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BUY-SELL AGREEMENTS AND RELATED TAX ISSUES FOR THE CLOSELY HELD BUSINESS

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I. INTRODUCTION

A. Definition.

1. A buy-sell agreement is an agreement between the owners of a business, or among the owners of the business and the entity, to purchase and sell interests of the business at a price determined under the agreement upon certain future events.

   a. These events may include death, disability, divorce, an offer to purchase an owner's interest from an outside party, and termination of employment.

   b. Other matters may be covered by the agreement, including restrictions on transfer, rights of minority owners in the event of the sale of the entity, and provisions to protect an S election.

2. While most of the considerations are the same whether the business operates as a corporation (either a C or an S corporation), a partnership, or a limited liability company (LLC), there are some important differences that are noted in the outline.

B. Items of Current Significance Regarding Buy-Sell Agreements.

1. There has been an increased use of S corporations and partnerships as a result of the Tax Reform Act of 1986 (TRA 86).

   a. Because of TRA 86's repeal of the *General Utilities* doctrine, gain on the disposition of an interest in a C corporation in many cases is subject to two levels of income taxation, one at the corporate level and one at the shareholder level.

2. All 50 states and the District of Columbia have adopted LLC acts, authorizing the formation of a limited liability company, which has the limited liability benefits of a corporation and the tax benefits of a partnership.

   a. LLCs were unavailable in most states before 1990.

   b. In this outline, it is assumed that an LLC will be classified as a partnership for income tax purposes, and, unless the context indicates otherwise, references to a partnership are intended to include an LLC.

3. Finally, I.R.C. § 2703, added by the Revenue Reconciliation Act of 1990 (RRA 90), mandates certain requirements that must be satisfied in order for the price established under a buy-sell agreement to be accepted as the value of an interest in a family-controlled business for federal transfer tax purposes.

II. OBJECTIVES OF A BUY-SELL AGREEMENT

A. For the Entity.

1. Restrict the sale or transfer of an ownership interest to unwanted third parties.

2. Void transfers to individuals or entities that would terminate an S election, the status of the corporation as a professional corporation under state law, or the termination of a partnership for tax purposes.

3. Enable a smooth transition in the control and/or ownership of the entity.

4. Provide a method of funding the buy-out of a withdrawing or deceased owner's interest and establish the terms for the payment of the purchase price.

5. If well drafted, avoid disputes among owners.

B. For the Deceased Owner's Estate.

1. Enable the estate to obtain a favorable price and terms for what could have been an unmarketable asset.

2. Ensure that the estate receives cash for payment of estate taxes and administration expenses.

3. Protect the estate from having to negotiate price and terms from a weak bargaining position.

4. Establish the value of the ownership interest for federal estate tax purposes.

5. Relieve the estate, distributees, or beneficiaries from involvement in the affairs of the business, such as guaranteeing loans to the entity.

6. Prevent delays in the administration of the estate because the price and the terms for the sale of the interest are settled under the agreement.

7. Provide a source of income to the spouse and other distributees or beneficiaries.

8. Prevent disputes between the spouse and children of the deceased owner and the remaining owners by eliminating the estate and beneficiaries as owners.

C. For the Retired or Disabled Owner.

1. Provide a source of cash, either in a lump sum or over a period of time, usually with favorable capital gain treatment.

a. There are at least four reasons why capital gain treatment is desirable.

(1) The maximum tax rate on capital gains for property held for more than 12 months is 20%, as opposed to a 39.6% maximum rate on ordinary income in 2017. *See* I.R.C. § 1(h).

(2) Capital losses in excess of capital gains may only offset $3,000 of ordinary income each year. I.R.C. § 1211(b)(1).

(3) In a capital gain transaction, the owner is taxed only on the amount by which the sale price exceeds his or her basis in the interest, thus allowing the owner to recover his or her basis tax-free. I.R.C. § 1001(a).

(4) Installment sale treatment is not available for certain transactions that are not treated as sales or exchanges, such as dividend distributions. *See generally* I.R.C. § 453(b)(1) (referring to a "disposition of property").

2. Eliminate the potential for conflict between the disabled or retired owner and remaining owners over policies of the entity concerning cash distributions (dividends), salaries, borrowing money, and growth.

D. For the Remaining Owners.

1. Enable the remaining owners to be certain of the terms under which a departing owner's interest will be purchased.

2. Provide a source of long-term financing for the purchase of a departing owner's interest, allowing payments to be made out of the business' cash flow.

3. Avoid the moral dilemma that could arise in negotiating price and terms with the spouse and children of the deceased or incapacitated owner (often a long-time friend, partner, or business associate).

4. Ensure that the efforts of active owner/employees do not inure to the benefit of an inactive owner or owners and that an inactive owner will be unable to interfere with the entity's management.

5. Decrease the chance of disputes when an owner wishes to withdraw from the entity, whether to enter into competition or otherwise.

III. PLANNING CONSIDERATIONS

A. Factors to Consider.

1. Nature and size of the entity.

2. Value of the entity as a going concern.

3. Book value, market value, or other liquidation value of the entity's underlying assets.

4. Relative ownership interests of the owners.

5. Ages of the owners.

6. Financial condition of the owners.

7. Health and insurability of the owners.

8. Commitment of owners to the business and importance of their participation in the business.

9. Availability of assets for redeeming the interest.

10. State law with respect to stock redemptions in the case of a corporation or distributions to members of an LLC.

11. Existence of restrictions under loan agreements on the use of the entity's assets to redeem equity interests.

12. Family relationships among owners.

13. Working relationships among owners.

14. The extent to which the owners are active in the business and intend to remain active in the business.

15. Licensing or other qualification requirements.

16. Type of entity: C corporation, S corporation, personal holding company, professional corporation, general partnership, limited partnership, or LLC.

17. Potential conflicts of interest and ethical questions involved in representing or advising more than one owner and the entity, either when the agreement is negotiated or when an event occurs that causes the agreement to become operative.

B. <u>Types of Buy-Sell Agreements</u>.

1. A "cross-purchase agreement," also referred to as a shareholders' or partners' agreement, requires, or gives an option to, the remaining owners to purchase on a pro rata or other basis the ownership interest of the withdrawing or deceased owner.

2. Under a "redemption agreement" or an "entity purchase agreement," the entity is obligated or has an option to purchase the ownership interest of the withdrawing or deceased owner.

3. Under a hybrid or combination agreement, the entity has either an option or an obligation to purchase the ownership interest of the withdrawing or deceased owner, but the entity is permitted to assign its right to purchase the interest to the remaining owners.

    a. A hybrid agreement may also require the remaining owners to purchase any interest of the withdrawing or deceased owner not purchased by the entity because of legal restrictions, lack of sufficient funds, or other reasons.

    b. In the case of a C corporation, the corporation should have the initial obligation to purchase the shares under a hybrid agreement.

        (1) Otherwise, if the corporation purchases shares that the shareholders are obligated under the agreement to purchase, the shareholders will be deemed to be receiving dividends taxable as ordinary income to the extent that the corporation has earnings and profits. Rev. Rul. 69-608, 1969-2 C.B. 42.

C. <u>Choosing the Right Type of Agreement</u>.

1. Number of owners.

    a. If life insurance will be used to finance the purchase of the interest of a deceased owner, a large number of owners may make the use of a cross-purchase agreement cumbersome because each owner will be required to purchase a policy on the life of each of the other owners.

(1) For example, if there are five owners, twenty policies would be required: five (the number of owners) times four (the number of owners minus one).

b. When there is a large number of owners and a cross-purchase agreement is desired, the owners may create a separate trust or partnership to purchase the necessary policies and hold the proceeds to be used to carry out the purchase of the departing owner's interest.

(1) Using a partnership or LLC to hold the policies may also provide creditor protection that would not be available if the polices were held in the corporation or individually.

(2) In addition, having a partnership or LLC own the policies facilitates the administration of the buy-sell agreement.

(3) The partners of the partnership or members of the LLC that holds the polices could be irrevocable trusts, which would enable the stock of deceased shareholders to be excluded from the estates of the remaining shareholders.

2. Premium payments on life insurance policies used to finance the purchase.

a. Because the premium payments, whether made by the entity or the owners, are not deductible, if a C corporation is in a lower income tax bracket than the shareholders, it will be less expensive for the corporation to pay the premiums as part of a redemption agreement. I.R.C. § 264(a)(1).

(1) For example, a corporation in a 15% bracket must earn $117.65 to pay a $100.00 premium.

(2) A shareholder in a 35% bracket would have to earn $153.85 to pay the same $100.00 premium.

(3) Therefore, the use of a cross-purchase agreement between shareholders would cause an additional $36.20 in taxes for each $100.00 of premium.

b. On the other hand, if the C corporation is in a 34% bracket and the shareholder is in a 28% bracket, the after-tax cost of premiums to a shareholder pursuant to a cross-purchase agreement will be less than the after-tax cost to a corporation under a redemption agreement.

c. In the case of an S corporation or partnership, because the shareholders or partners will report as taxable income any premiums paid by the entity, there will be no tax bracket differential whether the premiums are paid by the entity or by the owners.

d. Note that if the owners are not the same age or insurable at the same rate, or do not own the same percentage of interest, there may be perceived inequities depending upon whether the entity or the owners pay the premiums.

(1) If the entity is paying the premiums, the majority or older owner will in effect be funding part of his or her own redemption.

(2) If the owners are paying the premiums, a younger or minority owner will pay more in premiums than an older or majority owner.

(3) An owner may find it financially difficult to make premium payments, but the entity may increase the salaries of the owners or enter into split-dollar agreements with the owners to help defray the cost of the premiums.

3. Transfer-for-value problems.

a. Generally, life insurance proceeds are not subject to income tax unless the policy has been transferred to another person for valuable consideration. I.R.C. § 101(a)(1).

b. Such a transfer for value would subject the proceeds payable on the death of the insured to income tax to the extent they exceeded the purchase price and post-transfer premiums paid by the transferee.

c. The transfer-for-value rule does not apply to a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is an officer or shareholder. I.R.C. § 101(a)(2).

d. In the case of a corporate cross-purchase agreement, when one of the shareholders dies, the policies he or she owns on the lives of the other shareholders cannot be sold by his or her estate to any remaining shareholder without triggering the transfer-for-value rule, unless one of the exceptions applies.

e. A partnership among the shareholders will avoid the transfer-for-value problem.

(1) In PLR 9012063, the Internal Revenue Service (IRS) held that transfers to a partnership, which leased real estate to the corporation, of policies on the lives of the partners (who were also the shareholders of the corporation) and the naming of each partner as the beneficiary of the policy on the life of the other partner were not transfers for value. The transfers were made when the corporation and the shareholders switched from a redemption agreement to a cross-purchase agreement to avoid the alternative minimum tax (discussed below).

(2) In PLR 9045004, the IRS held that a corporation's transfer of a life insurance policy on the life of one of its shareholders to another shareholder was not a transfer for value because both shareholders were partners in a real estate and oil and gas partnership, even though the partnership had no business connection with the corporation.

(3) In PLR 9042023, the IRS held that the transfer-for-value rule did not apply when a corporation transferred a policy to a partnership in which the insured was a partner, even though the partnership was apparently created for the sole purpose of owning the policy.

(a) Technically, a partnership set up solely for the purpose of owning life insurance policies on the lives of shareholders of a corporation may not be treated as a partnership for tax purposes because it is not engaged in a business for profit.

(b) Nevertheless, in another private letter ruling, the IRS again ruled that a partnership engaging "in the purchase and acquisition of life insurance policies on the lives of its partners" would be classified as a partnership for federal income tax purposes, and, accordingly, the transfer to the partnership of life insurance policies insuring the lives of the partners for valuable consideration was exempt from the transfer-for-value rule. PLR 9309021.

(c) The IRS will no longer rule on whether a transfer of a life insurance policy to an unincorporated entity will be exempt from the transfer-for-value rule when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members. Rev. Proc. 2017-3, 2017-1 I.R.B. 130 (Dec. 29, 2017), § 3.01(14).

(4) The Tax Court has held that the partnership to which a policy held by a corporation is transferred must actually operate as a partnership and may not be a partnership in form only to satisfy the exception to the transfer-for-value rule. *W. Swanson, Jr. v. Commissioner*, T.C.M. 1974-61, *aff'd*, 518 F.2d 59 (8th Cir. 1975).

f. If a trust owns the policies pursuant to a cross-purchase agreement, the transfer-for-value rule may apply at the death of a shareholder when each of the remaining shareholders (as a beneficiary of the trust) obtains an increased interest in the remaining policies, presumably in exchange for the obligation to continue paying premiums. *See Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ma. 1961).

(1) The facts in this case are not typical of how a trust would be used to hold insurance policies to fund a buy-sell agreement.

(a) The case involved the transfer of two existing policies to a trust pursuant to an agreement that required the trustees to use the proceeds to pay the purchase price for the stock owned by two of the shareholders upon the death of one of them pursuant to an agreement whereby the remaining two shareholders were obligated to purchase the stock.

(b) According to the court, the consideration for the transfer of the two insurance policies was the mutuality of obligations and the actual cash consideration paid by taxpayers Monroe and Hickman in premiums, which was an integral part of the consideration for the assignment of the insurance policies for the use and benefit of the taxpayers.

(2) In the more usual case, the trust would purchase new policies on the lives of the shareholders, using contributions from all of the shareholders.

(a) The IRS might still contend that there was a transfer for value because each shareholder would receive an additional interest in the policies remaining after the death of a shareholder.

(3) If the beneficiaries are also partners in a partnership, the exception will apply.

4. Alternative minimum tax problems.

a. The corporate alternative minimum tax ("AMT") may apply to 75% of the proceeds of a life insurance policy paid to a C corporation.

(1) The AMT does not apply to a corporation if the corporation's average annual gross receipts for the prior three years do not exceed $7,500,000. I.R.C. § 55(e).

b. After 1989, 75% of adjusted current earnings in excess of base alternative minimum taxable income is an adjustment in arriving at alternative minimum taxable income for C corporations. I.R.C. § 56(g)(1)(A).

(1) Adjusted current earnings include life insurance proceeds to the extent they exceed the corporation's adjusted basis in the contract. Treas. Reg. § 1.56(g)-1(c)(5)(v).

(2) Therefore, the proceeds may be taxed at an effective rate of 15% (since the alternative minimum tax rate is 20% for C corporations) (75% x 20% = 15%).

c. Using an S corporation, partnership, or LLC avoids this problem, since the shareholders, partners, or members, rather than the entity, are subject to the individual alternative minimum tax, which does not include adjustments.

d. The increase in the cash value of a policy, to the extent the increase exceeds the premiums paid, is also included in adjusted current earnings. I.R.C. §§ 56(c)(1), 56(g)(4)(B)(ii), and 7702(g). *See also* Treas. Reg. § 1.56(g)-1(c)(5)(iii).

e. In some cases, the alternative minimum tax paid in one year will be recovered in a later year as a credit against the regular tax when the regular tax exceeds the tentative minimum tax for that later year. I.R.C. § 53(c).

f. The corporate alternative minimum tax problem can be dealt with in three ways:

(1) The corporation can buy more insurance to pay the tax;

(2) The corporation can be converted to an S corporation for federal income tax purposes and avoid the tax; or

(3) The entity buy-sell agreement can be converted to a cross-purchase agreement, also avoiding the tax.

5. Accumulated earnings tax.

a. A C corporation may have accumulated earnings tax consequences if it sets aside liquid assets to fund the purchase of shares under a buy-sell agreement.

(1) The accumulated earnings tax is equal to the highest tax rate on dividends (20% in 2017) times the accumulated taxable income of a C corporation. I.R.C. § 531.

b. Generally, accumulated earnings are earnings and profits of the corporation in excess of the amount required for operating the business.

(1) Generally, a corporation is entitled to accumulate $250,000 without showing that the accumulation is necessary for the needs of the business.

(2) A personal service corporation is limited to $150,000. I.R.C. § 535(c)(2).

c. Accumulating funds for the buy-out of a minority shareholder may be considered a reasonable need of the corporation. Compare *Dickman Lumber Co. v. Commissioner*, 355 F.2d 670 (9th Cir. 1966); and *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278 (7th Cir. 1958); with *Mountain States Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960); and *Ted Bates and Co., Inc*., 24 T.C.M. 1346 (1965).

d. Also, the reasonable needs of the business include any amount accumulated during the taxable year of a shareholder's death or any year thereafter to redeem shares under I.R.C. § 303, which affords sale or exchange treatment in connection with a redemption of shares from an estate or a beneficiary of a deceased shareholder to the extent of the estate's federal and state estate and death tax liability and administration and funeral expenses. I.R.C. § 537(b)(1).

6. Credit considerations.

a. Credit considerations may dictate whether the entity or the owners should have the primary obligation to purchase the interest of the withdrawing or deceased owner.

b. The entity may be prevented by restrictive covenants in loan agreements from redeeming its own shares or partnership interests.

c. The obligation to redeem the interest of a deceased owner may affect the entity's ability to borrow in the future.

d. The choice may depend upon the relative financial condition of the entity and the owners.

(1) Depending upon state law, the creditors of either may have a prior claim to insurance proceeds or other assets designated for the purchase of the interest when the triggering event occurs.

7. Capital gain treatment.

a. Because of the applicability of the attribution rules in characterizing a corporation's redemption of shares, a cross-purchase agreement may be necessary in a family corporation to ensure capital gain treatment for the selling shareholder when the shares are purchased.

(1) Under the attribution rules, shares owned by certain family members and certain estates, trusts, partnerships and corporations are considered to be owned by other family members, beneficiaries, partners, and shareholders. I.R.C. § 318.

(2) Attribution may cause the redemption of shares held by a family member, an estate, or beneficiaries to fail to meet the requirements for capital gain treatment under I.R.C. § 302(b).

b. If the estate of a deceased shareholder qualifies for sale or exchange treatment under I.R.C. § 303, capital gain treatment will be achievable to the extent of federal and state estate and death taxes and funeral and administration expenses regardless of the attribution rules.

c. On the other hand, a sale to another shareholder will always be a capital gain transaction, even if the shareholders are related.

8. State law.

a. State law may restrict the ability of a corporation to redeem its shares.

(1) In some states, a corporation may not redeem its own shares unless there is sufficient capital surplus or retained earnings to fund the redemption.

(2) In other states, a corporation may not redeem its own shares if it would cause the corporation to be unable to pay its debts as they become due in the ordinary course of business, or if the assets of the corporation after the redemption would be insufficient to satisfy its obligations, including the preferential rights of holders of senior securities. *See* Section 6.40 of the Revised Model Business Corporation Act.

(3) While the majority of cases hold that the surplus requirement applies when each payment on an installment note given as part of the purchase price is made, some jurisdictions hold that the surplus must be sufficient to cover the entire purchase price at the time the note is given.

b. A redemption agreement may resolve this problem in a number of ways.

(1) The shareholders may be required by the agreement to take action to cause the redemption to satisfy state law requirements.

(a) Examples of such action are reducing stated capital (and thereby increase capital surplus) or revaluing assets, particularly appreciated ones, to obtain a more accurate estimate of their fair market value.

(2) The shareholders may be obligated to purchase any shares that the corporation is unable to purchase.

9. Basis for income tax purposes.

a. Under a redemption agreement for a C corporation, the basis of the shares owned by the remaining shareholders is not increased as a result of the corporation's purchase of the shares of the withdrawing or deceased shareholder, while under a cross-purchase agreement each remaining shareholder obtains a basis in the newly purchased shares equal to the purchase price he or she pays.

(1) If it is anticipated that the remaining shareholders will continue to own the shares until death, the basis issue will not be important.

(a) As each shareholder dies, the basis of his or her stock will be increased to the fair market value at the date of death or at the alternate valuation date. I.R.C. § 1014(a).

(2) Despite the basis increase, the amount of potential gain in some cases may not decrease as a result of the use of a cross-purchase agreement when the purchase is not funded by life insurance.

(a) For example, assume that A and B each own 50% of the shares of Acme Corporation, that each has a basis of $100 in the shares, and that the value of the corporation is $300. If B dies and the corporation redeems his or her shares for $150, the corporation will presumably be worth $150. If A sells his or her shares immediately after the redemption for $150, the fair market value of the corporation, A will have a $50 gain ($150 minus $100 basis). Instead, if A had purchased B's shares for $150, A would have a basis afterwards in all his or her shares of $250. If A sold his or her shares immediately after the purchase for $300, the fair market value of the corporation, A would still have a gain of $50 ($300 minus $250 basis). This result assumes the value of the corporation is based on the value of its assets and not on its going concern value.

b. This issue is generally not relevant in the case of an S corporation, partnership or LLC since the remaining shareholders, partners, or members will receive an increase in the basis of their ownership interests regardless of the type of buy-sell arrangement used.

(1) The life insurance proceeds or the profits used by the entity to purchase a withdrawing or deceased owner's interest represent entity income that will have already been passed through to the remaining shareholders, partners or members, thereby increasing their basis in the same manner as if they had purchased the interest directly from the withdrawing or deceased owner with their own after-tax income, except for any life insurance proceeds allocated to the interest owned by the deceased owner. I.R.C. §§ 705(a)(1) and 1367(a)(1)(A).

10. Deductibility of interest.

a. In a C corporation, the interest paid by the shareholders under an installment note pursuant to a cross-purchase agreement will be investment interest and will only be deductible to the extent the shareholder has investment income. I.R.C. § 163(d).

b. If a C corporation is redeeming a shareholder's shares, any interest paid will be deductible because the general limitation on the deductibility of interest only applies to individuals.

c. In the case of an S corporation, partnership, or LLC, interest paid by owners will be classified as either deductible business interest, investment interest, or passive interest.

(1) If all the assets of the entity are used in the conduct of a trade or business and the purchasing owner materially participates in the business, the interest paid will be business interest and fully deductible.

(2) If all the assets of the entity are used in the conduct of a trade or business and the purchasing owner does not materially participate, the interest paid will be passive interest and deductible only to the extent of passive income.

(3) To the extent that the assets of the entity are investment type assets, a portion of the interest paid will be treated as investment interest and only deductible against the investment income of the purchasing owner.

(4) In the redemption context, if the entity is an S corporation, partnership, or LLC, the interest deduction passed through to the individual owners will probably be characterized in the same manner as if the individual owners had purchased the interest themselves.

Notice 89-35, 1989-1 C.B. 675.

11. Other issues.

a. Under a cross-purchase agreement for a C corporation, the remaining shareholders may receive tax free proceeds from life insurance policies used to fund the purchase in excess of the required purchase price, which if received by the corporation under a redemption agreement would be trapped in the corporation and would be difficult to distribute to the shareholders without being treated as a dividend if the corporation had earnings and profits.

b. If a redemption agreement grants the entity the option to purchase an owner's interest, the agreement should be drafted to exclude the withdrawing owner or the estate of a deceased owner from participating in the entity's decision concerning the exercise of the option.

c. If some of the interests are held by members of the same family, special provisions may be required to ensure that the family group retains the same ownership percentage.

(1) For example, if husband and wife each own 25% of the interest in the entity, the agreement may give the survivor the right to purchase the interest of the first spouse to die before the entity or other owners have a right or obligation to purchase the interest.

D. Suggested Terms of a Buy-Sell Agreement.

1. Ethical considerations.

a. While it usually is the advisor's responsibility to structure the buy-sell agreement in a way to avoid unnecessary taxes, the owners of the business must make the ultimate decisions about each of the issues discussed in the following sections.

b. In many cases it will be essential that the advisor make clear to the owners that the advisor is not representing any of the individual owners and that each of them should seek independent counsel in connection with the buy-sell agreement.

(1) As a practical matter, in many cases the owners will not seek independent advice.

(2) However, where the advisor has a long-standing relationship with one or more of the owners, but not all of them, it is crucial that the other owners be advised to seek independent counsel.

(a) Not only will this protect the advisor from a later charge of unethical conduct, but it will also increase the likelihood that the agreement will be upheld by a court in the event that there is a dispute among the parties relating to the negotiation of the agreement.

2. Triggering events.

a. The events triggering a purchase may include the death, retirement or disability of an owner, an attempted sale to a third party, and the termination of employment of an owner for reasons other than death, retirement, or disability.

(1) In many cases it may be advisable to add divorce as a triggering event to ensure that an interest in the entity will not be transferred to a former spouse of an owner pursuant to a divorce proceeding, even though such a transfer should arguably be covered under a general restriction on transferability contained in the agreement.

(2) The triggering termination of employment may be voluntary (for example, to enter into competition with the entity, to move to another geographic location, or to work for another employer) or involuntary (for example, as a result of the loss of the owner's professional license to practice the profession for which the entity is organized or the owner's permanent disability).

(a) The reason for the termination of employment may dictate the purchase price for the withdrawing owner's interest.

(i) For example a higher price may be paid to the estate of a deceased owner than to an owner withdrawing to enter into competition with the entity.

b. Bankruptcy or insolvency of an owner may also trigger an option or obligation to purchase.

(1) Such a provision will ensure that the remaining owners can avoid participation by the bankruptcy trustee in the entity's management.

(2) However, such a provision may not be enforceable under the Bankruptcy Code if the purchase price does not reflect the fair market value of the interest. 11 U.S.C. § 548.

3. Setting the purchase price.

a. Introduction.

(1) One of the most important features of a buy-sell agreement is the mechanism for determining the purchase price of the ownership interest.

(2) In many cases it may be advisable to use the services of a certified public accountant or a professional business appraiser.

(3) A good starting point would be a professional appraisal. See subparagraph III.D.3.d. below.

(a) If all the owners agree upon the method used by the appraiser in determining the value of the business, the same method could be used for purposes of determining the purchase price under the buy-sell agreement.

b. Fixed price method.

(1) One of the simplest methods is to use a fixed price, redetermined periodically by the owners.

(a) For example, the owners could agree to meet each year after the financial statements for the entity have been prepared to discuss adjusting the purchase price for purposes of the agreement.

(2) If this method is used, consideration should be given to using some other method to determine the price if the fixed price has not been redetermined within a specified period.

(a) It may be to the advantage of a younger or healthier owner to refuse to agree to an upward adjustment of the purchase price when the other owner or owners are older or in bad health.

(b) By requiring an automatic adjustment if the price is not readjusted by agreement, the older or less healthy owners are protected.

(c) For example, the buy-sell agreement may be drafted to provide that if the owners fail to agree to a new purchase price after a certain period of time, such as two years, and one of the owners dies, the last purchase price determined will be adjusted upward or downward based on the increase or decrease in the book value of the business or in the average earnings of the business over the period of time from the last redetermination of the purchase price to the occurrence of that owner's death.

c. Book value and adjusted book value.

(1) The book value of the business may be used to set the purchase price, although in most cases the book value will not reflect the real value of the business.

(a) The book value uses the historic cost of assets less depreciation, which in many closely held businesses is determined under the same depreciation method used for tax purposes.

(2) However, an adjusted book value may be more appropriate because it can take into account the following factors:

(a) Any assets not appearing on the balance sheet, such as good will and work in progress;

(b) Any accrued income or expenses not appearing on a balance sheet prepared under the cash or hybrid method of accounting;

(c) Any contingent liabilities;

(d) The appraised value of certain assets such as real estate and large machinery;

(e) The market value of securities of other companies held as investments that are listed on a recognized exchange;

(f) The loss of the deceased owner's services to the business; and

(g) Insurance proceeds.

(i) There are three ways to account for life insurance proceeds:

i. The cash value of the policy on the deceased owner's life before his or her death, which should be reflected in the balance sheet, can be used in place of the proceeds;

ii. The excess of premiums paid by the entity over the cash value before death can be added to the book value; or

iii. The proceeds can be substituted for the cash value of the policy.

d. Appraisal.

(1) The agreement may require that an appraisal be made at the time the interest of the withdrawing or deceased owner is to be purchased.

(a) Sometimes specific instructions will be given on what factors should be considered, including discounts, and the relative weight to be given to such factors.

(2) The cost of an appraisal of a closely held business may vary between $10,000 and $20,000, depending upon the type of business and the area of the country in which the business is located.

(3) The agreement should also provide the method by which an appraiser is selected.

(a) Many buy-sell agreements provide that the entity or remaining owners will choose and pay for the initial appraiser.

(b) If the selling owner disputes the first appraisal, he or she is allowed to pick a second appraiser (typically at his or her expense).

(c) If the appraisals are within a certain percentage of one another, then the purchase price is the average of the two.

(d) Otherwise, the two appraisers pick a third appraiser, whose expense is split evenly and whose appraisal becomes binding.

(4) The use of the appraisal method gives the owners the assurance that the purchase price will reflect the conditions existing at the time the interest is to be purchased.

(5) The agreement should require that the appraiser have experience in valuing businesses of the type in which the entity engages.

e. Capitalization of earnings.

(1) The agreement may provide for a formula price based on the capitalization of average earnings over a specified number of years.

(a) The earnings may be weighted in arriving at the average, giving more weight to the earnings over the last several years.

(2) The capitalization rate should be set forth in the agreement or should be based on some objective standard.

(3) Under this method, the capitalization rate times the average earnings would produce the value of the business.

(4) In a closely held C corporation, the earnings would have to be defined, because the after-tax earnings may not be indicative of the true earning capacity of the corporation.

(a) Often the shareholders of a closely held C corporation will receive either higher compensation than would be normal to reduce the taxable income of the corporation or lower compensation than would be normal in order to provide for the current cash needs of the corporation.

(b) Consequently, a fair market value rate of compensation for the positions that the shareholders hold in the corporation should be substituted for the compensation actually paid to the shareholders.

(c) Similar adjustments may be required for other types of closely held entities.

f. Other valuation methods.

(1) The owners may adopt a put-and-take method.

(a) Under this method an offer is made by one party or group to buy or sell its interest(s) in the entity at a price specified in the offer.

(b) The other party or group is then required to choose whether to buy the offering party or group's interest(s) or to sell its own interest(s) to the offering party or group at the price stated in the offer.

(c) This type of pricing mechanism is often referred to as a "Dutch auction."

(d) The party making the first offer to buy/sell may be required to post sufficient collateral to finance the purchase.

(e) This is usually an unsatisfactory method in the case of a disabled owner or a deceased owner's estate that may not be in a position to continue to run the business.

(2) Another method bases the purchase price on the estate tax value of the deceased owner's interest.

(a) However, such a method will not provide any certainty to the owners as to the purchase price until the death of one of them, and will not provide a price for purposes other than a purchase at death.

(b) Such a method may also give the estate an incentive to agree to a higher value since any additional estate tax will be less than the increased purchase price.

(3) The price may be based on a percentage of gross receipts or some other objective factor or related to the sales of interests in comparable companies.

(4) The price also may be set to equal a pro rata share of the proceeds of a forced sale of the entity's assets unless the remaining owners and the withdrawing owner or deceased owner's estate can agree on another price.

(5) Finally, a "blend" of several of the above valuation methods may be used.

(a) For example, the formula may be based on average earnings over a period, average gross receipts over a period, and either the book value or the adjusted book value of the business at the date the interest is to be purchased.

4. Payment terms.

a. The buy-sell agreement should specify how the purchase price will be paid.

(1) For example, the agreement may require the payment to be made entirely in cash.

(2) This probably will be unacceptable to the remaining owners if they or the entity have insufficient funds and would be forced to borrow money.

b. Most buy-sell agreements will permit a portion of the purchase price to be paid in installments, with the selling owner or the estate of the deceased owner taking back an installment note of the entity (or notes of the remaining owners under a cross-purchase agreement).

(1) If the installments are payable over an extended term, the purchase may be funded out of the entity's or remaining owners' cash flow.

(2) Consequently, the need for life or disability insurance funding will be reduced.

(3) In the case of a corporation, the note would usually be secured by a pledge of the shares held by the other shareholders.

(4) Even in the case of a corporate redemption, the shares of the other shareholders, rather than the redeemed shares, should be pledged to secure the payment of the note.

(a) In some states, redeemed shares of the corporation may be treated as authorized but unissued shares and therefore may not have any value as collateral.

c. The purchase price also may be paid over a period of time based on the profitability of the entity, so that the more profits the entity had in a given year, the more it would pay on the outstanding balance.

(1) Because the price itself would not be dependent upon the profits, but only the period over which the purchase price would be paid, this method is not analogous to an "earn-out" in the business acquisition context, where the purchase price may increase or decrease based on post-acquisition performance.

d. In some cases, a private annuity may be an appropriate way to pay for the interest of the withdrawing owner when all the owners are related or objects of one another's bounty.

(1) The use of a private annuity can result in significant estate tax savings if the annuitant dies prematurely.

(2) Proposed regulations would require immediate recognition of income on the gain inherent in the transferred asset.

e. The entity may use property to pay for the interest, including real property that the entity currently uses in the business.

(1) The selling owner would then lease the property back to the entity, thereby providing additional income to the seller and a deduction to the entity.

(2) However, a corporation will recognize gain on any appreciation in the property as a result of the exchange of the property for its own shares. I.R.C. § 311(b). This gain will be measured as of the date of the exchange.

f. Preferred stock or other securities of a corporation may be exchanged for the common stock of the corporation.

(1) In this situation, applicable securities laws should be reviewed to confirm that an exemption from securities registration is available.

g. The entity may redeem a portion of the ownership interest each year over a period of years.

(1) The use of a serial redemption/purchase will mean that the withdrawing owner will continue to have a voice in the affairs of the entity, unless the continued ownership interest is a non-voting one.

(2) If the formula for determining the price is adjusted as the earnings of the entity go up or down, the entity and the remaining owners may not be certain of the total price that will be paid for the withdrawing owner's interest.

(3) In addition, the remaining owners may object to this method because it in effect penalizes them for making the entity more profitable.

5. Mandatory or optional.

a. A decision should be made whether the purchase or sale will be mandatory or the entity or remaining owners will only have an option or right of first refusal.

(1) In most cases the withdrawing owner or deceased owner's estate should be obligated to sell if one of the goals of the buy-sell agreement is to limit owners to persons active in the business.

(2) From the viewpoint of the withdrawing owner or deceased owner's estate, the entity or remaining owners should be obligated to purchase the interest.

(a) Absent an obligation to purchase, the entity or remaining owners may decide that there is no practical reason to purchase the interest of the withdrawing owner or the deceased owner's estate if the interest is a minority one.

(b) It is unlikely that the withdrawing owner or deceased owner's estate will find a ready market for a minority interest in a closely held business.

(c) A minority owner in a closely held business derives little or no current economic benefit as a result of owning the interest since he or she cannot require the business to make him or her an employee, officer, managing partner, or director of the business.

(d) The minority owner may have no voice in the affairs of the business and may not be entitled to be compensated, unless he or she is rendering agreed-upon services to the entity.

(e) A closely held C corporation is unlikely to pay substantial dividends, since the dividends are not deductible for tax purposes, while reasonable compensation is.

(f) In an S corporation, partnership, or LLC, the owners of the majority interest, or the general partners or member-managers, will have control over the distribution of profits to the owners, unless otherwise agreed, and absent an agreement, there will be no distributions to pay taxes on the owners' share of the profits.

b. Estate tax consequences.

(1) The estate tax consequences to the deceased owner's estate must be considered if the entity or other owners have only a right of first refusal and the price at which the interest will be purchased is to be the higher of the price established under the agreement or the price contained in a good-faith offer from a third party.

(2) In such a situation, the purchase price established under the agreement is not likely to be accepted by the IRS for estate tax valuation purposes, because the actual price paid for the interest could be higher.

(3) However, if the entity or remaining owners have the right or obligation to purchase the interest at a price no higher than the price determined under the agreement, the buy-sell agreement should establish the estate tax value of the interest, assuming it is not subject to I.R.C. § 2703, discussed below.

(4) If the entity or remaining owners are not obligated to purchase the interest, the potential financial impact on the withdrawing owner or deceased owner's estate must be considered, particularly the need for sources of cash to pay estate taxes.

6. Restrictions.

a. The buy-sell agreement usually should contain restrictions on owners' voluntary transfers of interests in the business.

b. Transfers may be permitted to an owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions.

(1) Such a right may reduce the effectiveness of the agreement in establishing the estate tax value unless the transferees are subject to the same restrictions.

c. Transfers to third parties may be permitted after first offering the interest to the entity or the other owners, either at the price determined under the agreement or at the lower of the price determined under the agreement or the price offered by a third party.

(1) If instead the owners must purchase at the higher of the price determined under the agreement or the price offered by a third party, the buy-sell agreement may not be effective for establishing the value of the interest for estate tax purposes since the decedent could have sold his or her interest at a higher price during life.

7. Drag along, tag along, and other rights.

a. The agreement may provide that if a certain percentage of the equity interests is being sold to a third party, the selling equity owners have a right to require the remaining equity owners to join in the sale at the same price and on the same terms that apply to the selling equity owners.

b. The agreement may also provide that if the equity owners of more than a certain percentage of the equity interests have agreed to sell their equity interests to a third party, the other equity owners have the right to join in the sale at the same price and on the same terms that apply to the selling equity owners; provided that if the other equity owners are not permitted to join in the sale, they have the right to purchase the equity interests of the selling equity owners at a purchase price equal to the lower of the price determined under the agreement or that offered by the third party, and on the terms described in the agreement or contained in the offer by the third party, whichever are more favorable to the other equity owners.

c. The agreement may provide for an adjustment in the purchase price if either a certain percentage of the equity interests or a certain percentage of the assets of the entity are sold within a certain period of time.

(1) The adjustment would give the equity owners who have recently sold their interests either to the entity or to the other equity owners the advantage of the increased value of the entity, as determined by the subsequent sale.

E. Funding the Buy-Sell Agreement.

1. Life and disability insurance.

a. In many closely held businesses, life insurance will be used to fund the purchase of the interest of a deceased owner.

b. While term life insurance may be used, it will usually be cost-effective to use some type of permanent life insurance since it is likely that the insurance coverage will be needed for many years.

c. Although whole life insurance will provide predictable annual premium payments, universal life insurance or some variation could be used.

d. Another alternative would be to use a first-to-die policy, particularly when there are only two or three owners.

(1) When the first owner dies, the insurance proceeds would be paid to the entity.

e. Disability insurance can be used to fund the buy-out of an owner who has become disabled.

(1) Usually disability buy-out policies require a minimum period of disability before the benefits will be paid, typically one to two years, and may not provide enough cash to cover the entire purchase price.

(2) A disability policy designed to fund the buy-out of a shareholder may not pay disability benefits if the shareholder owns over a certain percentage (80%, for example) of the stock.

f. Ownership of the policies.

(1) The entity usually owns the policies under a redemption or hybrid agreement.

(2) The owners usually own the policies under a cross-purchase agreement.

(3) A life insurance trust may own the policies under any of the three types of agreements.

(a) The use of a trust may avoid the transfer-for-value problem.

(b) The trust would own one policy on each owner's life.

(c) When an owner dies, the proceeds would be paid to the trustee, who would pay the proceeds to the deceased owner's estate in exchange for the decedent's interest, which would then be distributed to the remaining owners.

(i) Under a cross purchase agreement, upon the death of a shareholder the transfer-for-value rule may still apply because each of the remaining shareholders obtains an additional interest in the policy insuring the other remaining owners in exchange for the obligation to pay premiums. *See Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961).

(4) Finally, a separate partnership of the shareholders could own the policies under a cross-purchase agreement for a corporation.

(a) The partnership would allow for transfers to other partners of life insurance owned by the deceased partner, since the transfer of a policy for valuable consideration to a partner of the insured (or to a partnership in which the insured is a partner) is an exception to the transfer-for-value rule. I.R.C. § 101(a)(2).

2. Other funding methods.

a. The entity could establish a sinking fund to provide for the purchase of the interests of deceased or withdrawing owners under a redemption agreement.

b. Non-liquid assets, such as appreciated real property, could be exchanged for the interest, although this would cause a corporation to recognize gain on any appreciation. I.R.C. § 311(b).

c. Finally, the entity could borrow money to buy the interests of deceased or withdrawing owners.

(1) The obligation to purchase could put the entity at a disadvantage in negotiating with banks or other financing sources.

(2) Also, banks may be reluctant to make loans to a business for payment to a withdrawing owner or the estate of a deceased owner unless the loan is well-collateralized or guaranteed by persons with significant net worth.

F. Alternatives to Buy-Sell Agreements.

1. Introduction.

a. While buy-sell agreements are typical in most closely held businesses, such arrangements may not be the only way to transfer value in the entity to the withdrawing owner or deceased owner's estate.

b. In some cases, it may not be the most tax effective way.

(1) The purchase price paid under a buy-sell agreement is generally not deductible, although partnerships and LLCs may treat payments as deductible in certain cases.

(2) The 15.8% tax differential between the 23.8% (including the 3.8% Medicare tax) marginal tax rate on long-term capital gains on property held for more than 12 months and the 39.6% marginal tax on ordinary income (in 2017) is not as beneficial as the 30% differential that existed before TRA 86 (20% versus 50%).

(a) Consequently, obtaining capital gain treatment is not as beneficial as it was before 1987.

2. Recapitalization.

a. Before the adoption of I.R.C. § 2701, a sole or majority owner of a corporation or partnership with younger family members might, pursuant to a traditional recapitalization, create two classes of stock or partnership interests: a preferred interest (such as preferred stock) and a residual interest (such as common stock).

(1) The preferred interest would be preferred to the residual interest with respect to distributions of income and liquidation proceeds.

(2) Older family members would receive preferred interests in exchange for their interests held before the recapitalization.

(3) Younger family members would receive residual interests in exchange for their interests held before the recapitalization, or, if they did not own any interests before the recapitalization, the older family members

would give or sell residual interests to the younger family members after the recapitalization.

(4) Future appreciation after the recapitalization would accrue to the benefit of the younger family members.

(5) In order to reduce or eliminate any gift tax at the time of the transaction, the preferred interest would be given certain rights in order to enhance the value of the preferred interest and depress the value of the residual interest, with the expectation that these rights would not be exercised in a manner that would actually increase the value of the preferred interest for subsequent transfer tax purposes.

(6) Consequently, the value of the preferred interest when later transferred or included in the older family member's estate would be significantly less than the original value used to determine the value of the transferred residual interest for gift tax purposes.

(7) Although the IRS attempted to deal with these alleged valuation abuses on audit, it was often difficult for the IRS to discover when an abusive transaction had taken place.

(8) In many cases, the transactions were not reported on gift tax returns because the older family members used the annual exclusion to avoid reporting the gift of the residual interests or the residual interests were sold to the younger family members at their purported fair market value.

b. As a result of the adoption of I.R.C. § 2701, which was added by RRA 90, such a recapitalization may now result in a gift of the entire value of the corporation or partnership at the time of the recapitalization.

(1) Under I.R.C. § 2701, discretionary rights retained by the older family members will generally be valued at zero, thereby increasing the value of the transferred interest.

3. Compensation-based plans.

a. In some cases, the shareholders of a C corporation may want to use deductible payments under nonqualified deferred compensation plans, severance pay plans, consulting agreements, and covenants not to compete, rather than nondeductible payments for the corporation's stock.

(1) These arrangements may not be as advantageous to a departing owner as a stock sale.

(a) For example, compensation will be taxable at ordinary rates and there will be no recovery of basis.

(2) As a result of RRA 93, any payment under a covenant not to compete must be amortized over 15 years. I.R.C. § 197.

b. These types of arrangements will be closely scrutinized by the IRS to ensure that such payments are not disguised payments for the former shareholder/employee's stock.

(1) I.R.C. § 1060 authorizes the Treasury to require reporting of information, including post-sale compensation arrangements, in the case of certain sales of stock. I.R.C. § 1060(e).

4. Defined benefit plans.

a. The owners may agree to fund a qualified defined benefit plan that will provide retirement income or death benefits to a withdrawing or deceased owner's beneficiaries and at the same time reduce the purchase price for his or her interest under the buy-sell agreement.

b. Because a retiring owner will receive retirement income under the plan, he or she may be willing to receive less than full value for his or her interest.

c. However, a defined benefit plan may be expensive if there are a number of non-owner/employees that must be covered under the plan because of the nondiscrimination and coverage requirements under I.R.C. §§ 401(a)(4) and 410.

5. ESOPs.

a. There are a number of tax benefits associated with the use of an ESOP to purchase the shares of a withdrawing shareholder or deceased shareholder, including:

(1) The deferral of tax on the gain realized on the sale by the withdrawing shareholder; and

(2) Increased deductions to the sponsoring corporation for contributions to pay the principal and interest on loans to the ESOP to purchase the shares.

b. ESOPs are not available to LLCs and partnerships, but are available to S corporations after 1997. Small Business Job Protection Act of 1996 (Small Business Act) § 1316.

6. Deferral of estate tax payment and special valuation.

a. While not really alternatives to a buy-sell agreement, the use of one or more of the deferral and special valuation provisions provided under the Internal Revenue Code (I.R.C.) for closely held business interests can alleviate the tax burden on a deceased owner's estate.

(1) Under I.R.C. § 6161, the IRS may extend the period for the payment of the estate tax for up to ten years for reasonable cause.

(2) Under I.R.C. § 6166, if more than 35% of the value of the gross estate consists of interests in closely held businesses, the estate tax attributable to such interests may be paid in installments, with no principal due until the fifth anniversary of the due date for the estate tax return.

(3) Under I.R.C. § 2032A, the value of real property used in a farm or closely held business can be reduced by as much as $750,000 (as

adjusted for inflation) by valuing the real property at its current use rather than its best use.

b. Unfortunately, in many cases it may be difficult to satisfy the requirements for special treatment under these provisions.

IV. ESTABLISHING THE VALUE FOR ESTATE TAX PURPOSES

A. Introduction.

1. The value of an asset for federal estate tax purposes is its fair market value at the time of death.

a. Fair market value is defined as the price a willing buyer would pay a willing seller for the property or interest in property, both with reasonable knowledge of the relevant facts and neither under a compulsion to sell or to buy. Treas. Reg. § 20.2031-1(b).

2. Under the regulations and the case law developed before the adoption of the special valuation rules contained in Chapter 14 (I.R.C. §§ 2701-2704), the purchase price determined under a buy-sell agreement can fix the value of an interest in a closely held business if the following four requirements are satisfied:

a. The price must either be fixed or determinable pursuant to a formula contained in the agreement.

b. The decedent's estate must be obligated to sell at death at the fixed price.

(1) This can be accomplished either by giving the entity or the other owners an option to buy the deceased owner's interest or by using a mandatory buy-sell arrangement.

c. The transfer restriction must apply during the deceased owner's lifetime. Treas. Reg. § 20.2031-2(h).

(1) At a minimum, the other owners must have a right of first refusal to buy the interest at the fixed or determinable price before the owner can sell the interest to a third party. *Estate of Lionel Weil*, 22 T.C. 1267 (1954).

(2) This requirement may not be satisfied if the owners may transfer their interests to relatives or other owners by gift during life unless the donees become subject to the same restrictions.

d. The agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration in money or money's worth. Treas. Reg. § 20.2031-2(h); Rev. Rul. 59-60, Sec. 8, 1959-1 C.B. 237.

(1) Historically, this requirement was satisfied if the price under the agreement was equal to the fair market value of the interest at the time the agreement was originally executed.

3. In *Rudolph v. U.S.*, 93-1 USTC ¶ 60,130 (S.D. Ind. 1993), which dealt with a buy-sell agreement predating the effective date of I.R.C. § 2703, the District Court reviewed the fourth requirement in some detail.

   a. In holding that the purchase price under the agreement controlled the estate tax value of the shares in a family-owned business, the court rejected the government's position that, because the price under the agreement was below fair market value, the agreement was a device to transfer the shares to the objects of the decedent's bounty without full and adequate consideration.

   b. The court held that "the reasonableness of the price set forth in a restrictive agreement should be evaluated based on the facts in existence at the date the agreement is reached unless intervening circumstances occur."

   c. In addition, intent to use the agreement as a testamentary disposition must be present before the agreement is held invalid.

4. The owners may be tempted to set an artificially low price in the buy-sell agreement in an attempt to reduce the federal estate tax of a deceased owner, especially when the owners are related.

   a. I.R.C. § 2703 should preclude related parties from depressing the value of an interest in a family-controlled entity through buy-sell agreements.

   b. In the case of unrelated owners, who may still succeed in depressing the value of an interest through a buy-sell agreement, the difference between the price of the interest under the agreement and the fair market value of the interest can be made up through the use of group term life insurance under I.R.C. § 79, split-dollar insurance arrangements, and death benefit only plans.

      (1) The benefits under these plans may be arranged so that they are not included in the deceased owner's estate, generally through the use of irrevocable trusts in the case of insurance arrangements.

      (2) Nevertheless, there are problems with using an artificially low price to reduce the estate tax value of the interest.

         (a) The buy-sell agreement may not qualify as a bona fide business arrangement, although under the regulatory exception to I.R.C. § 2703, it is not necessary that the agreement be a bona business arrangement.

         (b) Because dispositions during lifetime must be made at the lower price set out in the agreement if the agreement is to be effective for establishing the estate tax value, such a plan may not be acceptable to owners who may wish to sell their interests before death.

         (c) As a result of the reduced value of the interest, the estate may fail to qualify under I.R.C. §§ 303 (providing for sale or exchange treatment for certain redemptions), 2032A (special use valuation for real property used in a farming or other closely held business), and 6166 (installment payments for the estate tax on the value of the estate attributable to closely held business interests).

B. The Impact of Chapter 14 on Valuation.

1. I.R.C. § 2703, added by RRA 90, has a direct impact on the effectiveness of a buy-sell agreement in establishing the value of an interest in family-controlled partnerships and corporations for estate tax purposes.

   a. Although it could be argued that I.R.C. § 2703 does not change existing law in a significant way, the new provision makes it clear that the fourth requirement discussed above, i.e., that the agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner's bounty without full and adequate consideration, consists of two separate requirements.

   b. Consequently, merely because an agreement is a bona fide business arrangement does not mean that it will establish the value for estate tax purposes unless the agreement is also not a device to pass stock or a partnership interest to the natural objects of the deceased owner's bounty without full and adequate consideration.

   c. In addition, I.R.C. § 2703 adds a third requirement: the terms of the buy-sell agreement must be comparable to similar arrangements entered into in an arm's length transaction.

2. The general rule under I.R.C. § 2703 is that, for purposes of estate, gift, and generation-skipping transfer taxes, the value of any property is determined without regard to any right or restriction relating to the property. I.R.C. § 2703(a); Treas. Reg. § 25.2703-1(a).

3. A right or restriction means:

   a. Any option, agreement, or other right to acquire or use the property at a price less than its fair market value (determined without regard to the option, agreement or right); or

   b. Any restriction on the right to sell or use such property.

      (1) A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, shareholders' agreement, or any other agreement.

      (2) A right or restriction may be implicit in the capital structure of the entity.

   Treas. Reg. § 25.2703-1(a) (2) and (3).

4. A lease will be disregarded in valuing property for federal gift, estate and generation-skipping transfer tax purposes if the terms are not comparable to leases of similar property entered into among unrelated parties. Treas. Reg. § 25.2703-1(d), Example 1.

5. A perpetual restriction on the use of real property that qualified for a charitable deduction under either I.R.C. § 2522(d) or 2055(f) is not treated as a right or restriction. Treas. Reg. § 25.2703-1(a)(4).

C. Exceptions.

1. Statutory exception.

a. A right or restriction will not be disregarded if it satisfies the following three requirements:

(1) It is a bona fide business arrangement;

(2) It is not a device to transfer the property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

I.R.C. § 2703(b).

b. The regulations make two changes to the statutory language.

(1) In the regulations, the second requirement refers to "natural objects of the transferor's bounty" rather than "members of the decedent's family." Treas. Reg. § 25.2703-1(b)(1)(ii).

(a) Thus the regulations make it clear that I.R.C. § 2703 applies for gift tax purposes as well as estate tax purposes and expands the definition of members of the transferor's family to include objects of the transferor's bounty.

(b) The Technical Corrections Bill, § 102(f)(12), would have codified the change in the second requirement from members of the decedent's family to the natural objects of the transferor's bounty; however, the change was not part of the technical corrections provision in the Small Business Act of 1996.

(c) In the preamble to the final regulations, the IRS explained that it omitted a definition of the term "natural objects of the transferor's bounty" because the concept had long been part of the transfer tax system and could not be reduced to a simple formula or specific classes of relationship, and would not be limited to persons related by blood or marriage.

(d) In *Estate of Gloeckner v. Commissioner*, 152 F.3d 208 (2nd Cir. 1998), the 2nd Circuit reversed the Tax Court's decision that the price under a buy-sell agreement did not establish the value for estate tax purposes, concluding that an employee was not an object of the decedent's bounty, despite being named a beneficiary in his will and receiving several loans from the decedent during the decedent's lifetime, one interest-free.

(i) The case was decided based on pre-Chapter 14 law.

(2) The regulations add "at the time the right or restriction is created" to the third requirement, making it clear that the terms of the agreement are compared with similar agreements at the time the agreement is entered into, not when any rights conferred by the agreement are

exercised, such as at the death of the transferor. Treas. Reg. § 25.2703-1(b)(1)(iii).

c. Each of the three requirements must be independently satisfied for a right or restriction to meet the exception.

(1) The mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish the absence of a device to transfer property for less than full and adequate consideration to the objects of the transferor's bounty.

(2) The treatment of the first two requirements as independent codifies the holding in *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982) (*accord, Estate of Lauder v. Commissioner*, 60 T.C.M. 977 (1990)), and reverses the holding in *Roth v. United States*, 511 F. Supp. 653 (E.D. Mo. 1981).

Treas. Reg. § 25.2703-1(b)(2).

d. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arms' length transaction if the right or restriction would have been obtained in a fair bargain among unrelated parties in the same business dealing at arms' length.

(1) A right or restriction is considered to be similar to one arrived at in a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business.

(2) This determination will generally entail a consideration of such factors as:

(a) The expected term of the agreement;

(b) The current fair market value of the property;

(c) Anticipated changes in value during the term of the agreement; and

(d) The adequacy of any consideration given in exchange for the rights granted.

Treas. Reg. § 25.2703-1(b)(4)(i).

(3) Evidence of general business practice.

(a) Evidence of general business practice is not met by showing isolated comparables.

(b) If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods.

(c) It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement.

(d) If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

Treas. Reg. § 25.2703-1(b)(4)(ii).

2. Regulatory exception.

a. A right or restriction is considered to meet each of the three requirements under I.R.C. § 2703(b) if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family.

(1) Consequently, in such a case the agreement would have to satisfy only the first three requirements under the case and regulatory law before the adoption of Chapter 14; i.e., fixed or formula price, restriction applicable during life, and estate obligated to sell at death.

b. In order to meet this exception, the property owned by the unrelated parties must be subject to the right or restriction to the same extent as property owned by the transferor.

c. Members of the transferor's family are the transferor, applicable family members (the transferor's spouse, ancestors of the transferor and transferor's spouse, and spouses of such ancestors) and any lineal descendants of the parents of the transferor or the transferor's spouse, and natural objects of the transferor's bounty.

(1) Any property held by a member of the transferor's family under the indirect ownership rules applicable to I.R.C. § 2701 is treated as held only by a member of the transferor's family; i.e., no double attribution to nonfamily members. Treas. Reg. § 25.2703-1(b)(3).

3. If property is subject to more than one right or restriction, the failure of a right or restriction to satisfy the three requirements described above does not cause any other right or restriction to fail to satisfy those requirements if the other right or restriction otherwise meets those requirements.

a. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on all the facts and circumstances. Treas. Reg. § 25.2703-1(b)(5).

4. According to the explanation of the Senate Finance Committee's proposal, 136 Cong. Rec. S15629, S15683 (daily ed., Oct. 18, 1990), I.R.C. § 2703 does not otherwise alter the requirements for giving weight to a buy-sell agreement.

a. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to establish the value of the business at death, that the price be fixed or determinable, and that the estate be obligated to sell at the price determined under the agreement.

D. Modifications of Buy-Sell Agreements.

1. A right or restriction that is substantially modified is treated as a right or restriction created on the date of modification.

   a. Section 2703 applies to a buy-sell agreement entered into before October 9, 1990 if it is substantially modified after October 8, 1990.

   b. Note that if a buy-sell agreement intended to satisfy the statutory exception is substantially modified, the terms of the agreement must be reviewed to determine whether they are comparable to similar arrangements entered into by persons in an arm’s length transaction as of the date of the substantial modification.

2. The regulations provide some guidance as to what will be considered a substantial modification.

   a. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a *de minimis* change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification.

   b. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification.

   c. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless:

      (1) The addition is mandatory under the terms of the right or restriction; or

      (2) The added family member is assigned to a generation (determined under the generation-skipping transfer tax rules (I.R.C. § 2651)) no lower than the lowest generation occupied by individuals already party to the right or restriction. Treas. Reg. § 25.2703-1(c)(1); Treas. Reg. § 25.2703-1(d), Example 2.

3. The following are not considered substantial modifications:

   a. A modification required by the terms of a right or restriction;

   b. A discretionary modification of the agreement containing the right or restriction if the modification does not change the right or restriction (for example, an amendment to change the company’s name or registered agent, Treas. Reg. § 25.2703-1(d), Example 3);

   c. A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

   d. A modification that results in an option price that more closely approximates fair market value.

Treas. Reg. § 25.2703-1(c)(2).

E. Effective Dates.

1. Section 2703 applies to any right or restriction created or substantially modified after October 8, 1990. RRA 90 § 11602(e)(1)(A)(ii)(II); Treas. Reg. § 25.2703-2.

2. The final regulations were effective on January 28, 1992.

3. For transactions occurring before January 28, 1992, and for purposes of determining whether an event occurring before January 28, 1992 constitutes a substantial modification, taxpayers may rely on any reasonable interpretation of the statutory provisions. The proposed regulations and the final regulations are considered reasonable interpretations of the statute. Treas. Reg. § 25.2703-2.

F. Planning.

1. Nonfamily-controlled entities.

a. If more than 50% of a business is owned by nonfamily members who are not objects of the transferor's bounty, the traditional rules applicable to establishing the estate tax value of the business through the use of a buy-sell agreement should apply.

(1) In such a case, there will be no requirement that the agreement be a bona fide business arrangement and not a testamentary device.

(2) The regulations should expand this exception to apply when the same family owns no more than 50% of the interests or when two or more unrelated persons each own more than a de minimis interest in the business.

(3) In the real world, two or more unrelated parties are not likely to agree to a lower price for the business interest just to reduce estate taxes, since the amount passing to his or her beneficiaries would be reduced.

b. A buy-sell agreement among unrelated parties, or in cases where no family controls the entity, may not be required to satisfy any of the historical requirements in order for the value of the interest to be determined by the price established under the agreement.

(1) If the parties were dealing at arm's length at the time the agreement was executed, a court should be reluctant to require the estate of a deceased owner to report for estate tax purposes a value for the interest in excess of the proceeds the estate receives in a sale pursuant to the buy-sell agreement.

(2) However, in a case dealing with a nonfamily-controlled corporation, *Estate of Walon L. Carpenter*, 64 T.C.M. (CCH) 1274 (1992), the court, in holding that the purchase price established under a buy-sell agreement was the proper value for estate tax purposes, did refer to the traditional test.

(a) The court stated:

(i) As we pointed out in *Estate of Bischoff v. Commissioner* [Dec. 34,702], 69 T.C. 32, 39 (1977), it has long been recognized that a buy-sell agreement in effect at the date of a decedent's death may fix the value of the stock of a closely held corporation if: (1) It is an enforceable agreement, (2) it applied to the stock during the lifetime of the decedent as well as at his death, and (3) it had a bona fide business purpose rather than being testamentary in nature. The fact that there is a family relationship between the individuals to an agreement does not cause such agreements always to be ignored, but the lack of such relationship has been considered evidence of a lack of testamentary intent by the agreement.

(b) The court found that because there was a business purpose for the agreement and the price was at least an arm's length negotiated price, the agreement was reasonable at the time it was entered into.

(c) Note that in this case the purchase price under the agreement for the decedent's stock (50% of the total outstanding shares) was $107,073, whereas one-half of the value of the assets received by the remaining shareholder upon the liquidation of the corporation two months after the decedent's death was $538,615.

2. Family-controlled entities.

a. Modifications of buy-sell agreements entered into before October 9, 1990 should be carefully scrutinized to avoid losing the grandfather protection.

(1) If the existing buy-sell agreement satisfies the requirements applicable to such agreements before the effective date of I.R.C. § 2703, the price determined under the agreement will establish the value of the family-owned business interest for estate tax purposes.

(2) If a family member becomes an owner after October 8, 1990, and adding him or her as a party to the agreement would be considered a substantial modification, a separate agreement with the new owner may avoid losing the grandfather protection for the original agreement.

b. If a buy-sell agreement will have to satisfy the three requirements under the statutory exception to I.R.C. § 2703 in order to establish the value for estate tax purposes, the most difficult requirement to satisfy for family-owned businesses in many cases will be the third requirement.

(1) The third requirement states that, at the time the right or restriction is created, the terms of the right or restriction must be comparable to similar arrangements entered into by persons in an arm's length transaction.

(2) This may require assembling evidence at the time the buy-sell agreement is entered into.

(3) In comparing *Hall Estate v. Commissioner*, 92 T.C. 312 (1989) and *Estate of Walon L. Carpenter*, 64 T.C.M. (CCH) 1274 (1992), with *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982), and *Estate of Lauder v. Commissioner*, 60 T.C.M. 977 (1990), it is obvious that a formula price under a buy-sell agreement will not be effective for establishing the value for estate tax purposes if:

(a) There is no evidence that an attempt was made to arrive at a formula price based on objective standards at the time the parties entered into the agreement;

(b) The nature of the business changed considerably since the original formula was established; or

(c) The agreement was not enforced with respect to transfers occurring before the decedent's death.

c. If the value of the business interest established by a buy-sell agreement among related parties may be disregarded for estate tax purposes, careful attention should be given to the source of payment of any estate tax on the value of the interest in excess of the purchase price under the agreement.

(1) State law may require the purchaser to pay the additional tax if the state's estate tax apportionment statute applies.

(2) The agreement may require the purchaser to pay any additional tax attributable to the additional value under I.R.C. § 2703.

d. The buy-sell agreement's effect on the marital deduction should be considered separately since the interest's value for marital deduction purposes may be reduced, even though its value for estate tax purposes is established without regard to the buy-sell agreement.

(1) In *Estate of Renaldi*, 97-2 U.S.T.C. 60,281 (Ct. Cl. 1997), the Court of Claims held that stock passing to a trust designed to qualify as a QTIP trust did not qualify as a QTIP trust because the son had a right under the decedent's will to purchase the stock at less than fair market value, despite the fact that the stock was redeemed at fair market value before the QTIP election was made.

(2) In Technical Advice Memorandum (TAM) 9139001, a trust designed to qualify for the marital deduction as a QTIP trust was funded with shares subject to an option held by the son to purchase the shares at book value. The IRS held that since the son had a power to appoint the assets to someone other than the spouse (namely, himself) for less than full and adequate consideration, the QTIP requirements were not satisfied. *See also* TAM 9147065.

e. Note that an appraiser may value an interest in a closely held business not subject to a buy-sell agreement at a lower value than if there were such an agreement because of the lack of marketability of the interest and the uncertainty as to the future of the business caused by the absence of such an agreement.

V. OTHER TAX CONSIDERATIONS

A. Tax Consequences When Insurance Is Used to Fund Purchase.

1. Stock redemption agreements.

a. Premium payments.

(1) The premiums paid by a C corporation on life insurance policies owned by the corporation insuring the shareholders are not deductible by the corporation and are not income to the shareholders as a constructive dividend.

(a) In a C corporation, any increase in cash value in excess of the premiums paid during a taxable year would be subject to the alternative minimum tax. I.R.C. §§ 56(c)(1), 56(g)(4)(B)(ii), and 7702(g)(1) (B).

(2) In an S corporation or partnership, the payment of premiums, because they are not deductible, will not reduce the taxable income allocated to the shareholders or partners.

b. Proceeds.

(1) C corporation.

(a) Generally, insurance proceeds are not taxable income for regular tax purposes when paid to the entity, although they do increase earnings and profits of a C corporation, the measuring rod for further dividends and exposure to the accumulated earnings tax, by the amount the proceeds exceed the cash surrender value.

(b) The proceeds should not be included in a controlling shareholder's estate because they are paid to the corporation, although the purchase price of the shares under the agreement may be affected by the additional cash, depending upon the method of determining the purchase price. Treas. Reg. § 20.2042-1(c)(6).

(c) Since the proceeds may be subject to alternative minimum tax, 75% of the proceeds may be subject to a 20% tax rate. I.R.C. § 56(g).

(2) S corporation, partnership and LLC.

(a) Life insurance proceeds received by an S corporation, partnership or LLC are not subject to income tax at either the entity or owner level.

(b) However, such proceeds increase the basis of an owner in his or her ownership interest. See, e.g., I.R.C. §§ 1367(a)(1) and 1366(a)(1).

(c) Proceeds payable to an S corporation, partnership or LLC are not subject to the alternative minimum tax.

(3) Section 863 of the Pension Protection Act of 2006 generally limits, in the case of employer-owned life insurance, the amount of proceeds excludable from income to the amount of premiums and other amounts paid by the policyholder, for policies purchased after August 17, 2007. The balance will be includable income.

(a) There are a number of exceptions to the income inclusion rule, which are based on two separate requirements:

(i) Satisfying notice and consent requirements; and

(ii) The identity of either the insured or the beneficiary who ultimately receives the proceeds.

(b) Assuming the notice and consent requirements are met, the income inclusion rule does not apply:

(i) If the insured was an employee at any time during the 12-month period before the insured's death; or

(ii) If the insured was, at the time the contract was issued, a director or highly compensated individual; or

(iii) To the extent the proceeds are:

i. Paid to a member of the family of the insured, to an individual who is the designated beneficiary of the insured under the policy other than the employer, to a trust for the benefit of the family member or designated beneficiary, or to the insured's estate; or

ii. Used to purchase an equity interest in the employer from the family member, beneficiary, trust or estate.

(c) In addition, the employer must satisfy certain reporting and record keeping requirements.

c. The income inclusion rule and the exceptions will apply to life insurance purchased pursuant to an entity buy-sell agreement if the parties are employees of the entity.

(1) Some commentators have suggested that the notice and consent requirements may be satisfied by inserting language that satisfies the requirements in the buy-sell agreement itself.

(2) Although this procedure may work with respect to the initial parties and life insurance that will be purchased soon after the agreement is entered into, it may not deal with additional parties added to the agreement later

as new individuals become equity owners or with additional policies that may be purchased later as the value of the business increases.

d. The income inclusion rule should not apply to a cross purchase agreement.

(1) This was confirmed by Notice 2009-48, 24 IRB 1085.

(2) Question 1 reads as follows: Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

(3) The answer is: No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in I.R.C. § 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), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in I.R.C. § 101(j)(3).

2. Cross-purchase agreements.

a. Premiums.

(1) The owners may not deduct premiums paid on the life insurance policies purchased to fund the buy-out.

(2) If a C corporation pays the premiums on the policies owned by the shareholders, the premiums will be treated as either a dividend or compensation to the shareholder.

(a) To avoid the possibility of having nondeductible dividend treatment, it would be advisable to increase the shareholders' salaries if it is desirable to have the corporation assist the shareholders in paying the premiums, assuming that the total compensation paid to the shareholders is reasonable.

(b) A split-dollar arrangement, under which the corporation would pay some or all the premium, may also avoid dividend treatment.

b. Proceeds.

(1) The proceeds are not includible in the insured's estate, unless the insured had an incident of ownership with respect to the policy, such as the right to name the beneficiary.

(a) This should not be a problem when the other owners own the policies on the decedent's life, but it may be a problem if the policy is held by a partnership controlled by the deceased insured and the proceeds are payable to the partners rather than the partnership.

(b) In this case, the IRS may argue that the deceased insured possessed incidents of ownership.

(2) The value of any policy owned on the life of other owners will be included in a deceased owner's federal gross estate.

(3) The transfer-for-value rule will cause some of the proceeds to be subject to income tax if individual shareholders purchase policies from the deceased shareholder's estate on the lives of the other remaining shareholders.

(a) However, partners in a partnership may purchase policies from a deceased partner's estate since the transfer for value rule does not apply to a transfer to a partner of the insured. I.R.C. § 101(a)(2)(B).

(4) If a C corporation owns the policies, collects the proceeds, and distributes the proceeds to the deceased shareholder's estate under a cross-purchase agreement, the remaining shareholders will be deemed to receive constructive dividends to the extent of the corporation's earnings and profits because the corporation is satisfying the shareholders' obligation under the agreement.

B. Income Tax Consequences.

1. To the selling owner or estate of a deceased owner.

a. Under a cross-purchase agreement, the difference between the basis of the interest being purchased and the amount realized will usually be capital gain.

(1) In the case of an estate or beneficiary of a deceased owner, there should be little or no taxable gain because the basis of the interest will be stepped up to its fair market value under I.R.C. § 1014(a).

b. In the case of a C corporation, under a stock redemption agreement the entire distribution will be treated as a dividend (taxed as ordinary income at the highest income tax rates) to the extent of the corporation's earnings and profits unless the redemption qualifies for capital gain treatment under either I.R.C. § 302(b) or 303.

(1) Under I.R.C. § 302(b), there are three ways that a redemption of shares will qualify for sale or exchange treatment in the context of a buy-sell agreement.

(a) A redemption will qualify for sale or exchange treatment if it qualifies as a substantially disproportionate redemption.

(i) A substantially disproportionate redemption requires that after the redemption the shareholder must own less than 50% of the voting power determined after the redemption, and his or her percentage of voting shares and the value of all common stock, whether voting or non-voting, of the corporation after the redemption must be less than 80% of his or her percentage of such stock before the redemption. I.R.C. § 302(b)(2)).

(b) A redemption will qualify for sale or exchange treatment if all the shares owned by the shareholder are redeemed. I.R.C. § 302(b)(3).

(c) A redemption will qualify for sale or exchange treatment if the redemption is not essentially equivalent to a dividend. I.R.C. § 302(b)(1); *United States v. Davis*, 397 U.S. 301 (1970).

(i) Since it is difficult to determine whether the IRS will treat a redemption as not essentially equivalent to a dividend, this method of qualifying for sale or exchange treatment is not usually a viable planning technique.

(2) In determining whether a redemption qualifies under one of these exceptions, attribution rules generally treat an individual as owning shares that are held by his or her spouse, children, grandchildren, and parents, as well as partnerships, estates, trusts, and corporations in which the shareholder has an interest. An estate is treated as owning shares owned by any beneficiary. I.R.C. § 318(a).

(3) For purposes of determining whether all the shares owned by a shareholder have been redeemed, the family attribution rules (but not the entity attribution rules) may be waived, although the selling shareholder must agree not to acquire shares in the corporation for a period of ten years and certain other requirements must be met. I.R.C. § 302(c).

(4) Because entity attribution rules may not be waived, a redemption of shares from an estate in which a beneficiary of the estate also owns shares in the subject corporation will not qualify as a complete termination.

(a) The estate may distribute the shares to another beneficiary, who may then have the shares redeemed.

(i) If a waiver is then executed, the subsequent redemption will qualify for sale or exchange treatment even if the two beneficiaries are related.

(b) The redemption may qualify as a substantially disproportionate redemption if there are nonfamily shareholders.

(5) Note that in most cases the redemption of shares owned by the decedent's estate or beneficiaries will be tax-free if the transaction qualifies as a sale or exchange, since the basis of the shares should equal the purchase price under the agreement.

(a) On the other hand, if the transaction is treated as a dividend, the entire amount will be ordinary income, to the extent of the corporation's earnings and profits.

(b) In addition, if the transaction does not qualify as a sale or exchange, installment sale treatment will not be available.

(6) If a redemption fails to qualify as a sale or exchange, the basis of the redeemed shares shifts to any remaining shares owned by the withdrawing shareholder, or, if there are none, to the shares owned by those shareholders whose shares were attributed to the withdrawing shareholder. Treas. Reg. § 1.302-2(c).

c. Under I.R.C. § 303, an estate or beneficiary receives sale or exchange treatment, regardless of whether the redemption satisfies one of the exceptions to dividend treatment under I.R.C. § 302(b), to the extent of federal and state estate and inheritance taxes and funeral and administration expenses if the value of all shares owned by the decedent's estate in closely held corporations exceeds 35% of the gross estate reduced by deductions allowable under I.R.C. §§ 2053 and 2054.

2. To the remaining shareholders of a C corporation.

a. In a C corporation, the remaining shareholders will be treated as receiving a constructive dividend if the corporation redeems shares that the remaining shareholders are primarily obligated to purchase. *C. D. Pulliam v. Commissioner*, 48 T.C.M. 1019 (1984); Rev. Rul. 69-608, 1969-2 C.B. 42.

b. If the corporation purchases shares under a stock redemption agreement, or under a hybrid agreement in which the corporation has the primary obligation to purchase the shares, there will be no constructive dividend to the remaining shareholders, even though the value of their shares may be increased as a result of the redemption. *D. T. Jacobs v. Commissioner*, 41 T.C.M. 951 (1981); Rev. Rul. 69-608, 1969-2 C.B. 42.

(1) This increase in value will occur if the purchase price paid for the shares being redeemed is less than its pro rata share of the value of the corporation.

c. The shareholders obtain a tax basis in any shares purchased under a cross-purchase agreement equal to the price paid for the shares, but receive no increase in basis when the corporation redeems the withdrawing or deceased shareholder's shares.

3. To the corporation.

a. Before TRA 86, a corporation generally did not recognize taxable gain or loss upon the redemption of its own shares, with certain important exceptions.

(1) Therefore, it was common to plan on using appreciated property to redeem the shares of a deceased shareholder or a withdrawing shareholder.

b. However, as a result of TRA 86, a corporation will recognize gain if it distributes appreciated property in exchange for its own shares. I.R.C. § 311(b).