides that life insurance proceeds are income taxable if the insurance contract is transferred for a “valuable consideration.” This is known as the “transfer-for-value” rule. There are several key exceptions for the rule. When the transferee takes a substituted basis, in whole or in part, the transfer-for-value rule does not apply. Also, the rule may not apply if the transferee is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or an officer.

The transfer of life insurance owned by a corporation must be done in a manner which will come within the exceptions to the transfer-for-value rules of IRC §101(a)(2). This is frequently a problem when converting a corporate redemption agreement into a cross-purchase agreement because the corporate-owned policies would have to be transferred to the insured’s co-shareholders, not to the insured. The transferee being a co-shareholder with the insured is not one of the exceptions to the transfer-for-value rule. Unless one of the stated exceptions applies, distributing a corporate owned policy to someone other than the insured would result in the death proceeds in excess of the total consideration paid for the policy (if any) and all premiums paid by the “owners” after the transfer being subject to income taxation.

When converting a corporate redemption agreement to a cross-purchase agreement, one option for avoiding the transfer-for-value rule when the corporation distributes its policies to shareholders other than the insured is for the insured shareholder and the distribute shareholders to also be partners in a partnership.²²⁶ Another idea is for the corporation to contribute its policies to a partnership in exchange for a partnership interest and then distribute the partnership interest, rather than the policies, to its shareholders.

Once a cross-purchase agreement is triggered by the death of an owner, the deceased owner’s policies on the lives of the surviving owners are still necessary to fund the buy-outs of the

²²⁴ IRC §2042 (U.S.C.S. 2011). *But See, Estate of Smith v. Comm’r.*, 73 T.C. 307 (1979), acq. 1981-2 C.B. 1 (1981). *Compare First Nat’l Bank of Birmingham v. U.S.*, 64-2 U.S. Tax Cas. (CCH) P12,252 (N.D. Ga. 1964), rev’d 358 F.2d 625 (5th Cir. 1966).

²²⁵ Priv.Ltr. Rul 8049002.

²²⁶ IRS Priv. Ltr. Rul. 98-43-023 (July 24, 1998); IRS Priv. Ltr. Rul. 1999-05-010 (Oct. 30, 1998) (majority shareholder); IRS Priv. Ltr. Rul. 98-43-023 (July 24, 1998).

remaining owners. To avoid the transfer-for-value problem, and in many cases to avoid the necessity for multiple policies if there are more than two owners, some arrangements provide for a pooled ownership of the policies.²²⁷

If a shareholder sells his or her interest in the corporation prior to the date of his or her death, the policies on the life of the selling shareholder are no longer needed to fund a buy out of that insured. In that case, the parties may wish to transfer the policies on the life of the selling shareholder to that shareholder. One of the exceptions to the transfer-for-value rule is a transfer of the policy to the insured. As a result, no transfer-for-value issue should arise if the policy is transferred to the shareholder/insured after a buy-out.

G. Trustee or Escrow Arrangement to Hold Insurance

In order to ameliorate the problem of multiple shareholders requiring multiple policies, a trustee or escrow arrangement can be used. If the trust is used to hold the policies, the trust would have to qualify as a grantor trust under IRC §671 to §677. To avoid the transfer-for-value rule upon the death of a particular owner, the trustees agreement or escrow arrangement could specifically indicate that the grantors of the trust are not owners or beneficiaries and the sole rights of any deceased or withdrawn owner of the entity is merely that of a creditor. There is little authority for this position, however, and it is not recommended.

Since transfer-for-value problems may still exist if an escrow arrangement is used, it is preferable to use the trustees or escrow agreements only when a bona fide partnership which includes all of the parties to the cross-purchase agreement also exists. A more cautious approach would be to have all of the shareholders of a corporation form a partnership.

In a cross-purchase agreement, a collateral assignment of a shareholder owned policy to an escrow, trust, or partnership requiring the proceeds to be applied in accordance with the shareholders agreement adds a measure of security that the policy proceeds will not be diverted to other uses. Collaterally assigning policies to a trustees or escrow arrangement that discharges the cross-purchase obligation will not prevent the purchasing owners from being treated as having paid the purchase price in order to obtain an increase in the cost basis of the purchased ownership interest.

H. Partnership to Own Insurance

1. Advantages

The use of a partnership to own life insurance has a number of advantages and has been approved by the IRS,²²⁸ both for a cross-purchase agreement and corporate redemption. The

²²⁷ IRS Priv. Ltr. Rul. 94-10-039 (Dec. 14, 1993).

²²⁸ See, IRC §101(a)(2)(B) (U.S.C.S. 2011); IRS Priv. Ltr. Rul. 90-12-063 (Dec. 28, 1989); IRS Priv. Ltr. Rul. 93-28-010 (Apr. 16, 1993); IRS Priv. Ltr. Rul. 93-28-011 (Apr. 16, 1993); IRS Priv. Ltr. Rul. 93-28-012 (Apr. 16, 1993); IRS Priv. Ltr. Rul. 93-28-017 (Apr. 16, 1993); IRS Priv. Ltr. Rul. 93-28-019 (Apr. 16, 1993); IRS Priv. Ltr. Rul. 93-28-020 (Apr. 16, 1993).

partnership will be owned by the shareholders (all those who are subject to the buy-sell obligations) and will be the owner of a life insurance policy on the life of each shareholder. An LLC can also be used for this purpose with substantially the same effect.²²⁹ References in this Section to a partnership therefore also include references to an LLC.

Advantages of a partnership owning buy-sell insurance include the following:

- (i) Avoids the need for multiple policies on each insured.
- (ii) Allocation of premiums and proceeds among the partners is determined by the partnership agreement.
- (iii) May, if desired, effectively equalize premium costs for life insurance policies among the partners.
- (iv) Allows premium payments to be made by one administrator.
- (v) Provides administrative ease by allowing the stock certificates or membership or partnership units to be held by the trustee or escrow agent and immediately delivered upon receipt and distribution of the consideration.
- (vi) Eliminates or severely reduces exposure of policy proceeds to creditor and matrimonial issues of a stock purchaser.
- (vii) The stock redemption issues under IRC §302 and §303 are not applicable to the selling shareholder.
- (viii) Avoids an insured having incidents of ownership in a policy on his or her life that would cause inclusion of the policy death benefit in the insured's gross estate.
- (ix) Avoids application of transfer-for-value rule to policy transfers.
- (x) IRS has ruled that the transfer of life insurance policies by individuals and trusts to a partnership is permissible without adverse income or estate tax consequences.²³⁰

²²⁹ There are unanswered questions on the applicability of certain partnership tax provisions to LLC's. This includes basis issues relating to debt; *see* IRC §752 (U.S.C.S. 2011); Treas. Reg. §1.752-1(a)(1) (1991), (2)(c),(d) (1992) (Economic Risk); Treas. Reg. §1.752-2(e)(1992) (Non-Resource Financing); Treas. Reg. §1.704-1(b)(2)(ii)(d)(3) (as amended in 2005) (Qualified Income Offset); MCKEE, NELSON & WHITMORE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS (3d. 1997). Also, is a limited partner treated the same as a "member" of an LLC? Further, the definition of a "related party" under Reg. §1.752-4(b)(1) may not be applicable to LLCs.

²³⁰ IRS Priv. Ltr. Rul. 2000-17-051 (Jan. 24, 2000); *See* Kupferberg & Wolf, *Transferring Life Insurance Policies To A New Partnership*, 20 EST. PLAN 340 (1993); Levy, *The Life Insurance Partnership; A Promising Solution to Transferring Life Insurance Policies From A Corporation?* 48 J. AM. SOC'Y CLU & CHFC 64 (Jan. 1994); Richard Scolaro, *Coupling Insurance-Funded Buy-Sell Agreements with a Partnership: A Preferred Approach*, 55 J. Fin. Serv. Prof. 39 (Sept 2001).

- (xi) Allows pass through tax treatment for policy proceeds even though the stock to be purchased is of a C corporation.
- (xii) Partnerships are not subject to the AMT.
- (xiii) The basis of a partner's interests in the partnership will be increased by its allocable share of the tax-free policy proceeds received at the insured's death (including the portion of the proceeds allocable to the interest of the insured, which would have received a stepped-up basis at death in any event).
- (xiv) The purchase price of a partnership interest may be allocated to the basis of assets owned by the entity and deemed indirectly owned by the purchaser.²³¹
- (xv) If the event triggering a stock purchase is not death, the cash surrender value of a policy would be available under the insurance contract. In addition, insurance proceeds can be used to pay premiums on other policies.
- (xvi) Tax attributes upon liquidation of the partnership are controllable.

The IRS has expressly approved of a partnership created for the sole purpose of receiving and maintaining insurance policies.²³² The ruling indicated that the life insurance proceeds would be reflected in the surviving partner's distributive share as tax-exempt income.²³³ The rulings also hold that any proceeds of the life insurance policies distributed to the surviving partner would not be taxable.²³⁴ Since the advent of the "check-the-box" regulations in 1997, the uncertainty about whether a non-corporate domestic business entity would be treated as a "partnership" instead of a "corporation" for federal income tax purposes no longer exists.²³⁵ However, the IRS has announced it will not rule on whether, in connection with the transfer of a life insurance policy to an unincorporated organization, the organization will be treated as a "partnership" for federal income tax purposes when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of its members.²³⁶

2. Disadvantages

Disadvantages of using a partnership to own buy-sell insurance include the following:

²³¹ IRC §754 (U.S.C.S. 2011).

²³² IRS Priv. Ltr. Rul. 93-09-021 (Dec. 3, 1992).

²³³ IRC §705(a)(1)(B) (U.S.C.S. 2011).

²³⁴ See IRS Priv. Ltr. Rul. 96-25-013 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-019 (Mar. 20, 1996).

²³⁵ Treas. Reg. §301.7701-3.

²³⁶ Rev. Proc. 2011-3, I.R.B. 2011-1 (January 3, 2011).

- (i) In some states, a business purpose is required to form a valid partnership or LLC for state law purposes, and simply owning life insurance policies or other passive investments may not constitute a sufficient business purpose to satisfy the partnership law of such a state.
- (ii) The general advantages to the beneficiaries of a trust (such as spendthrift protection, professional management, creditor protection) are unavailable, unless the younger generation family members' interests are held in trusts.
- (iii) Policy proceeds insuring the life of a partner owned by, but not payable to, the partnership (or for its benefit under a binding obligation to be used to purchase the decedent's partnership interest) may be includable in the insured's gross estate for estate tax purposes.²³⁷
- (iv) Any incidents of ownership in the insurance policy which are exercisable by the insured in his or her capacity as a partner or member may cause the policy proceeds to be includable in his or her gross estate for estate tax purposes.²³⁸
- (v) The cash values and proceeds of a life insurance policy increase the value of each partner's interest to which they are allocated.
- (vi) If a partnership is used to hold policies to fund a buy-sell for a corporation, the terminating or deceased's interest in the partnership must also be subject to a buy-sell agreement.

If the deceased partner shared in the allocation of tax-exempt income from the proceeds, the surviving partners may not have enough basis to absorb the distribution of the policy proceeds, which would result in gain to the surviving partners upon distribution of the proceeds to them. Further, if the proceeds are allocated and distributable to all the partners (including the deceased), the value of the deceased's interest in the partnership would be increased, thus providing less money to the survivors to purchase the deceased's interest as well as increasing the cost of purchasing the deceased's interest in the partnership.²³⁹

3. Partnership Agreement

Because a partnership can be structured as a contractual arrangement among the parties, it is potentially more flexible than corporations which are governed by statutes. As a contract, the partnership agreement can be amended in the future with the consent of that number of the partners specified by the initial agreement.

²³⁷ IRC §2042 (U.S.C.S. 2011).

²³⁸ IRC §2042 (U.S.C.S. 2011).

²³⁹ Susan Kalinka, *Eighth Annual Corporate Law Symposium: Limited Liability Companies; Assignment of an Interest in a Limited Liability Company and the Assignment of Income*, 64 U. CIN. L. REV. 443 (1996).

The control of a partnership can be determined by the partnership agreement, thus governance and control is in the hands of select individuals, including the insured, without concern that the proceeds of the policies will be includable in the insured's gross estate. The extent of inclusion should be limited to the fair market value of the insured partner's interest in the partnership determined under IRC §2033. To the extent that death proceeds or the cash value of insurance policies on the deceased become assets of the partnership, a portion of such proceeds or cash values would be taken into account in determining the value of the insured's interest in the entity. The use of minority discounts or other available discounts in valuing the interest in the partnership of a terminated or deceased shareholder may be applicable.

4. Premium Payments

Funding the premium payments due on partnership-owned policies may come from a number of sources. While the partners may directly contribute the required premiums, the corporation whose stock is to be purchased with insurance proceeds may indirectly fund those premiums by distributions, dividends, or compensation to its shareholders who are also partners of the partnership. Payment by the corporation gives the partners some assurance that funding will occur without having to depend on each of the partners to contribute their part. Income from investments contributed to the partnership can fund the premiums. Insurance policies can be borrowed against, or surrendered when no longer needed, to help fund premiums. If receipts from other sources are not sufficient to pay the insurance premiums and the partnership agreement includes a "call" provision, the general partner or member may issue a call when additional funds are required. Partners would be required to satisfy the call in an amount commensurate with their proportionate interest in the partnership. There will need to be remedies if a partner defaults on the call obligation.

How each partner bears the burden of the premiums is a significant part of the business deal. One option is for each partner to contribute to the cost of policy premiums on all partners and to do so based on their relative percent ownership in the corporation whose stock is to be purchased. This results in an effective way of evening premium payments among the partners notwithstanding the difference in age and/or insurability of the insureds. Another possibility is for each partner to contribute to the costs of premiums for the policies on all partners other than his or her own with the non-insured partner's contribution to each policy based on the relative percent ownership of the non-insured contributors in the corporation whose stock is to be purchased. This approach takes into account the differing costs of insurance due to variations in the face amount of the policies and the health/condition of the insured.

Since premium payments are not deductible but still reduce a partner's outside basis, projections should be made to avoid the possibility the distribution of proceeds to surviving (or "non-disabled") partners will not result in part (or all) of the distribution constituting ordinary income upon receipt.²⁴⁰

²⁴⁰ Terence Floyd Cuff, *Tax Planning for Joint Ventures, Partnerships and Other Strategic Alliances, Partnership Dispositions, Redemptions and Exchanges*, 4 PRACTISING L. INST. 3685 (June-July, 1996).

5. Allocation of Proceeds

The insurance proceeds may be specially allocated under the terms of the partnership agreement to the partners, especially at the death of an insured partner, in a manner to achieve the desired result provided that appropriate provisions are included to satisfy the “substantial economic effect rules” of IRC§704(b).

The incremental increase in cash values over book values each year would be allocated to each partner’s capital account in accordance with the partnership agreement. For example, the incremental increase in policy cash value over book value would generally be allocated to each partner in accordance with his or her capital account.²⁴¹ Upon the death of an insured partner, a similar adjustment for cash value increases would be made to the book value of all policies and partner capital accounts.

Also upon the death of an insured partner, a special allocation of the proceeds in excess of cash value should be allocated to the surviving partners in proportion to their relative interests in the partnership capital accounts.²⁴² The deceased partner’s partnership interest should be determined without any consideration of the policy proceeds in excess of cash value.

Following the special allocation at a partner’s death, the agreement should also provide for how distributions will be made to the surviving partners so that they have the cash (directly or indirectly) to purchase the deceased shareholder’s stock. Since some of the death proceeds may be needed to redeem the deceased’s partner’s interest in the partnership, not all of the proceeds may be available for this distribution.

Suggested partnership agreement allocation language:

Upon the death of a partner, the insurance proceeds from any insurance policy on the life of the deceased partner in excess of the cash value of the policy shall be specially allocated to the remaining partners in proportion to their capital accounts. Following the partnership’s redemption of the interest of the deceased partner, the remaining partners shall receive a preferred distribution in proportion to their capital accounts in an aggregate amount equal to the insurance proceeds.

²⁴¹ IRC §704(b) (U.S.C.S. 2011); See Stephen R. Akers, *Business Succession Planning and Planning Considerations for Buy Sell Agreements*, (July 18-20, 1996, Coronado, Cal.) in ALI-ABA Course of Study: Estate Planning for Family Business Owner at 346-457.

²⁴² IRC §704(b) (U.S.C.S. 2011).

6. Other Accounting Issues

The book value of each partnership owned policy would be increased by the amount of premium paid. Accordingly, the capital accounts of each of the partners would be increased by the amount contributed by each partner to pay premiums.

Under general accounting principles, no part of the premiums of a permanent policy is expensed. However, premiums paid on term insurance are expensed over time as economic benefit of the policy's death protection is realized. The expense causes a reduction in the book income of the partnership and a corresponding adjustment in the capital accounts of the partners. So, at the end of the policy's year, its book value is zero and the partners' capital accounts have been reduced by the amount of premium.

In Rev. Rul. 2009-13²⁴³, the IRS stated that when determining the income tax basis of a life insurance policy sold to a third party during the life of the insured, there should be a downward basis adjustment from the total amount of premiums paid for the value of the economic benefit of the death benefit protection realized by the policy owner since the policy was issued. In the case of a term policy, that amount of economic benefit realized was earned portion of the total term premiums paid. In the case of a permanent policy, the total premiums paid were reduced by the policy's cost-of-insurance charges without explaining how these costs were determined. Query whether premiums paid by a partnership on permanent insurance on the lives of its partners should be expensed for book accounting purposes to the extent of the policy's cost-of-insurance and a corresponding downward adjustment made in the policy's book value and the partners' capital accounts.

When the insurance is owned by the corporation and there is a split dollar insurance agreement between the corporation and the partnership, the current policy book value is an asset of the corporation and the term cost of the death benefit in excess of that book value (if and to the extent that the corporation's premiums paid do not exceed the cash value) is an asset of the partnership. Given the term insurance nature of its death benefit, presumably the partnerships share of the premiums under the split dollar agreement will be expensed like regular term premiums for partnership book accounting purposes.

Except for premiums paid, other increases in the value of the policy (such as cash value exceeding premiums paid) are not reflected on the partnership's books unless a "book-up" occurs. A book-up is an adjustment in the book value of a partnership's asset to its fair market value and a correspondence adjustment in the capital accounts of the partners allowed by the special allocation regulations under IRC §704 for substantial non-tax business purposes. For example, booking-up the partnership assets is appropriate on a death of a partner, so that the decedent's partnership interest buy-out price reflects current fair market value of the partnership assets. This is important when the partnership policy cash values exceed the premiums paid. Also, when a new partner is added, booking up may be appropriate so that the new partner does not share in the prior policy cash value growth above premiums paid.

²⁴³ I.R.B. 2009-21 (May 26, 2009).

When booking up a partnership owned life insurance policy, valuation is important. Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value.²⁴⁴ For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.²⁴⁵ In a family context you may need to take both of these approaches into account.

The provisions of the agreement on allocation of income and loss need to be carefully considered in view of the business deal, as those provisions will determine how any book-up or expensed items are allocated among the partners, and thus ultimately how the value of the partnership assets are shared.

7. Other Provisions of the Agreement

In addition to the special allocation of the costs and the benefits of life insurance owned by the partnership, the partnership should also contain other traditional provisions regarding transfer of partner interests. Transferability of the interests in the partnership should be restricted by agreement like the stock in the corporation. The agreement should provide for the purchase of the deceased partner's interest in the partnership, as well as the partner interests of those who are no longer shareholders in the corporation.

There should be a method to value the partnership interest when a partner is bought out or dies, and when new partners are added, as well as for purchases triggered on involuntary transfers. It would be important for the book-up and capital account balance to be part of the valuation in order to give economic effect to those provisions. If the partnership is the purchaser (i.e. a redemption, which is likely easiest), then normally the purchase price would be based on the selling partner's capital account balance after book-up.

Recitals on the various business purposes of the partnership will be important could be helpful should the validity of the partnership for state law purposes come into question. Among the purposes that the partnership serves are avoiding multiple policies, specially allocating proceeds to those who have obligation to repurchase, protecting policies from risks of corporate creditors, and ease of administration of the policies.

²⁴⁴ See Rev Proc. 2005-25, which applies in the context of valuing compensation. For qualified retirement plan purposes, see Treas. Reg. §1.402(a)-1(a)(2), the preamble to which is T.D. 9223, which does a good job of explaining how that rule changed.

²⁴⁵ Treas. Reg. §25.2512-6(a) provides: The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

8. Incidents of Ownership

Care must be given to structure the terms of the partnership agreement in a manner that precludes an insured partner from having any incidents of ownership in a partnership owned policy on that insured partner's life which would inclusion of a portion of the proceeds in the gross estate of the insured partner at his or her death.²⁴⁶ The term "incidents of ownership" includes more than ownership of the policy in the technical legal sense. Generally, it refers to the right of the insured or the insured's estate to the economic benefits of the policy. It also includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. Therefore, any incidents of ownership in the insurance policy which are exercisable by the insured in his or her capacity as a partner may cause the policy proceeds to be includable in his or her gross estate for estate tax purposes.

Insurance proceeds owned by and payable to a partnership should not be directly includable in the gross estate of its deceased general partner where the policy was purchased by the partnership in the ordinary course of its business and the general partner owned less than 50% of the partnership.²⁴⁷ A safer and more widely accepted approach would be for the partnership agreement to expressly state an insured partner, whether a general or limited partner (or, as the case may be, a manager or a member in an LLC) shall not have any right or power to exercise or to otherwise participate in the exercise of any of incidents of ownership with respect to partnership owned policies on his or her life.²⁴⁸ Instead, only the partners other than the insured should have the ability under the partnership agreement to exercise such incidents of ownership over a partnership owned policy on an insured partner's life.²⁴⁹

In addition to avoiding direct incidents of ownership when the insured is a partner, care must also be taken to avoid an insured having indirect incidents of ownership in a partnership owned policy because of the insured's relationship to trusts which are partners. If the insured is a trustee of trust which is a partner in a partnership which owns a policy on the life of the insured, the insured, while acting as trustee, should not be able to exercise partner voting rights over what the partnership does with the policy in a way that is an indirect exercise of any incidents of ownership in that policy.²⁵⁰ For example, the insured may need to release

²⁴⁶ See Akers, *supra* note 169; See also Kupferberg & Wolf, *supra* note 170; Levy, *supra* note 170; Jane Ann Schlitz, JD, CLU, ChFC, *Uses of Life Insurance by the Closely Held Business* (Milwaukee, Wis.) (for an excellent review of the issue).

²⁴⁷ *Estate of Knipp v. Comm'r*, 25 TC 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

²⁴⁸ IRS Priv. Ltr. Rul. 2007-47-002 (June 21, 2007).

²⁴⁹ IRS Priv. Ltr. Rul. 2000-17-051 (Jan. 24, 2000).

²⁵⁰ IRS Priv. Ltr. Rul. 2009-47-006 (Jul. 20, 2009).

any such partner voting rights to be exercised by another trustee or the trust's partner interest might be a limited partner interest having no management rights over any partnership assets.

As long as a partnership owned policy on the life of an insured partner is payable to the partnership, the rationale against not attributing incidents of ownership in such a policy to the estate of the insured partner is that the insured partner's share of the death benefits will be reflected the value of his or her partnership interest. However, if the death beneficiary of a partnership owned policy on the life of a partner is someone other than the partnership itself, the policy proceeds would not otherwise be considered when valuing the deceased partner's interest. In this case, the IRS has ruled the deceased partner did have incidents of ownership in the partnership owned policy.²⁵¹

9. Transfer-for-Value Rule

IRC §101 provides that life insurance proceeds paid on the death of the insured are not taxable income to the death beneficiary who acquired the policy in a "transfer for value" if the policy transfer does not fall in the listed exceptions. Great care must be taken when transferring policies in a buy-sell context to analyze (i) if there is a "transfer for value" (transfers may be "for value" even though cash does not change hands) and (ii) whether an exception applies. If there is a transfer of a policy for value, policy proceeds are still excluded from gross income if the policy transferee is a partner of the insured or a partnership in which the insured is a partner. The IRS has ruled that when an LLC is treated as a "partnership" for federal income tax purposes, the members of an LLC will be considered "partners" of the same partnership for purposes of the transfer-for-value rules.²⁵² However, the IRS has announced that it will not rule on whether, in connection with the transfer of a life insurance policy to an unincorporated organization, the transfer of the policy to the organization is exempt from the transfer-for-value rules when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of its members.²⁵³

If there is an existing cross purchase agreement with the policies owned by the shareholders, each shareholder can contribute the policies he or she owns to the partnership. As a substituted basis transaction, the contribution is not subject to the transfer for value rule. The exception to the transfer for value rule for transfers to a partnership if the insured is a partner may also apply, subject to any uncertainty that may exist regarding whether this exception applies if the partnership has no other purpose. While the capital accounts will need to reflect the current value of the policies, which could be very different and not in proportion to the stock ownership, the proceeds in excess of cash value may be allocated among the partners in the manner desired.

²⁵¹ Rev. Rul. 83-147, 1983-2 C.B. 158.

²⁵² IRS Priv. Ltr. Rul. 96-25-013 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-014 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-015 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-016 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-017 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-018 (Mar. 20, 1996); IRS Priv. Ltr. Rul. 96-25-019 (Mar. 20, 1996).

²⁵³ Rev. Proc. 2011-3, I.R.B. 2011-1 (January 3, 2011).

If there is an existing stock redemption agreement with policies owned by the corporation being converted to a cross-purchase agreement funded with partnership owned insurance, the first step will be getting the policies out of the corporation without violating the transfer-for-value rule. One option with an S Corporation would be for the corporation to transfer each policy to the insured shareholder as an S distribution followed by the distributee's capital contribution of the policy to the partnership. Another possibility would be for the corporation to transfer its policies into a partnership owned 99% by the corporation and the rest by the shareholders, and then the corporation's interest in the partnership would be sold or distributed to the shareholders. A third option would be for the corporation to sell its policies to a partnership whose partners are also shareholders of the corporation.

When policies are being transferred for value, it is important that the exception to the transfer-for-value rule is in place before the transfer of policies.²⁵⁴ If the exception relied upon is a transfer to a partnership in which the insured is a partner, there needs to be a valid partnership in place before the transfer. If the exception relied upon is a transfer to a partner, there needs to be a partnership in place at the time of the transfer, so a transfer that liquidates the partnership could create an issue.

Admission of a new partner to an existing partnership owning life insurance is not considered a transfer for value.²⁵⁵ The IRS has also privately ruled that a transfer of an interest in a partnership that owns a life insurance policy is not subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.²⁵⁶

10. Family Context & IRC §2701

If a family “controls” the LLC within the meaning of IRC §2701(b)(2), the application of IRC §2701 to the LLC needs to be considered as it relates to whether the special allocation of life insurance is a transfer of a partnership interest to a member of the transferor's family, and, if so, whether that transfer is a gift and, if there is a gift, its value.

Under IRC §2701(e)(5), a change in the capital structure of an LLC is treated as transfer of an interest in the LLC if the taxpayer or an applicable family member receives an applicable retained interest in the LLC pursuant to such change in capital structure, or holds, immediately after such change in capital structure, an applicable retained interest in the LLC. A special, non-pro rata allocation of life insurance proceeds among the partners could cause a member's interest to constitute an “applicable retained interest,” as defined by Reg. §25.2701-2(b)(1)-(4). In the context of an LLC, an applicable retained interest in the LLC is a liquidation, put, call, or conversion right or a distribution right which is senior to the distribution rights of the transferred interest.²⁵⁷ The special allocation of insurance proceeds

²⁵⁴ Rev. Rul. 83-147, 1983-2 C.B. 158.

²⁵⁵ See Rev. Proc. 96-3, 1996-1 C.B. 456; Rev. Proc. 96-12, 1996-1 C.B. 616 (No Ruling Policy).

²⁵⁶ IRS Priv Ltr Rul 200826009 (June 27, 2008).

²⁵⁷ IRC §2701(c)(1) and (2).

itself is an accounting event which when it happens would not give any LLC member the right to liquidate, put, call or convert their LLC interest nor would it create in them a distribution right which is senior to than that of any other LLC member. Before and after the proceeds are collected and allocated, all of the LLC members would be entitled to distributions based on their relative capital accounts. Under the so-called “vertical slice” concept, there would be no IRC §2701 issue if the transferred interests and the retained interests are all of the same class.²⁵⁸

While the quality of distribution rights of the LLC members is the same before and after the special allocation of insurance proceeds, the special allocation does make a difference in the quantity of the LLC members’ distribution rights. The key issue is whether differing allocations of LLC income (not in proportion to the capital accounts) would result in the transferor’s retained interest being subordinate to the transferee’s class. For example, if the transferor is Dad and Son is the other LLC member, and Son gets an allocation of LLC book income on Dad’s death greater than what Dad gets in proportion to their capital accounts, there is clearly a difference between their two interests. But the nature of that difference is not like the traditional partnership freeze where Dad retains a preferred interest and gives away a common interest. Yet the result of the special allocation is to shift from Dad to Son the future increase in value attributable to Dad’s equity interest in the LLC similar to what would happen if Dad had transferred a common interest to Son while retaining a preferred interest (which is what gave rise to IRC §2701 in the first place). Thus, it would seem IRC §2701 would apply.

The next step, if IRC §2701 applies, is to determine the value for transfer tax purposes of the “transferred interest” under the so-called “subtraction method” set forth in Reg. §25.2701-3(b). That process generally involves (1) determining the value of all family-held equity interests after the transfer as if held by one person, (2) subtracting from that the value of the family-held senior (“preferred”) equity interests determined after valuing any applicable retained interests at zero, (3) allocating the balance among the transferred interests and other family held subordinate interests, and (4) adjusting the value of the transferred interest for minority or similar discounts and any consideration received to reach the transfer tax value of the gift.

If the time of the transfer for IRC §2701 purposes is at the time of the execution of the LLC operating agreement containing the special allocations, then valuing the family-held equity seems to require the valuation of the future allocation of book income, which is an event that may or may not occur. It is also not clear that a future profits interest is viewed in isolation as a “transferred interest” within the meaning of 2701. If the effect on capital during the time prior to the death of a member is considered, all members received a capital account in proportion to their capital contribution.

If the time of the transfer for IRC §2701 purposes is at the time that the special allocation of insurance proceeds occurs, there are still problems with identifying which interests, if any, are senior equity interests, ascertaining what applicable retained interests, if any, exist, and to

²⁵⁸ Reg. §25.252701-1(c)(3).

what extent the value of the senior equity interests will decrease if those applicable retained interests are valued at zero.

Even though the result of the special allocation of the insurance proceeds may feel like IRC §2701 should apply in this case, the above analysis demonstrates the difficulty in applying the statute and regulations in their current form to this arrangement. It is arguable that unrelated parties (such as A, B and C in the example above) would commonly participate in an LLC owning life insurance and having special allocations because they each get the same opportunity to receive a greater allocation of the proceeds when a death of another member occurs, and so they would consider themselves having the same class of interest. When viewed in a family context, the same argument could be made if the LLC members and insureds were Dad and Son, although it seems more obvious that Son will end up benefitting disproportionately by the arrangement.

The above analysis would apply each time a capital contribution is made to the partnership. If you use such a structure in a family-controlled entity, consider the complexity of the disclosure needed to get the gift tax statute of limitations running and the need to place such disclosure on annual gift tax returns for each person involved.

I. Irrevocable Trusts as Partners of a Partnership to Own Insurance

In addition to not inflating the value of a deceased shareholder's stock by policy proceeds paid at death, it may also be possible to remove the value of the stock purchased by those proceeds from the surviving shareholder's estates. In this case, the individuals who own the corporation would set up separate irrevocable life insurance trusts. The trusts may be funded by gift with policies on the life of the grantor and/or income producing assets with the gifts used by the trusts as capital contributions to the partnership. The partnership would acquire new or hold existing policies. To the extent the partnership's income from other assets is not sufficient to fund its premium costs, the shareholders would need to make regular gifts to their respective trusts to be used as partner contributions. To reduce the partnership's need for premium dollars, the corporation could, as an alternative, own the policies on the lives of its shareholders and split dollar agreements on each policy could be executed between the partnership and the corporation. Upon the buy-sell trigger event, the stock would be purchased by the partnership (if not an S corporation), or by the trusts (if an S corporation and the trusts were qualified S shareholders), and thus the stock purchased would be out of the surviving shareholders' estates for estate tax purposes.

J. Employer-Owned Life Insurance Rules

1. In General

The Pension Protection Act of 2006 (hereinafter referred to as "PPA") added §101(j) to the IRC, which limits the tax-free receipt of the proceeds on certain employer-owned life insurance contracts issued or materially changed after August 17, 2006.

An employer-owned life insurance contract for this purpose means a life insurance contract which "(i) is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary under the contract, and (ii) covers

the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.” The applicable policyholder means the owner of the contract; related persons includes a person bearing a relationship to the applicable policyholder including anyone holding a greater-than 50% interest in the applicable policyholder, or a member of the family, or who is engaged in trades or businesses with such person which are under common control. An employee is broadly defined for this purpose to include common law employees, self-employed individuals (such as members of an LLC who provide services to the company), an officer or director, and may even include certain independent contractors.

This definition might include all buy-sell insurance policies as employer-owned life insurance contracts. Out of an abundance of caution and in light of the relative ease by which one can comply, the safe course of action is to assume that buy-sell insurance policies are subject to these rules and follow the notice and consent requirements.

2. Exclusion

There is an exclusion to the application of this rule, which allows insurance proceeds to be exempt from income tax even if the policy otherwise falls within the definition, if (i) any one of the “exclusion factors” (discussed below) applies and (ii) the individual insured received specific notice of the employer’s intent to purchase the policy and consented specifically to the acquisition of such policy. Therefore generally the income tax-free benefit of life insurance in funding buy-sell agreements is preserved by the exclusions, but only if the notice is given and consent documentation is procured before the application for the insurance policy is signed.

The exclusion factors are as follows:

- (a) Status at Issuance of Policy - As of the date the insurance contract is issued the insured was one of the following with regard to the policyholder:
 - (i) a “director”;
 - (ii) a “highly compensated employee” within the meaning of IRC §414(q) (generally any employee who (x) was a 5-percent owner at any time during the year or the preceding year, or (y) for the preceding year had compensation from the employer in excess of the COLA adjusted amount of around \$100,000); or
 - (iii) a “highly-compensated individual” as defined in IRC §105(h)(5) (generally (x) a top five officer by compensation, (y) a 10% or more owner, or (z) in the top 35% of all employees by compensation).
- (b) Status at Insured’s Death - The insured had been, at any time within the 12-month period before death, an employee with regard to the policyholder.

- (c) Proceeds Paid to Family or Designated Beneficiary - the death proceeds are paid (by no later than the due tax for the tax return for the year in which the proceeds are received) to any of the following:
 - (i) the insured's estate;
 - (ii) a member of the insured's family or a trust for such family member within the meaning of IRC §267(c)(4) (generally siblings by the whole or half blood, spouse, ancestors, and lineal descendants); or
 - (iii) any individual who has been designated by the insured as the beneficiary (other than the applicable policyholder) or a trust for that beneficiary.

- (d) Proceeds Used to Purchase – The death proceeds are used to purchase an equity (or capital or profits) interest in the applicable policyholder (by no later than the due tax for the tax return for the year in which the proceeds are received) from:
 - (i) the insured's estate;
 - (ii) a member of the insured's family or a trust for such family member within the meaning of IRC §267(c)(4) (generally siblings by the whole or half blood, spouse, ancestors, and lineal descendants); or
 - (iii) any individual who has been designated by the insured as the beneficiary (other than the applicable policyholder) or a trust for that beneficiary.

3. Notice & Consent Requirements

For the exclusion to apply, the employee must receive written notification from the applicable policyholder/employer that it wishes to insure that particular employee. The notice must include: (i) information indicating the maximum amount of coverage intended to be acquired at issuance; and (ii) a statement that the employer/applicable policyholder will be the owner and beneficiary of the policy. Following receipt of the notice, the employee must provide to the employer written consent (i) to being insured and (ii) that the coverage may continue even after the employee's termination of employment.

See the ACTEC Shareholders Agreement for Closely-Held Corporations Sample Form for a suggested form of the notice and consent which can be used at the time a policy is obtained. It will be most efficient if the notice and consent could generally be given ahead of time in the shareholders agreement itself to avoid the risk that this critical requirement will be overlooked by the parties when policies are acquired later. It would seem that such a provision would be effective as long as a maximum amount can be specified (with the risk that if the actual amount of a policy obtained later is more, the notice and consent in the agreement would not be effective). Perhaps the safest course is to include such a provision,

and also recommend that individual forms of notice and consent be used for each policy issued. The Sample Form contains suggested language to this effect.

There are annual reporting requirements as well as record-keeping provisions. Each year, the applicable policyholder must complete Form 8925 and attaching it to its income tax return. You should consider notifying (or recommending that the client notify) the company's income tax preparer of these policies so that any required annual reporting regarding these policies is done.

4. Notice 2009-48

Notice 2009-48 elaborates on the rules and provides rules for what constitutes a material modification and guidelines for conducting tax-free exchanges.

Notably, this Notice provides that a contract is an employer-owned life insurance contract only if it is owned by a person engaged in the trade or business and is otherwise described in IRC §101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner) . . . is not an employer-owned life insurance contract.

Clearly, this would be the case in a cross-purchase agreement where the owners own the policies, and thus should be outside of this rule. However, if the agreement is a redemption agreement, care must be used to protect the exclusion.²⁵⁹

The rules also apply to non-qualified deferred compensation agreement funding set up for key employees if the corporation (employer) purchases life insurance to fund its obligation, and to split dollar insurance policies.

XI. VOTING & GOVERNANCE

A. General

State law generally provides that shareholders are entitled to one vote per share and a majority vote by the shareholder is required to elect directors. It is often necessary in closely-held corporations to alter this basic arrangement in order to provide an orderly system of decision making and to protect various groups of shareholders. A number of devices are employed for this purpose, including: cumulative voting, multiple classes of stock, supermajority voting rights, voting agreements, and irrevocable proxies. These arrangements are often used to assure representation on the board of directors, protect an employment or compensation arrangement, or prohibit certain transactions without participation of the minority interests.

In implementing any of these measures, compliance with the applicable state statutes is essential. Many, if not most, statutes require that specific provisions be included in the

²⁵⁹ See *Zaritsky: Pension Act Lays Trap for Some Insurance-Funded Buy Sell Agreements*, 33 ETPL 56, October 2006.

articles of incorporation in order for these arrangements to be legally enforceable. Some states may allow or require that provisions be included in the bylaws. In either situation, it is imperative that a provision be included to prohibit an amendment of the articles or bylaws by the majority interest. If this amendment right is not limited, the protections may be deleted by the majority group.

B. Cumulative Voting

Generally, the entire board of directors of a corporation can be elected by a majority of the shares. If cumulative voting is permitted, each shareholder may multiply his or her shares by the number of directors to be elected and may distribute his or her votes among the candidates or allocate all of the votes to one candidate. This greatly increases the likelihood that a minority shareholder will be able to obtain representation on the board of directors. The fewer the number of directors, the greater the percentage of votes the minority must cast to elect a single director.

The procedure for cumulative voting varies from state to state. In some states it is mandatory and in others it is only available if the articles of incorporation include cumulative voting provisions. Using cumulative voting as a means of guaranteeing minority participation is a very indirect approach. It may guarantee a seat on the board of directors but that in itself may be insufficient to protect a minority interest unless it is coupled with other rights discussed herein. Other devices may be more useful. Cumulative voting may not be effective to protect a minority interest if the holders of a majority of the shares can (i) amend the articles of incorporation to eliminate the cumulative voting right, or (ii) reduce the total number of directors or stagger the director terms so that fewer directors are elected each year.

C. Multiple Classes of Stock

The creation of multiple classes of stock is done by a provision in the articles of incorporation. The effect of those classes on the buy-sell and governance provisions, however, will need to be addressed in the shareholders agreement.

Using multiple classes of stock is another method of protecting the interest of minority shareholders. By giving each class of stock the right to elect one or more directors the minority interests can be assured of board representation in a manner that is much simpler than cumulative voting. Many state statutes provide that if there are multiple classes of stock, each class must approve significant corporate actions such as mergers, sales of substantially all of the assets, dissolution or amendment of the articles of incorporation. The articles of incorporation and bylaws may also require approval of one or more classes for specified transactions such as borrowing in excess of a specified amount, the sale of a particular asset, or entering a new line of business.

If the capitalization of the corporation provides for different classes of stock such as voting, non-voting, preferred, etc., a cross-purchase agreement should provide that shareholders holding the same class of stock as that held by the deceased or withdrawing shareholder should have the first option or be required to purchase the stock subject to sale. If a redemption is used this is not as significant.

Multiple classes of stock can also facilitate business succession issues. Dividing stock into voting and non-voting shares may also allow a senior family member to transfer a controlling interest in the company to another generation without having to transfer 51% of the economic value.

Multiple classes of stock can also be an effective way of allowing a family business to be passed down “per stirpes” to the next generation. Different family units would own different classes of stock, and voting and options to purchase would be done by classes. For example, a brother owns class A and a sister owns class B, and the classes have an equal 50% of the vote. The sister gives 10% of her stock to her daughter. The brother and daughter work in the business and the daughter tends to side with her uncle. The sister still has veto power over the company, since she will control the vote of the class B stock, and class B has a 50% vote. If the daughter gets an offer from her uncle to purchase her stock, the class B shareholders (i.e. the sister) will have the first right of refusal to buy that stock and thus keep her 50% position.

S corporations are allowed to have different classes of stock, provided that the only difference in the classes relates to voting rights. The liquidation and distribution rights of all shares of a S corporation must be identical.

D. Supermajority Voting Rights

Most states allow corporations to require supermajority votes or increased quorum requirements for certain actions by the shareholders or the board of directors. These rights in effect give one or more minority shareholders a veto power over certain specified corporate actions. The protection offered here is similar to that available for class voting. Supermajority voting may be used where the shareholders are not easily divided into different groups. A supermajority voting requirement may also be imposed upon the board of directors in order to give a minority group that has the right to elect a small number of directors a veto right over certain actions.

E. Voting Agreements

Most states authorize two or more shareholders to enter into a written agreement that provides for the manner in which they will vote their shares. This is similar to a voting trust. However, voting trusts typically are limited to a ten-year term by statute and voting trusts require a transfer of legal title to the shares that are subject to the agreement. The voting agreement is much less cumbersome than the voting trust and typically is not subject to any term limit.²⁶⁰ Often, an irrevocable proxy provision, discussed below, will be incorporated into the voting agreement so that the agreement will be “self-executing.”

Two shareholders who together own a majority of the voting stock may enter into an agreement that each will vote their shares to elect the other as a director of the Corporation. Furthermore, a group of minority shareholders who would have the authority to veto certain actions if they voted together may enter into a voting agreement.

²⁶⁰Missouri, however, allows perpetual voting trusts, one of the nation’s most liberal. RSMo §351.246.

F. Irrevocable Proxies

Under common law, all shareholder proxies are revocable by death, incapacity, or at will, unless “coupled with an interest.” The utility of such revocable proxies is very limited. Many states have adopted statutes that allow for irrevocable proxies if the proxy conspicuously states that it is irrevocable and the appointee is a party to a shareholder voting agreement or otherwise has an “interest” that is protected by statute. This enables the voting agreement to be enforced without court action.

G. Deadlock of Shareholders or Directors

You can provide for non-binding mediation preceding any other remedy, including the requirement of at least two meetings at least five days apart, for example.

You may want binding arbitration to be triggered if there is a material issue involving the corporation. The arbitrator could be a pre-designated third party (lawyer or accountant, for example) whom the shareholders know and trust.

In certain situations, if there is a material deadlock between owners of a corporation, an “Australian Lottery” may be attractive. Under this approach, one co-owner sets the price, and the other co-owners have a specified period in which to decide whether to be the buyer or the seller. This provision can work to the advantage of a wealthy shareholder who can afford to buy allowing that person to take advantage of a shareholder who has fewer resources.

Another approach is to give each shareholder the option to trigger a liquidation of the corporation, although that is a rather drastic measure and the attorney should be cautious in recommending its inclusion. It should probably be an option only if there are at least two deadlocks in six months, for example.

H. Governance Issues

There may be a number of issues regarding governance that the owner/employees of a closely-held corporation may want to agree on in advance. One significant issue is how compensation will be set among the owners. A shareholder agreement can set out formulas for compensation, or procedures for setting compensation, so that is agreed to “up front.” The other significant issue is the circumstances under which employment can be terminated. If stock is automatically repurchased upon termination of employment, this becomes a big economic decision. If the repurchase of stock or removal of a shareholder requires a super-majority decision of shareholders, it would be appropriate to require that the decision to terminate a shareholder’s employment be made by the same vote, not just by the board of directors or an officer.

Another issue that can be agreed to in advance is who will be on the board of directors. Protection can be provided to a minority shareholder who would not otherwise have the power to elect a board member by providing in the shareholder agreement that he or she shall be a member of the board as long as he or she is a shareholder.

Few state laws allow you to vary the basic rules that shareholders elect directors and directors run the company. Since the shareholder agreement is a contract, and the actual voting of shareholders and boards will be done pursuant to the terms of state law, if any special governance provisions are not carried out, the result is a claim for breach of contract. It is helpful to add to the shareholder agreement a provision where everyone agrees to take action, whether as a shareholder, director, or officer, to carry out the terms of the agreement.

XII. MISCELLANEOUS

A. Parties

The corporation itself should be a party to the shareholders' agreement if any action is required by the corporation, such as redemption of stock or prohibition on issuing stock without the approval of shareholders. Subject to state law, the articles of incorporation, and possibly the bylaws, not all shareholders need to be parties to make the agreement binding. There may be cases when it is desirable or practicable only to have certain shareholders be parties. For example, if part of the stock is owned by an ESOP, then ERISA would prohibit the ESOP from being a party to the agreement. You might also have non-family member shareholders to whom you do not want to give the benefit of a redemption on death, or who will not agree to be subject to repurchase on termination of employment, etc.

B. Founders Rights

If there is one person who "founded" the corporation, perhaps continuing to own most of the corporation but bringing in new owners who will acquire more ownership over time, that person may want priority over certain assets, such as the name or phone number, in the event there is a break-up in the future. These provisions should be included in the shareholder agreement.

C. Rights to Use Shareholder's Name

The right to continue to use a shareholder's name in the name of the corporation after that shareholder leaves should be specifically spelled out in the shareholder agreement, since it may not otherwise be a legally enforceable right of the corporation.

D. Personal Guarantees by Selling Shareholder

Often shareholders are required to personally guarantee the debt of the corporation. It is unlikely that the creditor will let a departing shareholder off the guarantee. Because the shareholder will no longer be involved in the corporation, it is usually fair to have the other shareholder(s) agree to use best efforts to remove the guarantee as soon as practicable, and to indemnify the departing shareholder in the meantime. Over time, as lines of credit are paid down, leases renewed, etc., the obligation to the creditor on the guarantee should go away.

E. Termination & Amendment

There are a number of circumstances which may require the agreement to be amended or terminated. Amendment and voluntary termination should be specifically allowed, and

consideration should be given as to whether the vote should be unanimous, majority, or super-majority. A majority or super-majority vote prevents a tyranny of the minority. A unanimous vote can be difficult to get if there is a “rogue” shareholder, but may be the only way to protect the minority. Experience indicates that the greater the number of shareholders the more reasonable it is to have a majority vote, and the fewer the shareholders the more important it is to have a unanimous vote. If the vote is less than unanimous it is important to clarify whether the vote is by shares held (more typical) rather than one vote per person (less typical).

If the agreement can be amended by less than unanimous vote, there may be a limit on how extensive an amendment can be made and still be binding all the shareholders who did not vote in favor of the amendment. It may be difficult to enforce an amendment that materially changes the rights or obligations of the non-consenting shareholder against that person. One way to address this is to have the “approved” amended agreement signed by all shareholders and if anyone does not sign, provide that they are in breach and penalties (such as repurchase of their shares) apply.

It is usually appropriate to automatically terminate the agreement when there are only a few shareholders and they all die within a short period of time. If the agreement is not terminated under those circumstances it can result in a windfall to the last to die, particularly if there are insurance proceeds to fund the buy-sell, or the price is less than what a sale to an outsider would bring.

F. Remedies & Governing Law

Any well-drafted contract will address remedies in the event of a breach. It is also important to clarify governing law and venue for any legal action. Resolution by binding arbitration and/or waiver of a jury trial can also be included.

G. Attorney Conflict of Interest & Ethical Issues

It is fairly typical for only one lawyer to be involved in the preparation of a shareholders agreement even though there will be various parties who have at least potential future conflicts of interest. Since such agreements are generally drafted before anyone contemplates leaving the corporation, each shareholder could be on either side of a future transaction - someone who may be selling or buying stock. Lawyers still need to be very careful to clarify who is the client (generally it is simplest if the corporation itself is the client) and to put the shareholders on notice of this fact. It is fairly common practice to place this disclosure in the agreement itself, which is then signed by all the parties. The use of independent counsel may be called for. Further, in many states there is the issue of transfers without spousal consent and whether the spouse have independent counsel.²⁶¹

²⁶¹ See Howard Zaritsky, *Forgotten Provisions in Buy-Sell Agreements*, in 19th Annual University of Miami, Philip E. Heckerling Institute on Estate Planning (1985); Cornfeld, *supra* note 175; American College of Trust and Estate Counsel Commentaries on the Model Rules of Professional Conduct (Oct. 18, 1993) (all contain an excellent review of these issues).

H. Notice

Notice clauses need to address how the parties give notice to each other and when notices are deemed to have been given. To avoid questions of delivery and to address the need to take prompt action, notice clauses frequently provide that a copy of the notice shall also be given to the respective parties' attorneys. Some consideration should be given to changes in addresses.

I. Incorporation of Exhibits

Buy-sell agreements frequently have exhibits attached to them, such as sample promissory notes and security agreements to be used if the buy-sell price is paid over time. It is important that it is clear that those exhibits are incorporated in, and are a part of, the agreement.

J. Counterparts & Date of Execution

Buy-sell agreements frequently are not signed by the shareholders simultaneously. If the shareholders are in different locations, they are often signed in counterparts. A counterparts clause typically is added to make clear that the assembly of the counterpart documents constitutes one and the same document. A date clause is also often included to make clear that the date on the document does not mean that every shareholder signed and delivered the document on that date.

XIII. RELATED AGREEMENTS

A. Noncompetition & Proprietary Information Agreements

It is common in many businesses to have key employees sign non-compete agreements. Depending on how the purchase price is calculated, a non-compete and proprietary information provisions can also be an essential part of a buy-sell agreement. If the value of the business is based to any extent on "good-will," and the good-will might otherwise follow the seller or be diminished if the seller competes, a non-compete provision is an essential part of a sale. This can be true even if only one individual's stock is being sold.

Most states do not look favorably upon restraint of trade, so covenants not to compete are scrutinized closely and strictly construed against the proponent of the covenant. Any non-compete agreement restrains trade to some extent, so the issue is whether the restraint is reasonable. Under most state laws any covenant not to compete must be reasonable: (i) reasonable in that it is no greater than necessary to protect the legitimate business or employer's interest; (ii) reasonable in that the employee or seller still has an ability to make a living; and (iii) reasonable from the standpoint of sound public policy. To determine if a covenant is reasonable, a court will examine three basic characteristics: (i) is the geographical area reasonably related to the area in which the business operates; (ii) is the length of time reasonable; and (iii) is the functional limitation reasonably related to the business's protectable interest and is it not unduly harsh and oppressive in curtailing the former employee or shareholder's legitimate effort to earn a living. If any of these three factors are found to be unreasonable, the court may reject the entire non-compete clause,

even if a contract specifically invites a court to rewrite or “blue pencil” the clause. However, courts in New York State have consistently modified covenant agreements in a manner to make them reasonable, rather than merely null and void. For example, if the geographic area is prohibitively large, such as the world, the court may limit the geographic area to the specific marketing area of the corporation. Similarly, if the prohibition is against any type of marketing, even within a prescribed area, a court may limit the provision to presently existing customers of the corporation.

Non-compete provisions in buy-sell agreements are generally analyzed in the same manner as those arising out of the employment relationship to determine if they are enforceable. The nature of the relationship from which the covenant arose can affect the court’s decision, however. A court will not be as sympathetic to an attack on a non-compete provision that was part of the sale of a business for which the former owner received significant compensation that was based, at least in part, on the bargained for non-compete. Claims of oppression, and that the provision is unduly harsh on preventing earning a living, will be viewed with greater skepticism.

In the context of a sale of a business, the geographic location will often be phrased in terms of the market in which the business competes (including where the business is located, the business makes sales, and the customers are located).

If a non-compete is part of a buy-sell agreement, the parties need to consider whether any of the purchase price is intended to be allocated to the non-compete. Any portion allocated to the non-compete will be taxable as ordinary income to the recipient, but the corporation should be allowed to amortize the payments over 15 years.²⁶²

Some states recognize an implied covenant not to compete on the sale of stock.

Often included in non-compete agreements are agreements not to solicit clients or customers, employees, or vendors. Proprietary and confidentiality provisions are also often included in non-compete agreements or are stand-alone agreements.

B. Non-Qualified Deferred Compensation Plans

1. Background

It is not uncommon for part of the value of the company to be based on accounts receivable, particularly with professional corporations. Cash basis taxpayers do not take accounts receivable into income until they are collected and turned into cash. The purchaser does not get a tax deduction for a stock payment. If the value of accounts receivable is reflected in the purchase price for stock, you have a potential mismatch, since the purchaser has to pay tax on the accounts receivable (directly if the purchaser is the corporation or indirectly if the purchaser is the stockholder) and gets no offsetting deduction.

²⁶² IRC §197 (U.S.C.S. 2006). See *Frontier Chevrolet Co. v. Comm’r.*, 329 F.3d 1131 (9th Cir. 2003); Thomas A. Brisendine, Thomas E. Veal & Elizabeth Drigotas, *Tax Management Deferred Compensation Arrangements*, 385-4th TAX MGMT. PORTFOLIO (2005).

One way of addressing this is to pay his or her deemed portion of the accounts receivable to the former owner as deferred compensation. (This option is only available, of course, if the former owner was an employee of the corporation). Thus, for example, if the value of the corporation is being determined based on book value, the stock value can be book value without accounts receivable, and the deferred compensation can be the amounts of the former owner's share of the accounts receivable. The former owner will have capital gains on the stock payment in excess of basis and ordinary income on the deferred compensation, and the corporation should get a tax deduction for the payment of deferred compensation to offset income receipt when the accounts receivable are collected. This is a very common pattern in a personal service corporation such as a medical practice.

The provision for payment of deferred compensation can be in a shareholders' agreement. To avoid the appearance that the deferred compensation is disguised purchase price, however, it is probably better to put this provision in the employment agreement or a separate agreement.

Apart from shareholders agreements, employers frequently wish to provide selected employees with retirement benefits to supplement or replace benefits available under qualified plans. Nonqualified deferred compensation is a deferred compensation plan that does not meet tax and labor law requirements applicable to qualified plans. While life insurance is not the only approach to meeting a business's obligation under a supplemental retirement agreement, it has certain advantages, including tax deferred cash accumulation, significant guarantees, advantageous tax treatment of loans and withdrawals for policies which are not modified endowments, and income tax-free death proceeds. Using life insurance for these plans provides added value for executives because pre-retirement survivor benefits are essentially built-in.

Generally, deferred compensation arrangements involve an agreement designed to compensate an employee at some future date for his or her current services. Traditionally, nonqualified deferred compensation arrangements are unfunded, unsecured promises to pay benefits at death, retirement or other termination of employment. Obligations under a deferred compensation plan constitute a liability payable at a future time by the corporation. The corporation is not entitled to a deduction until payment is made. The recipient is not taxed until receipt or upon the lapse of all substantial risks of forfeiture, i.e. vested.²⁶³ Historically, the arrangements have been popular with executive and key employees who were at or near the maximum income tax bracket during their employment years, but whose retirement income would be taxed at substantially lower rates. From the employer's perspective, this fits well with the employer's benefits program, since such an arrangement does not have to meet the employee coverage, funding and other requirements which IRC §401(a) plans must satisfy.

Enacted by the American Jobs Creation Act of 2004, IRC §409A imprints a layer of rules that supplements existing rules (constructive receipt, IRC §83, IRC §457(f), etc.) on taxing

²⁶³ IRC §83 (U.S.C.S. 2006); Treas. Reg. § 1.83-1(a)1 (as amended in 2003); Rev. Rul. 69-474, 1969-2 C.B. 105; Brisendine, Veal & Drigotas, *supra* note 187.

compensation. It punishes service providers (employees and independent contractors) who receive deferred compensation without complying with its terms. The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income. At the same time, the service provider must also pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture. Permissible triggering events for payments under §409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency.

One is required to have a written plan in place as soon as a legally binding right to deferred compensation exists.²⁶⁴

IRC §409A became effective January 1, 2005, and also applies to any plans “materially modified” after October 3, 2004. You should review §409A and the regulations and administrative pronouncements very carefully when preparing deferred compensation and other types of benefit plans.

2. Types of Deferred Compensation Arrangements

Non-qualified deferred compensation arrangements can generally be divided into two categories:

- (i) Arrangements related to stock or other securities of the employer. These may include incentives that meet the requirements of IRC §422A; non-statutory stock options and stock purchase plans; statutory stock purchase plans that meet the requirements of IRC §423; restricted stock purchase agreements; and phantom stock plans.
- (ii) Arrangements not related to stock or other securities of the employer. These include:
 - (i) deferred compensation plans that permit employees to elect to defer the receipt of currently earned compensation to a future date;
 - (ii) a bonus plan (IRC §162);
 - (iii) supplemental retirement plans and private pension arrangements;
 - (iv) severance plans; and
 - (v) death benefit only plans (“DBOs”).

3. “True Deferral” vs. “Salary Continuation”

The IRS refers to all deferred income benefit plans as “deferred compensation,” but there is a distinction to be made between two common forms of nonqualified deferred compensation plans:

- (i) “Elective” plans, also called “salary reduction” plans. “Elective” deferred compensation plans are those under which key employees voluntarily choose to defer a portion of their salary or a future bonus as a means of tax deferred savings. This

²⁶⁴ A plan is any arrangement or agreement providing for a deferral of compensation. IRC §409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy IRC §409A. Reg. §1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. 1.409A-1(a)(1).

type of plan is often referred to as a “top hat plan” because it is designed for use by a select group of executives or highly compensated employees. It is a pure deferred compensation plan in that the employee’s own earned compensation is deferred. Accordingly, the deferred money is usually not subject to forfeiture, but remains subject to the claims of corporate creditors. The employer is usually required to pay interest on the deferred amount. One of the advantages of a top hat plan is that the employee does not have to pay income tax immediately on the current earnings that are deferred. In addition, the current earnings are able to earn interest on the full pre-tax amount rather than the lower after-tax amount that would otherwise have been received.

- (ii) “In addition” plans, also called “salary continuation” plans. Included in this category are Supplemental Employee Retirement Plans (“SERPs”), Death Benefit Only Plans (“DBOs”) and § 162 Executive Bonus Plans. These plans are used to provide retirement benefits to a select group of executives or other key employees or to provide that select group with supplemental benefits over and above those provided in the company’s qualified plan(s). These “nonelective” plans are not true deferral plans, because the employer supplements (without reducing) the current salaries of participating employees with a promise to pay a supplemental retirement benefit.

4. Constructive Receipt & Economic Benefit Principles

The general rule for determining the taxable income to be recognized by a taxpayer is stated in IRC §451, which requires that the amount of any income received in the taxable year be included in the taxpayer’s taxable gross income for that year, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. However, the limitations imposed by the principles of constructive receipt and conveyance of an economic benefit play a crucial role in determining whether compensation is actually deferred for tax purposes.

Treas. Reg. §1.451-2(a) provides that income not actually received by a taxpayer is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time during the taxable year. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions. (The requirement of filing a notice of intention to withdraw is not deemed a substantial limitation). The IRS has taken the position that a taxpayer will not be in constructive receipt of deferred income so long as (i) the taxpayer elects to defer the income before it is earned, (ii) the deferred income, although set aside in a separate account, remains subject to the claims of the employer’s creditors, and (iii) the deferred income may not be assigned or otherwise anticipated by the taxpayer.²⁶⁵

Contrary to the practice for qualified plans, whereby the employer is required to contribute to the trust maintained for a pension or retirement plan, the requirement of funding a non-

²⁶⁵ See also Rev. Rul. 71-419, 1971-2 C.B. 220; Rev. Proc. 92-65, 1992-2 C.B. 428; Rev. Rul. 70-435, 1970-2 C.B. 100; Rev. Rul. 60-31, 1960-1 C.B. 174 (as modified by the above and by Rev. Rul. 64-279, 1964-2 CB 121).

qualified deferred compensation arrangement may lead to immediate taxation to the employee of the amounts transferred for his benefit, if that benefit can be reasonably valued.²⁶⁶ Court holdings and rulings have held that an economic benefit was conferred on employees where deferred compensation was transferred to an escrow account or an irrevocable trust.²⁶⁷ However, in *Casale v. Commissioner*,²⁶⁸ a life insurance policy providing benefits for an employee remained a general asset of the employer, since the employer was both owner and beneficiary. Consequently, no economic benefit was conferred on the employee simply by reason of purchase of the policy, since it was not set aside from the employer's creditors.²⁶⁹

New IRC §409A adds another layer of constructive receipt and economic benefit rules to the existing rules. Care must be exercised when amending or modifying any existing agreements. IRC §409A specifically limits the ability of an employer or an employee, whether acting in concert or independently, to modify existing agreements by accelerating benefits and in some cases deferring benefits. For example, if benefits are due to be paid as of July 1, 2007, and the employee and employer agree on December 31, 2006 to further defer the benefits until 2008, constructive receipt, while not necessarily present under Treas. Reg. §1.451-2(a), will have occurred in 2006 under IRC §409A. This results from violation of new rules requiring that (i) in most cases if the is going to be a "second" deferral election, the election be made more than 12 months before the original payment date, and (ii) the added deferral be for a period of at least five years from the original payment date.

5. Security for Deferred Compensation

The beneficiary of an unfunded deferred compensation arrangement is merely an unsecured general creditor having no priority over any of the employer's assets, whether earmarked for his deferred compensation benefit or not. By putting himself in a more secured position, the employee runs the risk of generating an "economic benefit" prior to actually receiving the compensation.²⁷⁰

Some employers would buy life insurance policies that had artificially low cash values when given to the employee as compensation, and then the true cash values would spring into effect in a later year. The IRS has shut down this idea.²⁷¹

²⁶⁶ Rev. Rul. 67-203 1967-1 C.B. 105; *Comm'r. v. Smith*, 324 U.S. 177, 179 (1945).

²⁶⁷ See, Rev. Rul. 60-31, 1960-1 C.B. 174; *Sproull v. Comm'r.*, 16 T.C. 244 (T.C. 1951) *aff'd. per curiam*, 194 F.2d 541 (6th Cir. 1952).

²⁶⁸ 247 F.2d 440, 445 (2d Cir. 1957).

²⁶⁹ *Id.* at 444.

²⁷⁰ I.R.C. §409A(b).

²⁷¹ If and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. *Matthies v. Commissioner*, 134 T.C. No. 141 (2010). The policy cash value and all other rights under a split-dollar arrangement (including any supplemental agreements), other than current life

C. Corporate-Owned Life Insurance

Corporate-owned life insurance (“COLI”) is a life insurance contract that covers a key executive participant in a deferred compensation plan. It is, of course, owned by the corporation and policy proceeds are payable to the corporation. Corporate-owned life insurance is one of the most frequently used assets as a reserve for deferred compensation plans. Like rabbi and secular trusts, COLI is considered to be an unfunded arrangement as long as the employee has no preferred claim or beneficial ownership interest in any employer-owned asset. Despite the “unfunded” status of nonqualified plans, accounting rules require unfunded benefits to be reported as corporate liabilities which will increase in time as the benefits increase. The informal financing methods, however, are shown as corporate assets and serve to offset corporate liability. By using the tax-deferred buildup of the cash surrender value of life insurance, a corporation can improve its credit position while providing an adequate source of funds when an executive dies or retires. Beware of the new COLI rules adopted in the Pension Protection Act of 2006. (See the discussion in Section J of Article X.)

1. Tax Implications for the Employer.

Corporate-owned life insurance has several advantages as a funding vehicle for nonqualified plans.

- Since nonqualified plans are technically “unfunded,” plan income is subject to taxation. However the earnings on the buildup within COLI are either tax-deferred or tax-free depending on when the insurance policy is terminated.
- Where the corporate plan provides a death benefit, COLI protects the employer against the premature death of an executive.
- COLI can provide funds to cover the cost arising from losing and/or replacing a key employee when the employee is not fully vested or the insurance is in excess of the vested amount.
- The cash surrender value of the policy can be shown on the employer’s balance sheet as an offset to the liability shown on it for deferred compensation. If circumstances require a loan when the corporation does not have an open line of credit, the corporation can borrow against the policy’s cash values.
- Proceeds received from COLI on the death of a key employee are tax free to the employer, yet the payout of death benefits by the employer would be tax deductible. Payments made to the employee or his beneficiary are deductible by the employer in the

insurance protection, are treated as property for purposes of determining compensation income under Reg. § 1.83-3(e). Rev. Proc. 2005-25 describes how to value policies. However, in the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. §1.83-3(e). Reg. §20.2031-8 and §25.2512-6 determine the value for estate and gift tax purposes.

year that benefits are includable in the employee's or beneficiary's income, to the extent that they meet the "ordinary," "necessary," and "reasonable" tests applied to all compensation issues.

The disadvantages of COLI include:

- The deductibility of interest on policy loans by corporate policy owners was limited in 1986. The limitation applies to policies on the lives of numerous employees as general not specific officers, directors or key people. The deduction disallowance only applies to "non-natural" persons (i.e., a corporation) under IRC §264(b)(4)(A). IRC §264(a)(3) This limit applies to contracts purchased after June 20, 1986. Contracts purchased on or before that date retain full interest deductibility under grandfathering provisions.²⁷²
- The death-benefit proceeds received by a corporation from COLI are included in the amount subject to the alternative minimum tax (AMT). The tax cost will depend on circumstances (but it can be as much as 15% of the death benefit; to offset this potential tax cost, the employer may wish to increase the amount of coverage by 15%).
- Due to acquisition costs, in the early years of the policy, the cash value of COLI is lower than the premiums paid.

2. Tax Implications for the Employee.

In a properly drafted plan (one which avoids constructive receipt, the economic benefit doctrine, and IRC §83), the employee or his survivors will not be taxed until the benefits are actually received, when he reports the benefits as ordinary income.

Amounts received from the plan by beneficiaries are taxable as received at ordinary rates, with one exception: to the extent that the inclusion of the benefit results in federal estate tax in the covered employee's estate, an income tax deduction may be allowed to recipients under IRC §691 as income in respect of a decedent.

Amounts deferred are subject to FICA tax when the services are performed or when the employee no longer has a substantial risk of forfeiture, whichever is later. In a nonqualified deferred compensation plan in which the employee is fully vested and cannot forfeit anything, Social Security taxes apply immediately. But because a particular participant in a nonqualified plan has other "wages" that may push him or her over the Social Security wage base (in 2006, \$94,200), that participant would pay only the Medicare portion of the FICA tax (1.45%) on such deferred benefits. Moreover, if the parties comply with the "early inclusion" rule, all future earnings on the deferred benefits will escape FICA taxes.

Likewise, amounts deferred under a nonqualified deferred compensation plan are wages for federal unemployment tax purposes when the services are performed or when the employee no longer has a substantial risk of forfeiture, whichever is later. But since federal

²⁷² See Rev. Proc. 92-57, 1992-2 C.B. 410; IRS Tech. Adv. Mem. 1999-01-005 (Sept. 29, 1998) and IRS Tech. Adv. Mem. 98-12-005 (Jan. 22, 1998).

unemployment tax is imposed only on the first \$7,000 of wages for the calendar year, a nonqualified plan in which the employee's interest is nonforfeitable should not cause any extra FUTA tax liability.

The present value of any death benefit (or any lump sum payment amount) payable to a beneficiary is includable in the deceased employee's estate.

The GST tax will be imposed on nonqualified deferred compensation payments made by a corporation to someone classified as being two or more generations below the employee, subject to the annual exclusion deduction and the \$2,000,000 exemption.²⁷³

Gift tax implications depend on whether the employee continues to have the right to change the beneficiary recipient of employer payments. If the employee retains the right to change the beneficiary (usually by notifying the employer in writing) and the prior beneficiary's consent is not required to make that change, there is no completed gift for gift tax purposes to the new beneficiary.

3. Implementation

There are basically six steps necessary for implementation of a nonqualified deferred compensation plan financed by a company-owned life insurance policy:

- (i) The employer adopts a corporate resolution authorizing an agreement between the corporation and the to-be-covered employee (or independent contractor) promising to make specified benefit payments upon the occurrence of certain triggering events, such as retirement or death (and in some cases disability) in return for the continuing services of the employee.
- (ii) A second and separate corporate resolution is adopted authorizing the purchase of life insurance to indemnify the business for the significant expenses it is likely to incur and loss it is likely to realize at the death before retirement of the covered employee (or independent contractor).
- (iii) The appropriate amount of life insurance is purchased by and made payable to the corporation. The corporation is the owner and no interest in the policy is given to the employee. The policy remains on the employer's books as a corporate asset (subject to the claims of the corporation's creditors).
- (iv) A nonqualified deferred compensation agreement is signed by the authorized company officer and the covered employee.
- (v) A domestic (not foreign) rabbi trust may also be adopted to hold the insurance. *See* § 409A, however, for limitations that apply.

²⁷³ IRC §§2601 to 2663 (U.S.C.S. 2006).

- (vi) A one-page notice to qualify for exemption from the normal reporting requirements for deferred compensation plans under ERISA should be completed and filed with the Department of Labor.

D. Death Benefit Only Plans

A Death Benefit Only (“DBO”) plan (sometimes called a Survivor’s Income Benefit Plan) is an executive benefit which promises payments from the employer to the survivors of one or more selected employees at the employee’s death. As its name implies, a DBO plan provides only death benefits and makes no promises or payments to the employee during lifetime. In essence, the DBO is a form of deferred compensation plan which provides no retirement benefit for the covered employee and defers payments until the employee dies. Payment of DBO benefits is typically conditioned on (a) survival, upon death of the employee, by a designated beneficiary, and (b) the employee working for the employer at the time of death.²⁷⁴

The key goals of a DBO plan are to provide a significant (and often estate tax free) death benefit, generate substantial amounts of income and/or capital to an employee’s family, and help recruit, retain, reward and overstep the discrimination against key employees who add most to a firm’s profits.

Although payments can take the form of a lump sum, in most cases benefits will be payable in monthly installments over a fixed period of time (five or ten years or more) or as a lifetime annuity. The death benefit can be a set predetermined amount, a multiple of the participant’s final salary, or a multiple of the covered employee’s final average pay (three years is common).

A successful salary continuation plan using life insurance to cover the plan’s financial obligations depends upon other types of tax leverage.

1. Income Tax Implications

Tax implications of a DBO Plan include the following:

- (i) A covered employee is not subject to income tax on premiums paid by the employer for key-person insurance used to finance the employer’s obligation. To ensure this result, the promises made by an employer under a DBO plan should not be, or even appear to be, dependent on and funded directly by an insurance policy.
- (ii) Policy premiums are not deductible if the corporation owns and is also the beneficiary of the policy.
- (iii) Excepting any alternative minimum tax (AMT), proceeds of key-person insurance policy used to finance the employer’s obligation under the plan are income tax-free.

²⁷⁴ IRC §2039(c).

- (iv) Corporate earnings and profits are decreased by the amount of premium payments, but increased by the sum of (i) cash surrender value increases, and (ii) the excess of death proceeds over cash values in the year received.
- (v) Cash values should not, in themselves, trigger accumulated earnings tax.
- (vi) Benefits paid by a corporation to an employee's survivor are taxable as "income in respect of a decedent" (IRC § 691 income). However, the survivor may take an income tax deduction (691(c) deduction) for any federal estate taxes paid on that income, thus reducing the effective income tax rate on this benefit.
- (vii) When benefits are paid, they are deductible as deferred salary by the employer corporation to the extent that the plan serves a valid purpose and the amounts paid represent "reasonable compensation" (in terms of both amount and duration) for the services actually rendered by the deceased employee.
- (viii) FICA taxes on death benefits paid to survivors of retired employees will depend on whether the plan covers a single employee or a class or classes of employees. If a single employee, only the benefits paid to the survivors in the calendar year of the employee's death will be subject to FICA taxes. Benefits paid after that calendar year should not be subject to FICA taxes. If the plan covers one or more classes of employees, benefits paid to survivors should be totally exempt from FICA taxes.
- (ix) Deferred compensation payments constitute "wages" for federal income tax withholding purposes.²⁷⁵ Death benefits paid pursuant to a deferred compensation agreement are not subject to withholding.²⁷⁶

2. Estate Tax Implications

Payments received from the corporation by the survivors of the covered employee may be excludable from the employee's gross estate if certain conditions are met. To assure estate tax exclusion:

- (i) The employer, rather than the covered employee, must have sole discretion as to the class of beneficiary to receive the death proceeds (preferably by including specific descriptions in the contract or plan). No rights over the life insurance policy used to finance the employer's obligation should be given to the employee; even the right to name, change, or veto an employer change of beneficiary will cause the payments to be included in the employee's estate. Obviously, the employee's estate should not be named as beneficiary.

²⁷⁵ IRC §3401, §3402(a) (U.S.C.S. 2006); Brisendine, Veal & Drigotas, *supra* note 187.

²⁷⁶ Rev. Rul. 71-456, 1971-2 C.B. 354, *superseded*, Rev. Rul. 86-109, 1986-2 C.B. 196; Brisendine, Veal & Drigotas, *supra* note 187.

- (ii) The plan must provide no lifetime post-retirement benefit to the employee (other than a qualified pension or profit-sharing plan). Be sure the plan provides only a death benefit and provides no post-retirement lifetime payments to the employee. Under IRC §2039, when a life insurance policy is used as part of the financing of an employee benefit, proceeds may be includable as an annuity. (Beware that the IRS can also link lifetime payments under other plans to the DBO plan and consider the two as a single plan even if they are separate. Estate tax inclusion cannot be avoided by providing death benefits under the DBO and lifetime payments under a separate plan.)
- (iii) The employee (and the employee's estate) must have no right to dispose of the payments in the event of the death of specified recipients. The IRS may find that the employee holds a reversionary interest in the plan (one which could revert back to his estate). If that interest has an actuarial value exceeding 5% of the benefit, the payments would be included in the employee's estate.
- (iv) The employee (either alone or in conjunction with any other person) must have no right to alter, amend, revoke or terminate the agreement or change its terms. Giving an employee any of these rights would prompt the IRS to require inclusion in his or her estate. This is particularly likely where the covered individual also owns more than a 50% interest in the corporation, although it could be argued that the fiduciary responsibility one owner owes to another negates the ability to make unilateral decisions that affect others.

The payment of the death benefit no longer constitutes a completed gift in the calendar quarter of death; therefore, it is not subject to gift tax.

E. Section 162 Plans

1. Description

A §162 plan, also known as an "Executive Bonus" plan, involves the purchase of a life insurance policy on the life of one or more employer-chosen employees. The employer pays premiums on the policy, but charges the employee with a bonus in an amount equal to that payment.

The employee (or the third party such as an irrevocable trust designated by the employee) purchases and owns the policy and names the beneficiary. The policy owner has all rights in the policy. The corporation never has any right to any part of the policy cash values, dividends, or death benefits and at no time does the corporation own any incident of ownership in the policy.

The arrangement is called a §162 plan because the corporation will take an income tax deduction under §162 for the amount of the bonus charged to the covered employee. In some cases the corporation will pay premiums directly to the insurer while in other situations the corporation will actually pay the money to the employee or a trust for the employee's benefit which in turn will send the premium payment to the insurer.

2. Uses

The use of a §162 plan would be particularly indicated in the following circumstances:

- (i) As an alternative for split dollar coverage. Equity split dollar plans have been popular with employers who wish to give executives or other key employees a fringe benefit. The arrangement has been used as a cost-effective way to generate retirement income for employees from policy cash values via loans and/or withdrawals. However, IRS pronouncements culminating in the issuance of final regulations in 2003 have made equity split dollar plans less attractive than had previously been promoted.²⁷⁷
- (ii) When the business is in a relatively high income tax bracket and wants to provide fringe benefits to selected key employees.
- (iii) When an employer would like to carve out large amounts of coverage under the group term life insurance plan and provide individual coverage to specified key employees.
- (iv) When an employer seeks a replacement for or supplement to a qualified pension or profit-sharing plan.

3. Tax Implications

Tax implications of a §162 plan include the following:

- (i) Payments made as a bonus to an employee, regardless of method, are currently deductible by the employer as compensation, subject only to reasonable compensation standards. Payments may be made directly by the employer to the insurer or by the employer to the employee, who in turn pays the insurer.
- (ii) The entire bonus (premium) is reportable as income by the insured.
- (iii) Direct payment of premiums by the employer to the insurance company will probably be considered a “non-cash” fringe benefit for withholding purposes. Employer payments of premiums are subject to FICA and FUTA taxes.
- (iv) Since the employee has already paid tax on the full cost of the policy, he or she has a cost basis equal to the sum of all premiums paid by the employer. In most cases this basis, or “investment in the contract”, can be used to offset income tax as amounts are withdrawn or when the policy is surrendered.

²⁷⁷ Notice 2007-34 discusses the interaction between split-dollar rules and IRC §409A.

XIV. ADDENDUM REGARDING PARTNERSHIP ENTITIES²⁷⁸

A. Partnerships & LLCs in General

Many businesses are conducted as partnerships or limited liability companies ("LLCs"), rather than as corporations. There can be many reasons for this choice, including (i) a desire by the owners to deduct net losses currently against other income; (ii) the structural flexibility offered by partnerships and LLCs, including the ability to shift certain types of income to certain partners disproportionately from the sharing of control; (iii) the ease of withdrawing money and property from a partnership or LLC without current income taxes; (iv) The ability to increase the income tax basis of appreciated partnership or LLC assets on the death of a partner; and (v) the traditional use of the partnership form for certain types of businesses (such as law and accounting firms).

Regardless of the reason why one selects the partnership or LLC form for conducting a business or investment activity, a buy-sell agreement is still very important. These agreements permit the partners or members to assure that the entity interests remain within the family or existing control unit and to establish a method for determining the price at which an interest will be sold upon the death or departure of a partner or member, just as they do for a business conducted in corporate form.

1. Partnerships

A partnership is a method by which multiple persons act in association to make an investment or conduct an unincorporated business, sharing in both the profits and expenses of the venture. All partners of a general partnership have unlimited liability for partnership recourse debts and can participate in the management of the partnership, except to the extent that the partnership agreement limits the participation of certain partners.

Only the general partner in a limited partnership is personally liable for partnership recourse debts (unless the limited partners expressly assume the debts) and only the general partner may manage the partnership assets; the limited partners are liable on partnership debts only to the extent of their investment in the partnership (including any amounts the partnership agreement requires them to contribute in the future), and they do not share in the management of the partnership assets.

2. Limited Liability Companies

An LLC is created and owned by "members," rather than by stockholders or partners. The activities of the LLC are managed by the members themselves, by one or more managers chosen by the members or by the members in conjunction with managers. Managers may

²⁷⁸ Sections A, B and C of this Addendum is derived from Sections 5.01, 5.02, and 5.06 of Zaritsky, Aghdami, and Mancini, *Structuring Buy-Sell Agreements* 2d Ed. Thomson Reuters. A substantial portion of Sections E, F and G of this Addendum was prepared by J. Conrad Garcia and Jenny H. Connors, who are thanked for their contributions.

themselves be individuals, corporations, partnerships, or even other LLCs. Managers need not also be members, much as officers of a corporation need not be stockholders.

The members of an LLC can vary the terms under which they do business. Such variations are usually detailed in a written LLC Operating Agreement, which in most respects is quite similar to a partnership agreement. The LLC Operating Agreement must be agreed to by all members, and can be modified only by unanimous agreement, unless the agreement itself provides to the contrary. Under most LLC statutes, the agreement can provide for all or some amendments to be implemented by a majority vote of the members, rather than by unanimous agreement.

An LLC may have any number of members, and the identity of the members need not be divulged on the organizational documents filed with the state authorities. Like both the stockholder of a corporation and the limited partner in a limited partnership, no member of an LLC is liable for the LLC's debts and claims, except to the extent of his or her investment in the LLC. Thus, an LLC is superior to a partnership and is similar to a corporation with respect to the ability to limit the liability of the investing members.

The members of an LLC obtain their interests by contributing cash, property, services, promissory notes, or by entering into a binding obligation to make such contributions. Profits and losses of an LLC, as well as cash and property distributions, are allocated based on the value of the contributions of the members, unless the agreement provides to the contrary. The LLC Operating Agreement can provide for a different allocation of profits and losses and of cash flow distributions, in much the same manner as a partnership agreement. Thus, an LLC can have more than one "class" of membership interests.

Early LLC statutes provided that a member of an LLC may resign membership on giving notice to the LLC, unless the articles of organization provides to the contrary. Upon withdrawal, an LLC is required to distribute cash, assets, or both, having a fair value equal to that of the interest of a member who withdraws, within a reasonable time after resignation. Most states now provide that a member cannot withdraw from an LLC before its stated termination date without express authority in the governing instruments. This approach may produce more significant valuation discounts for estate and gift tax purposes under IRC 2704.

The membership interests in an LLC are personal property, even if the underlying assets of the LLC are real estate. In this respect, the LLC is like a corporation or partnership. This also makes an LLC useful as a tool to hold real estate owned by a client in a state other than the state of domicile, thereby converting the real estate holding to personal property, and avoiding ancillary probate.

Interests in an LLC are transferable, but the assignee does not become a member, nor is he or she entitled to exercise the rights of membership; the assignee is, however, entitled to receive the transferor's share of distributions. The assignee can become a member only if the other members of the LLC consent to the assignment. A buy-sell agreement among the members can certainly provide greater restrictions on transfer of shares of an LLC, and in some states the articles of organization or the operational agreement can provide for broader transferability.

B. Documentation of the Agreement

The structure of a partnership (and LLC) buy-sell agreement is similar to that of a corporate buy-sell agreement. There are three types of partnership buy-sell agreements: (i) redemption (or “entity”) agreements, in which a partner's interest in the enterprise is bought by the partnership on the occurrence of a specific event (such as death or intent to sell one's interest); (ii) cross-purchase agreements, in which a partner's interest in the enterprise is bought by the remaining partners on the occurrence of a specific event; and (iii) hybrid agreements, in which a partner's interest is bought either by the partnership, the other partners, or partly by each.

There are relatively few tax differences between a partnership's redemption of a partner's interest and the cross-purchase of that interest by the remaining partners. Partnership buy-sell agreements are simpler than corporate buy-sell agreements, because a corporation is a separate taxable entity and a partnership is not. Partnership buy-sell agreements also differ from corporate buy-sell agreements because of the special problems raised by the family partnership rules and in certain income tax consequences related to the fact that the partnership is not itself a taxable entity.

A buy-sell agreement, in the corporate context, is typically a stand alone agreement of the shareholders. The provisions of a corporate buy-sell agreement are rarely found in its organic documents, such as the articles of incorporation or the by-laws. By contrast, the buy-sell provisions for a partnership or LLC are usually found within the partnership agreement of a partnership or the operating agreement of an LLC.

C. Tax Treatment of a Sale

1. Sale of a Capital Asset

Except as otherwise provided in IRC §751 (discussed below), a partner’s sale or exchange of his interest in a partnership is treated as the sale or exchange of a single capital asset.²⁷⁹

2. Calculation of Capital Gain

Under the general rule of IRC §1001, the partner’s gain on the sale of his partnership interest is determined by subtracting the partner’s amount realized by his adjusted basis in the transferred interest. The partner’s amount realized includes the sum of money and the fair market value of any property received for the interest, plus the selling partner’s share of partnership liabilities under IRC §752(d).

The selling partner’s adjusted basis is determined under IRC §705 and is increased (or decreased) to take into account his share of undistributed partnership income (or loss) for the portion of the partnership’s taxable year which ends on the date of the sale. The selling partner’s adjusted basis includes the selling partner’s share of partnership liabilities under IRC §752(d).

²⁷⁹ IRC §741 (U.S.C.S. 2010).

In some instances, the selling partner may have utilized his debt basis to receive allocations of loss in excess of his capital account balance.²⁸⁰ If so, the partner's liability relief upon the sale of his partnership interest will cause him to recognize gain in an amount equal to his negative basis.

3. Ordinary Income Treatment for §751 Property

If the underlying partnership holds certain types of ordinary income property, often referred to as "§751 property," the partner's sale of his or her partnership interest is partially recast under IRC §751 to the extent of such §751 property. There are two categories of §751 property: "unrealized receivables" and "inventory items."

"Unrealized receivables" is broadly defined to include the underlying partnership's rights to (i) goods delivered or to be delivered, or (ii) services rendered or to be rendered, if the partnership has not yet included such amounts in income under its method of accounting.²⁸¹ Additionally, "unrealized receivables" includes certain "recapture items."²⁸² Most notably, this definition brings IRC §1245 and IRC §1250 recapture income within the purview of "unrealized receivables;" however, it also includes any other amount that would be recaptured as ordinary income if the underlying partnership had sold its property for fair market value.²⁸³

Inventory under IRC §751(d) is broadly defined to include those items listed in IRC §1221(1) (i.e., classic inventory and other property held for sale to customers). It further includes any other property which, if sold, would not be considered a capital asset or property described in IRC §1231.²⁸⁴

4. Calculation of Ordinary Income

To the extent of the underlying partnership's §751 property, a portion of the selling partner's gain will be taxed as ordinary income under §751(a). To determine the portion of the partner's gain that will be taxed as ordinary income, the partner must first determine his total amount realized on the sale of his partnership interest.²⁸⁵ Next, the selling partner must determine that portion of gain or loss that would be allocated to him upon a hypothetical sale of all of the partnership's §751 assets for their fair market values.²⁸⁶ The portion of gain or

²⁸⁰ This is especially common in the case of real estate partnerships.

²⁸¹ IRC §751(c) (U.S.C.S. 2010).

²⁸² *Id.*

²⁸³ *Id.*

²⁸⁴ I.R.C. § 751(d) (U.S.C.S. 2010).

²⁸⁵ Treas. Reg. 1.751-1(a)(2) (as amended in 2004).

²⁸⁶ *Id.*

loss that would be allocable to the selling partner upon such a hypothetical sale represents the selling partner's ordinary income on the sale of his partnership interest under IRC §751.²⁸⁷ The selling partner's amount realized, reduced by the amount which the partner must recognize as ordinary income, represents the selling partner's capital gain or loss under IRC §741.²⁸⁸

5. Installment Sale Treatment

IRC §453 permits the selling partner to report his gain under the installment method if at least one payment for the sale of his partnership interest is to be received after the year of sale. However, if a portion of the selling partner's gain is attributable to §751 property, and such property would not have been eligible for IRC §453 treatment had it been sold directly (e.g., inventory, accounts receivable, recapture, securities traded on an established exchange, etc.), such gain must be reported in the year of sale.²⁸⁹

6. §754 Election

The sale of a partnership interest frequently results in a disparity between the purchasing partner's inside basis in the partnership's assets and the partner's outside basis in his partnership interest. If, however, a partnership opts to make a §754 election (or if it has a substantial built-in loss) this disparity is resolved.

Pursuant to IRC §743(b), which applies whenever an interest in a partnership is transferred, the purchasing partner is treated as if he purchased an undivided interest in each of the partnership's assets. IRC §743(b) calls for an adjustment in an amount equal to the difference between the purchasing partner's inside and outside basis. IRC §755 and the regulations thereunder provide rules for allocating the basis adjustment among the partnership's assets. Essentially, the purchasing partner is given a cost basis in his share of each asset. It is important to note that a basis adjustment under IRC §743(b) is personal to the purchasing partner. It has no effect on future allocations of income, deduction, gain or loss to the other partners.

Once a §754 election is made for a particular transaction, the election remains in effect with respect to all future transactions of the partnership.²⁹⁰ A §754 election can only be revoked with the consent of the IRS.

If the partnership has a substantial built-in loss at the time of sale, the partnership must make the adjustments under IRC §743. IRC §743(d)(1) provides that a partnership is deemed to

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ Rev. Rul. 89-108, 1989-2 C.B. 100.

²⁹⁰ The IRC §754 election would apply to any future transfer of a partnership interest. A transfer for this purpose would include a sale, exchange or transfer at death. The IRC §754 election would not apply to a transfer by gift or to the admission of a new partner or liquidation of a retiring partner.

have a “substantial built-in loss” if its adjusted basis in its property exceeds such property’s fair market value by more than \$250,000.

D. Tax Treatment of Redemption

1. Liquidating Distribution Treatment

A partnership may opt to redeem the selling partner’s partnership interest, as opposed to having the partner sell his interest to a third party. Complete redemptions of a partner’s interest are governed by IRC §736, which relates to liquidating distributions of partnership interests. IRC §736 provides that liquidating distributions to a partner will either be treated as distributions or as allocations of income or guaranteed payments.

Subject to two exceptions (discussed below), liquidating payments made to a partner in exchange for such partner’s interest in partnership property are treated as distributions and taxed under the normal partnership distribution rules of IRC §731 and, potentially, IRC §751.²⁹¹

To the extent that cash is distributed to the redeemed partner (including any deemed distribution of cash under §752(b) relating to the relief of partnership liabilities), the partner will recognize gain if the cash distribution exceeds his basis, regardless of what other assets are distributed to him.²⁹² The redeemed partner will then have a zero basis for any other assets distributed to him in liquidation of his interest.

If the cash distributions to the retiring partner do not exceed his outside basis, and he also receives property distributions, the partner will be required to allocate his remaining outside basis among the various properties that are distributed to him in accordance with IRC §732. Under these rules, the partner’s outside basis is first allocated to any undistributed §751 property (i.e., unrealized receivables and inventory) in an amount equal to (but not in excess of) the partnership’s bases in such assets.²⁹³ The remaining balance of the partner’s outside basis, if any, is allocated among all other distributed properties.²⁹⁴ If after all distributions of cash and property, the partner has excess outside basis, the partner recognizes a capital loss in the amount of such balance in accordance with IRC §731(a)(2).

The character of the liquidating distributions to the retiring partner generally will be capital; however, to the extent that the partner is treated as having sold his interest in §751 property, the character of the income will be ordinary.²⁹⁵

²⁹¹ I.R.C. §736(b) (U.S.C.S. 2010).

²⁹² I.R.C. §731(a)(1) (U.S.C.S. 2010).

²⁹³ I.R.C. §732(c) (U.S.C.S. 2010).

²⁹⁴ *Id.*

²⁹⁵ I.R.C. §§731(a)(2) and 741 (U.S.C.S. 2010).

As discussed above, there are two exceptions under IRC §736(a) to the general rules under IRC §736(b) for the tax treatment of liquidating distributions. The two exceptions relate to amounts paid to retiring partners of service partnerships for (i) unrealized receivables²⁹⁶ and (ii) goodwill of the partnership. In these two scenarios, payments made in liquidation of a retiring partner's interest are treated as an allocation of income to the redeemed partner or as a guaranteed payment.²⁹⁷ In either case, IRC §736(a) payments primarily are considered ordinary income to the redeemed partner, and they reduce the ordinary income of the continuing partners.

The exceptions under IRC §736(a) only apply to liquidating distributions from service partnerships. A service partnership is defined as one in which "capital is not a material income-producing factor."²⁹⁸ Generally, a partnership will be deemed a service partnership if most of the partnership's revenue is generated by the services of individuals.

Payments described in IRC §736(a) are treated as a partner's allocable share of income unless the amount is determined without regard to the income of the partnership, in which case, the payments are treated as guaranteed payments to the redeemed partner.²⁹⁹ If the payment is treated as the partner's distributive share of partnership income, the character of the income flows through to the recipient. Under IRC §736(a), the continuing partners in the partnership can treat amounts paid to a redeemed partner for goodwill as a deductible expense, provided that the redeemed partner is willing to forgo favorable capital gains tax rates.³⁰⁰ Unlike allocable shares of partnership income, however, which may or may not be subject to ordinary income rates, guaranteed payments are always subject to ordinary income rates.³⁰¹ Such payments, in turn, are always deductible by the continuing partners in the partnership.³⁰²

2. §754 Election

Following the redemption of a partner's interest, a partnership may make a §754 election to adjust the inside basis of its assets. In the case of a redemption, the authority for making such an election is found in IRC §734(b).

²⁹⁶ It is important to note that, for purposes of IRC §736, "unrealized receivables" does not include IRC §§1245 or 1250 depreciable property or real property.

²⁹⁷ I.R.C. §736(a) (U.S.C.S. 2010).

²⁹⁸ I.R.C. §736(b) (U.S.C.S. 2010).

²⁹⁹ I.R.C. §736(a)(2) (U.S.C.S. 2010).

³⁰⁰ *See generally*, I.R.C. §736(b) (U.S.C.S. 2010).

³⁰¹ Treas. Reg. 1.736-1(a)(4) (as amended in 1965).

³⁰² *Id.*

IRC §734(b) provides that if a redeemed partner recognizes gain on a liquidating distribution, the partnership increases the basis of its assets by the amount of the gain recognized. If, on the other hand, a redeemed partner recognizes a loss on a liquidating distribution, the partnership decreases the basis of its assets by the amount of the loss recognized.³⁰³

If the partnership distributes property instead of cash, and the redeemed partner takes a basis in distributed property that is lower than the partnership's basis in the property immediately prior to the distribution, the partnership increases the basis of its remaining property by the difference.³⁰⁴ If the redeemed partner takes a basis in the distributed property that is higher than the partnership's basis in the property immediately prior to the distribution, the partnership decreases the basis of its remaining property by the difference.³⁰⁵

Unlike IRC §743(b), which applies in the case of partnership interest transfers and calls for partner-specific basis adjustments, basis adjustments under IRC §734(b) affect the common basis of partnership property. Further, §734(b) adjustments are based specifically on the event that triggers the adjustment.³⁰⁶ For instance, if the adjustment is triggered by the distribution of cash to, and the recognition of gain by, the selling partner, the §734(b) adjustment is assigned to capital gain property.³⁰⁷ If, however, the adjustment is triggered by a change in the basis of a specific asset, the §734(b) adjustment is assigned to assets within the same class.³⁰⁸ If the partnership has no assets in the appropriate class, the basis adjustment is suspended until the partnership acquires one.³⁰⁹

Adjustments under §734 are elective, except where there would be a “substantial basis reduction.”³¹⁰ In that case, the partnership is required to adjust the basis of its property, regardless of whether it makes a §754 election. For purposes of §734 adjustments, a “substantial basis reduction” is any negative adjustment in excess of \$250,000.³¹¹

E. Sales vs. Redemptions

In most instances, there will not be significant tax differences between sales and redemptions of partnership interests. There are, however, several instances in which the tax consequences

³⁰³ I.R.C. §734(b)(2) (U.S.C.S. 2010).

³⁰⁴ I.R.C. §734(b)(1) (U.S.C.S. 2010).

³⁰⁵ I.R.C. §734(b)(2) (U.S.C.S. 2010).

³⁰⁶ Treas. Reg. §1.755-1(c)(1)(i) (as amended in 2004).

³⁰⁷ Treas. Reg. 1.755-1(c)(1)(ii) (as amended in 2004).

³⁰⁸ Treas. Reg. 1.755-1(c)(2) (as amended in 2004).

³⁰⁹ Treas. Reg. 1.755-1(c)(4) (as amended in 2004).

³¹⁰ I.R.C. §734(a) (U.S.C.S. 2010).

³¹¹ I.R.C. §734(d) (U.S.C.S. 2010).

of a sale will be preferable to those of a redemption, and vice versa. These instances involve, among others, the use of the installment method of reporting gain on the sale or redemption of a partnership interest, terminations under IRC §708 upon the sale or redemption of a partnership interest and the treatment of intangibles in a personal services partnership.

1. Installment Reporting.

As set forth above, IRC §754 provides an election to step-up the basis of partnership property where there is a difference between the inside basis of partnership assets and the partners' respective bases for their partnership interests. IRC §743 contains the operative provisions of a §754 election upon the sale or exchange of a partnership interest, and IRC § 734 provides the operative provisions in the event of a redemption (or other liquidating distribution). Generally, the operational aspects of IRC §§734 and 743 are similar; however, where payments are made and reported under the installment method, the tax consequences resulting from the operational differences under the two sections can be significant.

In the event of a sale, the retiring partner recognizes a pro rata portion of his gain ratably over the payment term. IRC §743(b), in turn, provides that the continuing partners are entitled to an immediate basis increase in the partnership's property equal to the amount of gain ultimately to be recognized by the retiring partner.

In the case of a redemption, the retiring partner is able to reduce his basis, first, and, then, recognize gain on any remaining proceeds. IRC §734(b), unlike IRC §743(b), only permits the continuing partners to adjust the basis of partnership property in an amount equal to the gain actually recognized by the retiring partner.³¹² In other words, where a §754 election is made following a redemption, the basis adjustment in partnership assets must correspond both in timing and amount with the recognition of gain by the retiring partner. Additionally, each basis step-up is treated as the acquisition of new recovery property in the case of depreciable property.

2. §708 Terminations

Generally, IRC §708 provides that a partnership is considered to have terminated if there is a sale or exchange of 50% or more of the total interests in the partnership capital or profits within a 12-month period.

When a partnership terminates under IRC §708, the partnership is deemed to have contributed its assets and liabilities to a new partnership in exchange for an interest in the new partnership.³¹³ The terminated partnership then makes a liquidating distribution of partnership interests in the new partnership to its partners (including the purchasing partner) in proportion to their respective interests.³¹⁴ The termination of the partnership requires all of

³¹² See, e.g., Rev. Rul. 93-13, 1993-1 C.B. 126.

³¹³ Treas. Reg. 1.708-1(b)(4) (2001).

³¹⁴ *Id.*

the contributed partnership property to be treated as new recovery property. Consequently, if the retiring partner's interest is purchased, the depreciation timeline for the remaining basis of depreciable partnership property will be restarted.

IRC §708 does not apply to redemptions. Therefore, the redemption of the retiring partner's interest would have no effect on the depreciation timeline of the partnership's property.

3. Intangibles in Personal Services Partnerships

If a partner in a service partnership opted to sell his partnership interest, the portion of the consideration paid to the selling partner for intangibles (i.e., goodwill and going concern value) would be treated as capital gain to the selling partner and would create an asset that would be amortizable by the remaining partners (subject to certain anti-churning rules) in the service partnership over a 15-year period, assuming the partnership made, or had in effect, a §754 election. If, however, the service partnership opted to redeem the partner's interest, the parties likely would have a choice as to the tax characterization of the payment to the retiring partner for certain intangibles.³¹⁵

IRC §736(b)(3), provides that payments to a retiring partner shall include goodwill of the partnership if (i) the parties' agreement provides for a payment with respect to goodwill, (ii) capital is not a material income-producing factor of the partnership and (iii) the payment is made to a retiring general partner. To the extent that such payments include goodwill under the circumstances, §736(b)(3) further provides that they are deductible by the partnership and ordinary income to the retiring partner. Essentially, this provision allows a service partnership to choose the tax treatment of payments to a retiring partner for certain intangibles of the partnership.

While the IRS has yet to rule on the application of IRC §736(b)(3) payments to a retiring member in a limited liability company, it is likely that the provisions of IRC §736(b)(3) would also apply in that instance.³¹⁶

4. Depreciation Recapture under §1250

Treas. Reg. §1.1(h)-1(b)(3)(ii) states that, upon the sale or exchange of a partnership interest, the selling partner must take into account that portion of unrecaptured IRC §1250 gain that would have been allocated to him if, immediately prior to transfer of his partnership interest, the partnership had sold all of its depreciable real property for cash equal to the fair market value of such property. This look-through rule only applies in the case of a sale or exchange

³¹⁵ I.R.C. §736(b)(3) (U.S.C.S. 2010).

³¹⁶ Cases, such as *Gregg v. United States*, 186 F. Supp. 2d 1123 (D.C. Or. 2000), which allowed limited liability company members to qualify for the seven "general partner" material participation tests under the IRC § 469 passive loss rules, rather than the three "limited partner" material participation tests, suggests that limited liability company members are akin to general partners. Based on this ruling, it is likely that the favorable redemption payment treatment under IRC § 736(b)(3) would extend to members in service-based limited liability companies.

of a partnership interest. It does not apply to partnership redemptions.³¹⁷ Consequently, a selling partner may opt to have his partnership interest redeemed to avoid the recognition of additional tax on §1250 property.

XV. CREDITS & BIBLIOGRAPHY

Credit for contributions to this outline is given to the following members of the ACTEC Business Planning Committee: Nancy Schmidt Roush (chair), James L. Boring, C. Fred Daniels, Clarence J. Ferrari, Jr., Steven B. Gorin, Robert S. Marquis, Randy S. Nelson, Richard S. Scolaro, and David C. Sojourner, Jr.

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