TABLE OF CONTENTS

Introduction

- Buy-Sell Agreements Should Contemplate (and Be Coordinated with) Estate Planning Documents and Objectives
  - Wills, Trusts and Other Estate Planning Vehicles
  - Family Holding Companies
  - Transfer Tax Planning
  - Confidentiality and Dispute Resolution
- Standard Forms are Often Inadequate

Case Study: Brown Real Properties, LP

- $25M of Income-Producing Real Property, Some Cash
- Actively Managed within the Meaning of IRC Sec. 6166

- 1% General Partner: John Brown Revocable Trust
- 25% Limited Partner: John Brown Revocable Trust

- 1% General Partner: Mary Brown Revocable Trust
- 25% Limited Partner: Mary Brown Revocable Trust

Brown Real Properties, LP *(cont.)*

- 10% Limited Partners: Adult children of John and Mary (Anna and Barbara)
- 4% Limited Partner: Adult child of Mary (Charles)
- 10% Limited Partners: Irrevocable exempt trusts for each of Anna, Barbara and their descendants *(Anna has lots of pets, but no children at age 40)*
- 4% Limited Partner: Irrevocable exempt trust for Charles and his descendants

Brown Family When LP Created
(John is taking the picture ...)

... But there are also *these* Brown family members

Meet John's estranged son, David, and his Wife ...

<u>John's Estate Plan</u>

- Pour-Over Will to Revocable Trust
- John's Revocable Trust:
  - Mary is Successor Trustee
  - Discretionary Bypass Trust for Mary and for John's descendants
  - Exempt and Non-Exempt QTIPs for Mary

John's Revocable Trust *(cont.)*

- Upon Mary's Death (or John's Death, if John is the Survivor):
  - GST exempt assets divided into two shares and added to Irrevocable Exempt Trusts for Anna, Barbara and their respective descendants
  - GST Non-Exempt assets divided equally between Anna and Barbara and distributed to them outright
  - David, Charles and their respective descendants are specifically disinherited

Mary's Estate Plan

- Pour-Over Will to Revocable Trust
- Mary's Revocable Trust:
  - John is Successor Trustee
  - Discretionary Bypass Trust for John and for Mary's descendants
  - Exempt and Non-Exempt QTIPs for John

Mary's Revocable Trust *(cont.)*

- Upon John's Death (or Mary's Death, if Mary is the Survivor):
  - GST exempt assets divided into three equal shares and added to Irrevocable Exempt Trusts for Anna, Barbara, Charles and their respective descendants
  - GST Non-Exempt assets divided equally between Anna, Barbara and Charles and distributed to them outright
  - David and his descendants are specifically disinherited

John's and Mary's Goals

- Maintain Control of the Partnership and Its Business by Family Members
- Protect Family Members from Impulsively Liquidating Their LP Interests for a Quick Buck
- Save *(or at Least Defer)* Transfer and Other Taxes

John's and Mary's Goals *(cont.)*

- Protect the Business from:
  - Estranged Family Members *(David)*
  - Hostile Former Spouses of Family Members
  - Creditors of Family Members
  - Interference from Non-Family Members and Disruptive Family Members
  - Disputes among Family Members

Buy-Sell Agreements: Part I

- Trusts and Entities as Family Business Owners
- Handling Ex-Spouses, Creditors and Involuntary Transferees
- Buying Out Disruptive or Unpleasant Partners
- Rights Arising from Non-Cash and Gratuitous Transfers

Drafting for Trust Owners -Common Considerations-

- Who is the Shareholder/Member/ Partner?
  - The Settlor?
  - The Beneficiary?
  - The Trustee?
- What is a "Transfer" by a Trust Owner?

Drafting for Trust Owners -Common Considerations- *(cont.)*

- Whose Death, Incapacity or Divorce Matters?
  - The Settlor?
  - The Beneficiary?
  - The Trustee?
  - A Spouse?

What is a "Permitted Transferee"?

- A Transferee of a Partner's Interest that Does Not Trigger Buy-Sell Provisions
- Generally Limited to "Family Members"
- Should Include "Family Member Trusts"

What is a "Family Member"?

- Generally Members of a Line of Descent (and Sometimes Ascent)
  - Does the definition of "*ancestor*," "*descendant*" or "*issue*" match the estate planning documents?
    ...Think about David!
  - Are spouses "Family Members"
    ...If so, how is "spouse" defined?

Sample Language: Defining a Spouse"

Spouse as a Permitted Transferee: A spouse of a Family Member shall be a Permitted Transferee. For purposes of this provision only, the spouse of a Family Member means an individual who is a Family Member's lawfully married spouse (determined under the applicable laws of the jurisdiction in which that Family Member resides or resided at the time such determination must be made), or who was such Family Member's lawfully married spouse at the time of such Family Member's death (whether or not such surviving spouse subsequently remarries), except that an individual shall not be considered a Family Member's spouse for purposed on this provision (a) if a petition for marital dissolution or legal separation was pending between the individual and the Family Member at the time the individual's status as a spouse is to be determined and

(b) unless that individual is or was residing with the Family Member as husband or wife at the time that it is necessary to determine the individual's status as such Family Member's spouse. For purposes of determining whether an individual is or was residing with a Family Member as husband or wife, temporary and short term absences unrelated to an intentional marital separation (including, but not limited to, absences due to vacation or business travel, illness, education, or emergency), or long term absences unrelated to an intentional marital separation (including, but not limited to, absences where either spouse resides in a nursing home or other skilled care facility), shall be disregarded. The determination of whether an individual satisfies the requirements to be a Family Member's spouse under this Section shall be made in the General Partner's sole and absolute discretion.

Concept of a "Family Member Trust"

- Revocable Trust
  - A Family Member...
    - Is the settlor, sole beneficiary and sole Trustee
    - Has unilateral power of revocation and amendment
  - A Family Member and his or her spouse...
    - Are joint settlors
    - The Family Member spouse must exercise all rights as a Partner
    - The Family Member spouse has unilateral power to revoke or amend the trust as to Partnership Interest

Concept of a "Family Member Trust" *(cont.)*

- Irrevocable Trusts
  - Only Family Members are current beneficiaries and first line remainder beneficiaries
    - *Should QTIP Trusts for surviving spouses be Family Member Trusts?*
  - Trustee is a Family Member or is approved by the other Partners and/or the General Partner
  - Family Members should have the power to remove a Non-Family Member Trustee

Sample Language: <u>"Family Member"</u>

<u>"Family Member"</u> means JOHN BROWN, MARY BROWN and their respective descendants. For purposes of determining the members of a class of descendants, the provisions of *[STATE LAW REFERENCE]* shall apply. Notwithstanding the foregoing, under no circumstances shall JOHN BROWN's son, DAVID BROWN nor any of DAVID BROWN's lineal descendants be included within the definition of "Family Member."

<u>Sample Language: "Family Member Trust"</u>

"**<u>Family Member Trust</u>**" means a trust with respect to which only individual Family Members, or an individual Family Member and his or her spouse, or the surviving spouse of a deceased individual Family Member, or another Family Member Trust, are permissible current recipients of the income or principal of such trust or would succeed to the trust property if all such current beneficiaries then died, provided that the Trustee or co-Trustees of any such trust must at all times be one or more (i) individual Family Members or (ii) individual or institutional Trustees approved by the General Partners and a Majority of the Limited Partners, but only if such individual or institutional Trustees can be removed and replaced by the action of one or more Family Members without the consent of any non-Family Members.

What Should Be a "Transfer" by a *Revocable* Trust?

- Death of the Settlor
  - Partnership Interest must pass to a Permitted Transferee
  - If does not pass to a Permitted Transferee, Buy-Sell Provisions Apply
    - Allow a reasonable period of time to determine who will receive the partnership interest

What Should Be a "Transfer" by an *Irrevocable* Trust?

- Change in Beneficiaries
  - May arise due to death of a settlor, a beneficiary or some other event
  - Trust must continue to qualify as a "Family Member Trust" after the event or Buy-Sell Provisions will apply

What Should Be a "Transfer" by *Any Trust?*

- Change of Trustee
  - By resignation, removal, death or incapacity
- Successor Trustee must be
  - A Family Member or
  - A non-Family Member approved by the other Partners and/or the General Partner

…or Buy-Sell Provisions will apply

Sample Language: "Transfer" Defined

"Transfer" means any sale, hypothecation, encumbrance, pledge, assignment, conveyance, exchange, attachment, gift, bequest, alienation, transmutation, or other intervivos or testamentary transfer. As to any Partnership Interest (including an assignee interest) that is held in a trust, a transfer of such Partnership Interest shall be deemed to occur upon any of the following events:

(a) if such trust qualifies as a Family Member Trust, any event which causes such trust to fail or cease to qualify as a Family Member Trust;

(b) if such trust is a revocable trust, the date that such trust becomes irrevocable;

(c) any change in the then acting trustees of such trust;

(d) the termination of such trust;

(e) the date that the exercise of a trust beneficiary's power of appointment over a Partnership Interest takes effect; and

(f) any change in the beneficiaries who are permissible current recipients of the income or principal of such trust or would succeed to the trust property if all such current beneficiaries then died.

Revocable Trust as a General Partner: Death or Incapacity of the Settlor

- Does the Successor Trustee automatically assume the role of General Partner?
- Does the General Partner Interest convert to a Limited Partner Interest?
- Does the Successor Trustee acquire an assignee interest?
- Does the Limited Partnership dissolve if no General Partner is elected by the remaining Partners?
- Best Solution: Hold GP Interest in an entity

Back to the Brown Family ...

John and Mary take your advice and transfer their GP interests to Brown Asset Management, LLC

John's and Mary's Revocable Trusts are 50/50 members of Brown Asset Management, LLC

John and Mary are both Managers in their individual capacities

Drafting for Entity Owners

- What makes an entity a "Family Member Entity" so that it is a Permitted Transferee?
- What changes in the entity should be treated as a "Transfer" of the entity's Partnership Interest?

A "Family Member Entity"

- Family Members Must Hold Interests in
  - Capital
  - Profits
  - Voting Rights
- How Much of an Interest Must Family Members Hold?
  - 100% of all interests?
  - Supermajority of all interests?
  - 100% of voting interests and supermajority of all other interests?

A "Family Member Entity" *(cont.)*

- Managers/General Partners/Officers/ Directors ("Managers") Must Be
  - Family Members
  - Non-Family Members approved by Limited Partners and/or General Partner
- One Manager is the "Designated Representative" of the Entity
  - Gives and receives all information relevant to the Partnership
  - Has unilateral authority to act for *and bind* the entity in all Partnership matters

What Should Be a "Transfer" by an Entity?

- Change in Ownership
  - If a change in ownership causes the entity to cease to be a Family Member, Buy-Sell Provisions apply
  - If change is due to the death of an owner, allow a period of time to determine status before Buy-Sell Provisions apply
    - *Deceased Owner's interests could be acquired under the entity's own Buy-Sell Provisions rather than the deceased Owner's estate plan.*

What Should Be a "Transfer" by an Entity? *(cont.)*

- Change of Management/Control
  - By resignation, removal, death, or incapacity
  - By adding a co-Manager
  - Failure to appoint a Designated Representative

Sample Language for Entities as Family Business Owners

"Family Member Entity" means a corporation, limited or general partnership, limited liability company, limited liability partnership, or other entity in which Family Members or Family Member Trusts hold, directly or indirectly, a one hundred percent (100%) interest in the capital, the profits and the voting rights. To qualify as a Family Member Entity, a single Family Member must be appointed to serve as the "Designated Representative" to represent all interests of such entity with regard to the Partnership and to bind the entity with regard to all Partnership matters. *[Note: Provisions in the Partnership Agreement should permit all Partners and the Partnership to rely upon the authority of the Designated Representative to act for the entity.]*

"Transfer" .... As to any Partnership Interest that is held by a corporation, limited or general partnership, limited liability company, limited liability partnership, or other entity, a Transfer of such Partnership Interest shall be deemed to occur upon any of the following events:

- if such entity qualifies as a Family Member Entity, any event which causes such entity to fail or cease to qualify as a Family Member Entity;
- any change in the Managers, Officers, Directors, General Partners or other similar managerial level positions in such entity;
- the dissolution of such entity;
- any Transfer (within the full meaning of this Agreement) of an economic or voting interest in such entity; and
- the failure of such entity to appoint a Designated Representative within thirty (30) days of a vacancy in such position.

How John's Business Interests are Held after His Unfortunate Death

- Bypass Trust for Mary and Descendants
  - Holds John's 50% interest in Brown Asset Management, LLC (GP)
  - Holds a 15% LP interest

- QTIP Trust for Mary
  - Holds a 10% LP interest
  - Holds balance of John's assets

Fast Forward ››› The Brown Family 20 Years Later

Meet Charles Lindquist

(Mary's 58 Year Old Son)

Loves Sports and Sports Bars *(and Women Who Frequent Them)*

Married Three Times

Has Run the Family Real Estate Business since John's Unfortunate and Untimely Death

Drafting for Divorce or Death of Non-Family Member Spouse: The "Marital Interest"

- Any interest in the Partnership of a Non-Family Member Spouse, Whenever or However Acquired
  - During life or upon death or divorce
  - Prior to marriage or during marriage
  - By voluntary permitted transfer
  - By other voluntary transfer
  - By operation of law
    - Community or other marital property
    - Inheritance rights
    - Contract to make a will

Drafting for Divorce or Death of Non-Family Member Spouse

- Disposition of a "Marital Interest"
  - Marital Interest must be allocated to Family Member spouse (or other Permitted Transferee) within a stated time frame or Buy-Sell Provisions apply
  - Same rule if Non-Family Member spouse dies and does not leave Marital Interest to Family Members
  - General Partner can determine the scope of the "Marital Interest" if unclear
  - Should spouses sign a Consent and Waiver?

Sample Language: Interests Held by Spouses

"Marital Interest" means the entire interest in the Partnership of the non-Family Member spouse of a Family Member (whether held directly or indirectly through a trust or entity) and the community property or like interest of such non-Family Member spouse in the Partnership Interest of the Family Member spouse, whether any such interest was created during the lifetime of either spouse or upon the death of either spouse.

Declaration of a "Marital Interest." If, on the date that is fifteen (15) months after (i) the death of a Family Member; (ii) the death of the spouse of a Family Member; or (iii) the date that the General Partner has received written notice from a Family Member that such Family Member and his or her spouse are engaged in a Separation, or the General Partner acknowledges in a written instrument actual notice of such Separation, it remains unclear whether and to what extent the spouse of the Family Member possesses a Marital Interest, then the General Partner may, at that time, or at any time prior to the end of the Partnership Option Period, declare that all or any portion of the Partnership Interest then held by the Family Member and/or his or her spouse (directly or indirectly through a trust or entity) constitutes a "Marital Interest" that is subject to the provisions of this Agreement. The good faith determination of the General Partner as to the nature of the Marital Interest under this paragraph shall be conclusive and binding upon all parties even if there is a later contrary judicial or other determination of whether and to what extent the spouse of the Family Member possesses a Marital Interest, but only with respect to the portion of the finally determined Marital Interest that was included within the Marital Interest determination of the General Partner.

Sample Language: Divorce

"**Separation**" means the filing of any judicial action for the dissolution or annulment of a marriage, for a legal separation, or the division of property of a married couple.

Separation of Family Member and His or Her Spouse. Upon the Separation of a Family Member and his or her non-Family Member spouse, the non-Family Member spouse shall offer his or her Marital Interest, if any, to such Family Member spouse, for the price and upon the terms described in Sections 8.7 and 8.6 of this Agreement, or such other price and terms as they shall mutually agree. If the Family Member spouse fails to acquire the Marital Interest within two (2) years after the date of such Separation, first the Partnership and then the Other Partners shall have the option to purchase the Marital Interest for the price and upon the terms described in Section 8.7 and 8.8 of this Agreement. For the purpose of applying the provisions of Section 8.6, the Partnership's right to purchase ("Partnership Option Period") shall begin upon the earlier of the date following the date of Separation that the General Partner is first notified in writing by the Family-Member spouse that he or she will not acquire the Marital Interest, or six months after the date the General Partner receives actual notice of the Separation (or acknowledges actual knowledge of the Separation in writing), and shall be extended from thirty (30) days, as provided in Section 8.6.3, to two (2) years.

Sample Language: Death of a Spouse

Death of the Spouse of a Family Member-Interest Holder. Upon the death of the non-Family Member spouse (or surviving spouse) of a Family Member, any Marital Interest held by such deceased non-Family Member spouse (whether held directly or indirectly through a trust or entity) that does not pass to a Permitted Transferee within eighteen (18) months following his or her death shall be offered to the Family Member spouse, if then living, for the price and upon the terms described in Sections 8.7 and 8.8 of this Agreement, or as otherwise mutually agreed. If the Family Member spouse is not then living, or fails to purchase or otherwise acquire the Marital Interest within two (2) years following the death of the non-Family Member spouse, first the Partnership and then the Other Partners shall have the option to purchase the Marital Interest for the price and upon the terms described in Section 8.7 and 8.8 of this Agreement. For the purpose of applying the provisions of Section 8.6, the Partnership's right to purchase ("Partnership Option Period") shall begin upon the earlier of two (2) years following the non-Family Member spouse's death if the Family Member spouse is then living, or eighteen (18) months following the non-Family Member spouse's death if the Family Member spouse is not then living, and shall be extended from thirty (30) days, as provided in Section 8.6.3, to six (6) months, but no less than six (6) months following actual notice of such Non-Family Member spouse's death.

Sample Language: Death of Married Family Member

Death of a Married Family Member. Upon the death of a Family Member who is survived by his or her non-Family Member spouse, the surviving non-Family Member surviving spouse shall offer to sell any Marital Interest he or she may hold (whether held directly or indirectly through a trust or entity) to the Partnership and then the Other Partners for the price and upon the terms described in Sections 8.7 and 8.8 of this Agreement. For the purpose of applying the provisions of Section 8.6, the Partnership's right to purchase ("Partnership Option Period") shall begin immediately upon the death of the Family Member spouse and shall be extended from thirty (30) days to eighteen (18) months, but no less than six (6) months following actual notice of such Family Member spouse's death.

Fiduciary Duties and a Marital Interest in Divorce

- Valuation and Terms Must Be Reasonable
  - Any discount or onerous terms will likely be factored into division of marital property *against* the Family Member spouse
  - Price and terms might not be enforced if deemed a forfeiture or a breach of spousal fiduciary duties

Fiduciary Duties and a Marital Interest in Divorce *(cont.)*

- Courts Can Be Very Protective of the "Out Spouse" in these Situations
- Family Collusion against the "Out Spouse" is Expected, if Not Presumed

Meet Anna Brown-Smith, Age 52

(...but you will wish you hadn't)

Argumentative, Opinionated and Drinks Too Much
Can Totally Disappear for Long Periods of Time
Ungrateful when Business is Going Well
Entirely Charles's Fault if Business Hits Tough Times
Sued for Libel for Lawn Signs Disparaging Her Neighbor
Wants to Trade a Portion of Her Partnership Interest with a "Friend" for a 40 Foot Cruising Sailboat

Buying Out Problem Partners

- Focus is Protecting Business from Disruptive Partners *(even Family Members or prior approved transferees)*
- Generally Requires a Supermajority Vote
- Should Not Require any Reason *(leads to litigation over whether reason exists)*
- Price and Terms Should Be Consistent with Other Mandatory Sales

Sample Language: Problem Partner

Mandatory Sale of Partnership Interest. Upon the vote of all of the General Partners and eighty-five percent (85%) of the Limited Partners, any Partner, including any assignee of a Partnership Interest ("Seller"), can be required to offer his or her entire interest in the Partnership ("Offered Interest") first to the Partnership and then the Partners, excluding the affected Partner ("Other Partners") for the price and upon the terms described in Sections 8.7 and 8.8 of this Agreement. For the purpose of applying the provisions of Section 8.6, the Partnership's right to purchase ("Partnership Option Period") shall begin immediately upon the vote described in this Section.

Creditor Protection

- Focus is Protecting Business from Partners' Creditors
- Valuation and Terms Must be Reasonable
  - Price and terms might not be enforced if deemed a forfeiture
  - Best if same price and terms apply in other contexts
- Fraudulent Conveyance Issues Possible if Not for Full Consideration

Uniform Voidable Transactions Act

- Applies Rules to Current and Future Creditors if Purpose is to Hinder, Delay *or* Defraud
- Comment 8 on *Intent*, reads in part:

  "*A transaction that does not place an asset entirely beyond the reach of creditors can nevertheless 'hinder, delay or defraud' if it makes the asset more difficult for the creditors to reach. Simple exchange by a debtor of an asset for a less liquid asset, or disposition of liquid assets while retaining illiquid assets, may be voidable for that reason.*"

- Could the Conversion of a Partnership Interest into an Installment Note with Deferred Payment Terms be a Voidable Transaction?
  - *Is the debtor the transferor? Is the note really less liquid or marketable than the Partnership Interest?*

Sample Language: Creditor Claims

Mandatory Sale of Partnership Interest. In the event that:

(i) any Partner makes an assignment for the benefit of creditors (other than to a Permitted Transferee);

(ii) the Bankruptcy of a Partner; or

(iii) any attempt is made to gain control or ownership of an Partnership Interest by means of attachment, levy, or any other remedy utilized by judgement creditors in aid of execution, but only to the extent that such creditors are not Permitted Transferees,

first the Partnership and then the Partners, excluding the affected Partner ("Other Partners") shall have the right to purchase the Partnership Interest ("Offered Interest") of such Partner ("Seller"), for the price and upon the terms described in Sections 8.7 and 8.8 of this Agreement.

The Partnership's right to purchase ("Partnership Option Period") shall begin immediately upon receipt of written notice of any event described in this Section, regardless of whether the General Partner or any of Partners had prior actual knowledge of the event, provided, however, that the General Partner may, in it's discretion, waive the requirement of written notice based upon actual knowledge of the event at any time after acquiring such knowledge and before receiving written notice, in which case the Partnership Option Period will begin on the date such waiver is delivered to the Seller.

Right of First Refusal: Transfers for Non-Cash Consideration

- Many Agreements Fail to Address Proposed Transfers that Involve *Non-Cash Consideration (such as a 40 foot cruising sailboat)*
- Should Provide the Option to Purchase for Offered Consideration/Offered Terms OR for Price and Terms as Set Forth in the Buy-Sell Provisions

Right of First Refusal: Gratuitous Transfers

- Many Agreements Fail to Adequately Address Proposed Transfers that Involve *NO Consideration (Gifts/Donations)*

- Should Provide the Option to Purchase for the Price and Terms Set Forth in the Buy-Sell Provisions

Sample Language: Non-Cash and Gratuitous Transfers

8.6 Partnership's Option to Purchase. The Partnership shall have thirty (30) days from the date of receipt of the Transfer Notice, or, if the Purchase Price for the Offered Interest is to be determined under Section 8.7 of this Agreement, thirty (30) days after the Purchase Price for the Offered Interest has been so determined (collectively, the "Partnership Option Period"), within which to elect to purchase the Offered Interest at the price and upon the terms described below:

(a) as to any Transfer which is for cash consideration only, the price shall be as stated in the Transfer Notice and the terms shall be either those described in the Transfer Notice or the provisions of Section 8.8 of this Agreement, as shall be selected by the General Partner;

(b) as to any Transfer which is entirely gratuitous, the price and terms shall be those described in Sections 8.7 and 8.8 of this Agreement; and

(c) as to any Transfer which is other than for cash consideration, the price and/or terms shall either be those described in the Transfer Notice or Sections 8.7 and 8.8 of this Agreement, as shall be selected by the General Partner.

Sample Language: Purchase Price

8.7 Purchase Price. Whenever the Purchase Price for a Partnership Interest is to be determined by reference to this Section, then the Purchase Price for such Partnership Interest ("Offered Interest") shall be determined as follows:

8.7.1 Appraised Value. Subject to Sections 8.7.2 and 8.7.3 below, the Purchase Price for the Offered Interest shall be its Appraised Value as of the date of the event giving rise to such purchase, or the first day of the Partnership Option Period, if different, as shall be selected by the General Partner in the General Partner's sole and absolute discretion. Such Appraised Value shall be determined by a qualified appraiser who shall be selected by the Seller and the purchaser or purchasers ("Purchaser"), or if the Purchasers cannot agree, by the General Partner. If the Seller and the and the Purchaser (or the General Partner) cannot agree upon an appraiser, then the Seller shall select an appraiser and the Purchaser (or General Partner) shall select an appraiser, and such appraisers shall select a third appraiser. The third appraiser shall determine the Appraised Value of the Offered Interest. In determining the Appraised Value of the Offered Interest, the appraiser shall apply federal estate and gift tax valuation principles. The appraiser may consider any factors which the appraiser determines relevant, including, but not limited to, appropriate discounts for the minority status and lack of marketability of the Offered Interest, with or without consideration for family attribution, as the appraiser shall determine appropriate under the circumstances, and unrealized tax liabilities. The Purchaser (or Purchasers) shall bear one-half of all appraisal costs proportionately based upon the relative interest acquired by each Purchaser, and the Seller shall bear the other one-half of such costs.

8.7.2 Existing Appraised Value. Notwithstanding Section 8.7.1 above, if an Appraised Value has been obtained for accordance with Section 8.7.1 above within six (6) months of the date an appraisal becomes necessary to purchase an Offered Interest, then the General Partner, in the General Partner's sole and absolute discretion, may declare that the existing Appraised Value is the Appraised Value of the Offered Interest, provided, however, that the Partnership Interest for which the Appraised Value was previously obtained must be comparable to the Offered Interest. A Partnership Interest for which the Appraised Value was previously obtained shall be deemed "comparable" if it represents a Percentage Interest that is within ten percent (10%) of the Percentage Interest of the Offered Interest. For example, a twenty percent (20%) Limited Partnership Interest would be comparable to a ten percent (10%) and a thirty percent (30%) Limited Partnership Interest. In no event, however, shall (a) a minority Limited Partnership Interest be comparable to a majority Limited Partnership Interest; (b) a General Partnership Interest be comparable to a Limited Partnership Interest, nor (c) a non-voting interest be comparable to a voting interest. Notwithstanding the foregoing, the Seller may require that a new appraisal be secured to establish the Appraised Value of the Offered Interest. If such Appraised Value is more than one hundred and ten percent (110%) of the Appraised Value determined under this Section 8.7.2, the Purchaser (or Purchasers) shall bear one-half of all appraisal costs proportionately based upon the relative interest acquired by each Purchaser, and the Seller shall bear the other one-half of such costs. If, however, such Appraised Value is equal to or less than one hundred and ten percent (110%) of the Appraised Value determined under this Section 8.7.2, the Seller shall bear the entire cost of such appraisal.

8.7.3 Unanimous Agreement by Seller and the Other Partners. In lieu of obtaining an appraisal for any Offered Interest in accordance with Section 8.7.1 above or using an existing appraisal in accordance with Section 8.7.2 above, if the Seller and all of the Partners unanimously agree on a purchase price for the Offered Interest, such agreed price shall be the Purchase Price.

Sample Language: Terms of Purchase

8.8 **Terms of Purchase.** Whenever the terms for the purchase of an Offered Interest are to be determined by reference to this Section, then the Purchase Price for the Offered Interest shall be paid to the Seller pursuant to the following provisions:

8.8.1 **Escrow.** Within five (5) business days immediately following the applicable notice of purchase or notice of exercise of option to purchase, an escrow account ("escrow account") shall be opened with a person or entity selected by the Purchaser acting as escrow holder ("escrow agent"). The Seller shall, if he, she, or it has not already done so, execute an assignment of the Offered Interest to be purchased, which assignment shall be deposited with the escrow agent. Thereupon, the escrow agent shall deposit such assignment into the escrow account cash or a promissory note equivalent to the Purchase Price for the Offered Interest to be purchased. Escrow shall close at the offices of the Partnership or other acceptable location on a mutually acceptable date not later than thirty (30) days following the applicable notice of exercise of option to purchase or, in the event the purchase of the Offered Interest requires the prior approval of a federal or state regulatory agency, on such later date that is ten (10) business days after the expiration of any statutory waiting period or the receipt of notice from such agency approving the consummation of the purchase of the Offered Interest. At the closing, the escrow agent shall deliver the cash and/or promissory note(s) to the Seller and shall deliver to each Purchaser the assignment for the Offered Interest purchased by such Purchaser.

8.8.2 <u>**Deferred Payment**</u>. In order to reduce the burden upon the resources of the Partnership or the Partners, as the case may be, any Purchaser of an Offered Interest pursuant to the terms provided under this Section 8.8 may pay the Purchase Price for such Offered Interest by transferring to the escrow account a promissory note in the amount of the Purchase Price. The promissory note (the "Note") shall bear interest on the unpaid principal balance at the Long-Term Applicable Federal Rate, or the maximum rate permitted by applicable law, if less. Payments of interest only shall be made on a quarterly basis, with the entire principal amount of the Note to be paid in full on or before the date that is the tenth (10th) anniversary of the Note. The Note shall provide for full privilege of prepayment of all or any part of the Principal

at any time without penalty or bonus. The Note shall provide that if a default occurs, at the election of the holder and upon thirty (30) days' written notice of such default without any cure thereof, the entire sum of principal and interest will immediately be due and payable and that the Purchaser shall pay reasonable attorneys' fees to the holder if suit is commenced because of default. Each Note shall be secured by a pledge of all the Offered Interest being purchased in the transaction to which the Note relates, such pledge to remain in full force until the Note has been paid in full. The pledgeholder shall be the Seller, and the pledge agreement shall contain such other terms and provisions as may be customary and reasonable. As long as no default occurs in payments on the Note, the Purchaser shall be entitled to receive all the Distributions paid with respect to the Partnership Interest securing the Note and to exercise any Partnership rights. The obligation of each Purchaser to the Seller under a Note executed by such Purchaser shall be independent of the obligations of all other Purchasers to the Seller under their respective Notes. The Purchaser shall expressly waive notice of sale and shall consent to public or private sale of the Partnership Interest securing the Note in a default, in mass or in lots at the option of the pledgeholder, and the pledgeholder shall have the right to purchase at the sale, subject to the restrictions on transferability set forth in this Article.

Buy-Sell Agreements: Part II

- Valuation Issues
- Post-Mortem Administration
- Dispute Resolution and Confidentiality
- Charitable Vehicles as Business Owners

Meet Mary's New Husband
Sean O'Malley

Likable Irishman Mary Met while Traveling
Naturalized U.S. Citizen, Not Wealthy, Age Appropriate
No Children, Loves Mary Dearly, So-So Health

(a.k.a. The Perfect Spouse for Estate Planning)

Mary's New Estate Plan

- Intervivos QTIP for Sean
  - Goal is to defer estate tax, secure Sean's applicable exclusion and GST tax exemption
  - Funded with a 20% LP interest
  - Augmented at Mary's death with assets from her trust in excess of her Applicable Exclusion
  - Upon Sean's death, distributed in accordance with Mary's own plan
    - *Limited to Sean's applicable exclusion if Mary is the Survivor, with the balance held in a continuing QTIP for Mary's benefit*

Mary's New Estate Plan
(cont.)

- Applicable Exclusion Amount Distributed to Descendants at Mary's Death if Sean is Survivor
  - GST exempt assets divided into three equal shares and added to Irrevocable Exempt Trusts for Anna, Barbara, Charles and their respective descendants
  - GST Non-Exempt assets divided equally between Anna, Barbara and Charles and distributed to them outright

Buy-Sell Provisions and QTIP Trust

- Is the QTIP Trust Mary Created for Sean a Permitted Transferee?
- Could Events Occur during Sean's Lifetime (*or during Mary's Overlife)* that Result in a Required Sale of LP Interests in the QTIP?

Buy-Sell Provisions and <u>QTIP Trust</u> *(cont.)*

- Could the QTIP Trust be Required to Sell the LP Interest for Less than Full and Adequate Consideration in Money or Money's Worth as Determined for Federal Transfer Tax Purposes?

- Could the Terms of the Buy-Out Create a Transfer of Sean's (or Mary's) Income Interest under IRC Sec. 2519?

Buy-Sell Provisions Not Likely <u>to Control Transfer Tax Value</u>

- Requirement to Sell for Less than
  - Final federal estate tax value at death
  - Full and adequate consideration during the lifetime of the surviving spouse

  …. *Will Reduce the Marital Deduction*

- Beware of Circular Calculation

Buy-Sell Provisions Not Likely to Control Transfer Tax Value

(cont.)

- Simply Referring to Final Estate Tax Values Insufficient if Purchase Is Not Effective as of Date of Death
  - Can have special Buy-Sell Provisions dealing only with LP Interests passing under the marital deduction

Buy-Sell Provisions Not Likely to Control Transfer Tax Value

(cont.)

- Consider requiring an Independent Trustee for the QTIP to secure its own appraisal and negotiate the purchase price
- Consider requiring the reporting of any purchase to the IRS for estate or gift tax purposes and a purchase price adjustment if necessary

Who Pays Transfer Tax if Marital Deduction Reduced or Sec. 2519 Triggered?

- State Apportionment Statutes Will Not Likely Allocate Tax to the Buyer (not a "Beneficiary")
- Consider Adding Requirement to the Buy-Sell Provisions that Buyer Incurs any Transfer Tax
  - Creates a net gift for lifetime transfers (and a "reverse" circular tax computation)
  - *Not* a complete solution for Sec. 2519 tax on entire QTIP
    - Already a net gift calculation
    - QTIP assets are still included in the spouse's estate

Reducing Sec. 2519 Risk: Provide Spouse a Limited Power of Appointment

- Creates Incomplete Gift Argument
- Can Be Very Restrictive as to Permissible Appointees
- Can Require Consent of a Non-Adverse Party
- Could Be Limited to QTIP Assets Treated as Gifted under Sec. 2519

Reducing Sec. 2519 Risk: Provide Surviving Spouse a Limited Power of Appointment (*cont.*)

- "Bargain sale" Portion is Still a Completed Gift to Buyers
- Inclusion of Sec. 2519 QTIP Assets in Surviving Spouse's Estate
  - Under Secs. 2036/2038, not 2207A
  - Tax apportionment and recovery rules are different
  - Consider applying 2207A rules in all circumstances

Buy-Sell Agreements and Post-Mortem Administration

- Concern for Valuation Inconsistencies
- Can Transfers be Prohibited until Audit is Over? Challenges Include:
  - Uncertain time frame to conclude audit
  - Death of more than one partner in close succession (multiple audits)
  - Involuntary transfers
  - Transfers for consideration v. gift transfers

Buy-Sell Agreements and IRC Sec. 6166

- Requirements for Sec. 6166 Estate Tax Deferral
  - Interest(s) in *active* trade(s) or business(es) are more than 35% of Decedent's gross estate
  - Decedent held at least a 20% interest in each active trade or business
  - Each active trade or business has 45 or fewer owners

Buy-Sell Agreements and IRC Sec. 6166 *(cont.)*

- IRS *May* Accelerate the Deferred Estate Tax if:
  - Distribution, sale, exchange or other disposition of 50% or more of the value of the decedent's interest in the closely held trade or business
  - Withdrawal of 50% or more of the value of the closely held business
  - IRS is more likely to accelerate on transfers to non-family members

Section 6166 and Mary's Estate Plan

- If Mary Predeceases Sean
  - Only 16% of LP is in Mary's taxable estate (John's LP Interests in QTIP + Mary's own LP Interests not gifted to Sean's QTIP)
    - *But all tax is deferred anyway by the QTIP for Sean if it qualifies for the marital deduction*
  - Must allocate an LLC interest (GP) to the QTIP for Sean's estate to qualify as holding an "active business" interest

Section 6166 and Mary's Estate Plan *(cont.)*

- If Sean Predeceases Mary
  - Mary's estate may no longer qualify for Sec. 6166
  - Mary might want to purchase some LP interests from the children or their trusts to meet 20% requirement

Take Away: Buy-Sell Provisions Can Alter Sec. 6166 Mathematics
(positively or negatively depending upon the facts)

Dispute Resolution

- Considerations in Family Dispute Resolution
  - Time
  - Cost
  - Privacy
  - Preservation of Family Relationships
- Choice of Venue
  - Location of Business or Beneficiaries?

Dispute Resolution Provisions

- Confidentiality
- Small Claims Preservation
- Mandatory Mediation
- Mandatory Arbitration
  - Limited discovery?
  - Non-appealable?

Dispute Resolution Provisions
(cont.)

- How Are Costs Shared?
  - Agreed allocation?
  - Party who prevailed pays nothing?
  - Party determined to have prevailed on the most points pays nothing?
  - Arbitrator/mediator decides on appropriate allocation among parties?

Sample Language: Confidentiality

Prohibited Disclosure. The Partners acknowledge that they may receive information regarding the Partnership in the nature of trade secrets or that otherwise is confidential. They acknowledge that the release of this information may be damaging to the Partnership or persons with which it does business. Each Partner will hold in strict confidence any information it receives regarding the Partnership that is identified as being confidential (and if that information is provided in writing that is so marked). The Partners acknowledge that breaching this provision may cause irreparable injury to the Partnership for which monetary damages are inadequate, difficult to compute, or both. Accordingly, the Partners agree that the provisions of this Section may be enforced by specific performance. No Partner may disclose confidential information to any person other than another Partner, except the following disclosures:

(a) those compelled by law. But the Partners must notify the General Partner promptly of any request for that information, before disclosing it, if practicable; and

(b) those to advisors or representatives of the Partners, but only if they have agreed to be bound by the provisions of this Section.

Sample Language: Mediation

Agreement to Mediate. If any dispute or disagreement among the Partners or between one or more Partners and the Partnership ("Dispute") cannot be resolved within the Small Claims Division of the applicable court system or via non-judicial administrative proceedings, the Partners agree to attempt to resolve such dispute first through direct negotiations. If the dispute cannot be so resolved after thirty (30) days of direct negotiations, any party to the Dispute may request a mediation procedure be commenced, but in all events such mediation shall commence within thirty (30) days following the failure of direct negotiations. Each party to the dispute shall submit to each other party a written list of as many as three (3) acceptable qualified attorney-mediators located in [venue] and not affiliated with any Partner nor the Partnership listed in order of preference. If one or more names are on all lists, the highest ranking person will be designated as the mediator. If no mediator has been selected under this procedure, the mediator will be drawn by lot. If the mediator so selected is not available to serve, the parties will proceed to draw the names of mediators in this fashion until they select the name of a mediator who is willing and able to serve. The mediator so selected will establish the time, place and procedures for the mediation.

(1) **Commitment to Participate in Mediation in Good Faith.** The mediation session will be private and only the disputing parties may participate. The parties involved in the Dispute commit to participate in the proceedings in good faith with the intention of resolving the Dispute if at all possible.

(2) **Confidentiality.** Mediation is a compromise negotiation for purposes of Federal and State Rules of Evidence and constitutes privileged communication under California law. All conduct, statements, promises, offers, views, and opinions, whether oral or written, made in the mediation's course by any of the parties, their agents, employees, representatives or other invitees and by the mediator are confidential and will, in addition and where appropriate, be deemed privileged. The conduct, statements, promises, offers, views, and opinions will not be discoverable or admissible for any purpose, including impeachment, in any litigation or other proceeding involving the parties. It will not be disclosed to anyone nor any Partner's agent, employee, expert, witness, or representative. Evidence otherwise discoverable or admissible is not, however, excluded from discovery or admission as a result of its use in the mediation.

(3) **Mediation Fees; Disqualification.** The mediator's fees and expenses will be shared equally by the parties to the Dispute. The mediator will be disqualified as a witness, consultant, expert, or counsel for any of the parties with respect to the Dispute and any related matters. Further, the mediator may not serve as arbitrator of the Dispute.

Sample Language: Arbitration

Arbitration. The parties agree to participate in good faith in the mediation procedure to its conclusion. If the disputing parties are not successful in resolving the dispute through mediation, then the disputing parties agree that the dispute shall be settled by arbitration in [VENUE] and judgment upon the award rendered may be entered in any court having jurisdiction thereof. Except as specifically provided herein, the arbitration shall proceed in accordance with the laws of the [APPLICABLE STATE]. The initiating party shall give a written demand for arbitration to the other party by registered or certified mail. The demand shall set forth a statement of the nature of the dispute, the amount involved and the remedies sought. No later than twenty (20) calendar days after the demand for arbitration is served, the disputing parties shall jointly select and appoint an attorney-arbitrator or a retired judge of the [APPLICABLE COURT SYSTEM] ("Retired Judges"), to act as the arbitrator. In the event the parties have failed to agree upon the selection of an arbitrator at the end of such 20-day period, the parties will have five (5) additional business days thereafter to submit to each other a written list of acceptable qualified attorney-arbitrators or Retired Judges not affiliated with any Partner or the Partnership. Within five (5) days from the date the list is received, the parties will rank the arbitrators in numerical order of preference and exchange the rankings. If one or more names are on both lists, the highest ranking person will be designated as the arbitrator. If no arbitrator has been selected under this procedure, the parties agree to each submit not more than three attorney-arbitrators' or Retired Judges' names and to draw an arbitrator's name from those submitted by lot. If the arbitrator so selected is not available to serve, the parties will proceed to draw the names

of arbitrators in this fashion until they select the name of an arbitrator who is willing and able to serve. No later than ten (10) calendar days after the arbitrator is appointed, the arbitrator shall schedule the arbitration for a hearing to commence on a mutually convenient date. The hearing shall commence no later than one hundred twenty (120) calendar days after the arbitrator is appointed and shall continue from day to day until completed. As rules for the arbitration, the arbitrator shall apply the provisions of [APPLICABLE STATE LAW], and the parties may pursue discovery in accordance with [APPLICABLE STATE LAW], except as specifically provided herein. Absent a showing of good cause, which shall be in the sole discretion of the arbitrator, each Party shall be limited to not more than two (2) depositions, twenty (20) interrogatories, and ten (10) document requests. All discovery shall be completed no later than the commencement of the arbitration hearing or one hundred twenty (120) calendar days after the date that a proper demand for arbitration is served, whichever occurs earlier, unless upon a showing of good cause the arbitrator extends or shortens that period. The arbitrator shall issue his or her award in writing no later than twenty (20) calendar days after the conclusion of the hearing. The arbitration award shall be final and binding regardless of whether one of the disputing parties fails or refuses to participate in the arbitration. The arbitrator is empowered to hear all disputes between the Partners and the Partnership concerning the subject matter of this Agreement or the management of the business of the Partnership, and the arbitrator may award monetary damages, specific performance, injunctive relief, rescission, restitution, costs, and attorneys' fees. The results of such arbitration shall be conclusive, binding and non-appealable.

Sample Language: Attorney's' Fees and Costs

Attorney's' Fees and Costs. In the event of any action instituted among the parties in connection with this Agreement or the rights of the Partners and the Partnership under applicable law, the prevailing party shall be entitled to recover from the losing party all the prevailing party's costs and expenses, including court and arbitration costs and reasonable attorneys' fees, but not mediator's fees or attorneys' fees incurred in connection with mediation. "Prevailing party" means the party determined by the court, administrative board or arbitrator to have most nearly prevailed, even if such party did not prevail in all matters, not necessarily in whose favor a judgment or award is rendered. If the court, or administrative board or arbitrator fails or refuses to make a determination of the prevailing party, the party who is awarded costs of suit, if any, shall also be deemed to be the prevailing party for purposes of awarding attorneys' fees.

Valuation Disputes

- Agreed Price/Book Value/Other Fixed or Objectively Determinable Value
  - Fewest avenues for dispute *but…*
    - Unlikely to fix value for transfer tax purposes
    - May be a forfeiture v. ex-spouses and creditors if too low
    - Maybe best solution for small fractional interests

Valuation Disputes *(cont.)*

- New Appraised Value
  - Fairest but most expensive approach
  - Appraisers can have different opinions
- Previous Appraised Value
  - Possibly appropriate for small interests or multiple sales of similar interests that are close in time
  - Could allow buyer or seller opportunity to secure new appraisal at their own expense (to be shared if new appraisal favors that party)

Anticipating Disputes over Appraiser Selection

- Agreement Names Appraiser

  Might not be available

  Might no longer be as good as they once were (changes in personnel)

- Each Party Provides a List of Appraisers in Order of Preference, Pick Highest Ranking Appraiser

- Two Appraisers Pick a Third

  What appraiser wants to do that?

Anticipating Disputes over Appraiser Selection *(cont.)*

- Average of Two (or More) Appraisals

  So both must be outrageous in case one of them is?

  Also a very expensive option

  Will this apply to both valuation of assets in the business or just the business/business interest?

  Might be appropriate for very large valuations

Anticipating Disputes over Appraiser Selection *(cont.)*

- Pick an Appraiser by Lot
- Majority of Limited Partners and/or General Partner Selects the Appraiser
- Appraisal Committee Consisting of Insiders and Outsiders Pick Appraiser

Other Valuation Disputes

- Disputes over Methodology to be Applied
  - Net asset value
  - Discounted cash flow model
  - Other?
  - Might differ based upon relative size of interest

Other Valuation Disputes *(cont.)*

- Disputes over Appropriate *(or any)* LOM/LOC/BIG Discounts
  - Could agree applies in accordance with transfer tax valuation principles
  - Should principles of Chapter 14 (particularly Section 2704) be applied consistently, regardless of the relationship of buyers and sellers?

Other Valuation Disputes *(cont.)*

- Disputes over Communication with Appraisers
  - Could appoint two designated representatives (for Buyers, collectively and Sellers, collectively)
    - Receive all information
    - Communicate directly with appraiser
  - Could permit all points of view to be communicated to appraiser in writing

Meet Barbara Brown-Davis, Age 55

(and her furry family members)

Content, Happily Married for 30 Years, No Children
Owns 6 Rescue Dogs and 1 Rescue Cat
Entire Estate to Support Animal Welfare Charities
Also Considering Lifetime Charitable Gifts

Addressing Ownership by Charitable Vehicles

Most Common Vehicles

- Bequests to Charities
- QTIP Trust with Charitable Remainder
- Lifetime Gifts to Charities
- Private Foundations
- Donor Advised Funds
- Charitable Remainder Trusts
- Charitable Lead Trusts

Addressing Ownership by Charitable Vehicles *(cont.)*

Special Issues

- Involvement of charities (and their lawyers) to protect the charities' interests
- Involvement of Attorney General to protect the people's interests
- Direct and indirect self-dealing
- Excess business holdings
- Income tax charitable deductions
- Estate and gift tax charitable deductions

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. <u>Suggested Terms of a Buy-Sell Agreement</u>.

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. <u>Introduction</u>.

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. <u>The Impact of Chapter 14 on Valuation</u>.

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. <u>Exceptions</u>.

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).

e. *Smith III v. U.S.*, 94 AFTR2d 2004-5283 (W.D. Pa. 2004)

In what the court referred to as a case of first impression, a magistrate judge's report held that I.R.C. § 2703(a) applied to a provision in a limited partnership agreement dealing with a transfer of an interest in the partnership. The provision set out the price and the terms upon which the partnership was required to pay a partner for his or her limited partnership interest if the partnership exercised its right of first refusal. Consequently, if the safe harbor under I.R.C. § 2703(b) did not apply, the provision would be ignored in valuing a limited partnership interest in the partnership. The taxpayers had argued that I.R.C. § 2703 only applied to independent buy-sell agreements, relying on *Church v. U.S.*, 2000-1 USTC 60,369 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) and *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part and rev'd and remanded in part*, 293 F.3d 279 (5th Cir. 2002). The report distinguished *Church*, because in that case the IRS had argued that state law restrictions on the admission of a transferee as a partner should be ignored, and distinguished *Strangi I*, because in that case the IRS had argued that the entity itself should be ignored. Neither case dealt with restrictions in the limited partnership agreement itself.

Although the court found that the agreement was a bona fide business arrangement because it facilitated maintenance of family ownership and control, the court denied the taxpayers' motion for summary judgment that all three requirements of the safe harbor under I.R.C. § 2703(b) were satisfied. The court believed that taxpayers had presented insufficient evidence in the record to allow the court to determine whether the agreement was a not testamentary device and was comparable to similar arrangements entered into by persons in an arm's length transaction, which are the second and third requirements under the safe harbor.

The court stated that the determination of whether a restrictive agreement is merely a testamentary device involved an inquiry into the intent of the parties at the inception of the agreement, as well as the transferor's health at the inception of the agreement, significant changes in the business subject to the restrictive agreement, selective enforcement of the restrictive provision, and the nature and extent of the negotiations that occurred among the parties regarding the terms of the restrictive provision.

While the case indicates that satisfying the comparability test may be difficult, most commentators had already noted that the comparability test would be difficult to satisfy, depending upon how the courts approached it. The court, citing the regulations, stated the test was met if the right or restriction "conforms with the general practice of unrelated parties under negotiated agreements in the same business." In this case, the court dismissed the affidavits of two lawyers that the restrictions at issue were common in both family limited partnerships and transactions among unrelated parties as conclusory in nature and not evidence sufficient to dispel any genuine issue of material fact as to whether the restrictions met the test. It is true that buy-sell agreements for closely held businesses are not generally made public. However, using the method in a qualified business appraisal prepared at the time the buy-sell agreement is negotiated to establish the formula for determining the purchase price may serve as evidence that the purchase price under the buy-sell agreement is commercially reasonable.

The holding that I.R.C. § 2703(a) applies to restrictions in a partnership agreement is also no surprise to most practitioners. It has been assumed since I.R.C. § 2703 was enacted in 1990 that it was not limited to stand alone buy-sell agreements, but could apply to any restrictions in the entity's operative agreements.

The Magistrate on rehearing concluded that it was unnecessary to determine whether the safe harbor under I.R.C. § 2703 was satisfied, because it found that the restriction in the partnership agreement did not satisfy the law before the enactment of § 2703. Specifically, the Magistrate found that the agreement was not binding on the donor because he had the ability under the agreement to amend or modify the agreement as the owner of 2/3 of the general partnership interest and more than 50% of the limited partnership interest. While the Magistrate's conclusion would be correct if the limited partnership interests were being valued in the estate of a decedent rather than as gifts made by a donor, the Magistrate's conclusion is not correct for purposes of valuing a gift. In valuing a gift, the fair market value is what a willing buyer would pay to a willing seller for the gifted interest, and in this case a willing buyer of a minority interest, who would not be able to amend or modify the agreement, would take into account restrictions in the agreement in determining what he or she was willing to pay for the interest.

f. *Estate of Amlie v. Commissioner*, TC Memo 2006-76

Facts of the Case. Pearl Amlie (the decedent) had three children, Rod, Thomas, and Rosemary. In her 1978 will she left farm land in equal shares to Rosemary and Thomas, and an amount of bank stock to Rod equal in value to one-half of the value of the farm land, and the balance of her estate in equal shares to her three children. Rod and his family were given the right to purchase any bank stock not passing to them.

In 1988, a conservator was appointed to handle the decedent's affairs. During the conservatorship, there were acrimonious disputes among the decedent's children. Thomas and Rosemary distrusted Rod, whom they blamed for the FDIC's forced closing of one of the banks decedent owned and Rod had managed.

In 1991, the decedent's bank stock was converted to common and preferred stock of Agri-Bank (Agri). The conservator entered into an agreement (the 1991 Agreement) with David Hill, the majority shareholder of Agri providing for restrictions on the transfer of Agri stock and giving the decedent a put option to sell the stock to Agri for book value and Agri a call option to purchase all of decedent's stock at the same price. In addition, if Hill sold his controlling interest to a third party, the decedent would be offered the opportunity to sell her stock to the same party for the same consideration, which included the value of any noncompete, consulting or similar arrangements or payments for the benefit of Hill (referred to as the Hill Rights). Finally, if the prospective third party purchaser of Hill's stock conditioned the purchase on the right to acquire the decedent's stock as well, the decedent was required to sell her stock for the prescribed consideration.

The conservator's reasons for entering into the agreement were to postpone the sale of the bank stock until after the decedent's death in order to eliminate capital gain tax on the unrealized appreciation because of the step-up in basis under I.R.C. § 1014, to protect the decedent's minority status in the event of the sale of the controlling shareholder's stock, and to provide liquidity for the decedent's estate, which included a number of valuable illiquid assets. The agreement was approved by the local county court (the District Court) as being in the decedent's best interest.

In 1994, Hill agreed to sell his stock in Agri, as well as two other banks, to First American Bank Group (FABG) in exchange for FABG stock, based on book value, a five year employment contract, a signing bonus, retirement of certain capital notes held by one of the other banks, and an option to exchange his FABG stock in five years for all of the stock of a subsidiary of FABG. The decedent's shares were also exchanged for FABG stock, again based book value.

The conservator and FABG entered into an agreement (the 1994 Agreement) to purchase the decedent's FABG stock at the decedent's death for approximately $118 per share, 1.25 times the book value at the time of the exchange. The consideration over book value took into account the decedent's Hill Rights. In addition, under the 1994 Agreement, FABG and the decedent were given call and put rights exercisable within 60 days after the notice of the decedent's death at $118 per share. The conservator, by this time Boatmen's Bank of Iowa, had a valuation specialist from Boatmen's Trust Co., a related entity, review the terms of the 1994 agreement. She determined that the $118 per share price was fair for the decedent's FABG stock, including the Hill Rights. The conservator also believed the 1994 Agreement was in the decedent's best interest because the agreement guaranteed a fixed price and buyer for the FABG stock and deferred the sale until after the decedent's death, avoiding capital gain tax. Rod objected to the agreement in the proceedings before the District Court because he believed the Hill Rights were undervalued. Consequently, the District Court did not approve the 1994 Agreement because it found that the $118 price failed to compensate the decedent adequately for the Hill Rights.

In 1995, pursuant to negotiations started by the conservator, the prospective heirs of the decedent (which included the children of Thomas, who had died) reached a settlement, the 1995 Family Settlement Agreement (the "1995 FSA"), that provided that the $118 price for the FABG stock would be used in determining the number of shares required to satisfy Rod's specific bequest under the decedent's will and the price Rod and his family had to pay for the balance of the stock not otherwise passing to them. In addition, the Hill Rights were assigned to Rod's family. Finally, certain legal fees were paid by the conservator out of the decedent's assets, including $30,000 to Rod. The District Court found the 1995 FSA was in the decedent's best interest.

In 1997, Rod's family reached an agreement with FABG (the 1997 Agreement) that required FABG to purchase all of FABG stock Rod's family would receive at the death of the decedent at $217.50 per share. The increased price was due to the increased value of the Hill Rights, particularly the value of the option to exchange FABG stock for all the stock of the subsidiary.

The decedent died on October 18, 1998, at the age of 96. Rod's family exercised its option to buy the balance of FABG stock not passing to them under the decedent's will for $118 a share. FABG then purchased the stock for the agreed price of $217.50 a share, which eventually went to Rod's family.

The IRS, in its notice of deficiency, determined that the value of the FABG stock was $1,489,725, the purchase price paid to Rod's family pursuant to the 1997 agreement, rather than $993,757 that was reported on the estate tax return and that represented the $118 price under the 1995 FSA. In addition, the IRS determined that the underpayment arising from the undervaluation of the FABG stock was attributable to fraud or, in the alternative, negligence or disregard of rules and regulations under I.R.C. § 6662. The IRS also determined that the payment of Rod's legal expenses in connection with the 1995 FSA was a taxable gift. Although the IRS also disputed the reported value of five parcels of land owned by the decedent, this discussion only deals with the stock valuation issue.

<u>Court's Opinion</u>. After determining that the estate was not entitled to have the burden of proof shifted to the government under I.R.C. § 7491 because Rod had refused the IRS' agent's request for an interview, the Tax Court turned to the valuation of FABG stock. At the heart of the matter was whether the 1995 FSA was controlling for determining the value of the stock for federal estate tax purposes. In reaching its conclusion that the 1995 FSA did establish the value of the stock, the Tax Court considered the requirements set forth in the regulations and case law before the enactment of I.R.C. § 2703, as well as the additional requirements imposed by I.R.C. § 2703.

The Tax Court found that the 1995 FSA satisfied the requirements under the regulations and case law before the enactment of I.R.C. § 2703; namely, that the agreement contained a fixed and determinable price for decedent's FABG stock and that the agreement was enforceable. The IRS had contended that the price was not determinable because it was not certain that Rod's family would have to purchase any of the stock from the estate at the $118 price, since it could have received all of the stock pursuant to the specific bequest. However, the Tax Court viewed the satisfaction of the specific bequest with the stock at the $118 price as a sale or exchange. The court stated:

> Pursuant to the agreement reached between the conservator and the prospective heirs, the estate could receive no more (and no less) than the $118 price for all shares of decedent's FABG stock, thereby effecting a transfer of the risk of loss or opportunity for gain on the shares from the decedent and her estate to the Rod Amlie Trust.

The court also found that the 1995 FSA satisfied the three requirements under I.R.C. § 2703; namely, it was a bona fide business arrangement, it was not a device to transfer the stock to members of the decedent's family for less than full and adequate consideration in money or money's worth, and its terms were comparable to similar arrangements entered into by persons in an arm's length transaction. The court rejected the IRS' argument that the 1995 FSA was not a bona fide business arrangement because the subject of the agreement was not an actively managed business interest but merely an investment asset. In the court's view, the agreement served a business purpose within the meaning of I.R.C. § 2703(b)(1) because it represented the conservator's efforts to hedge the risk of the decedent's holding of a minority interest in FABG. In addition, planning for future liquidity needs of the decedent's estate, which was also one of the objectives underlying the 1995 FSA, constituted a business purpose under I.R.C. § 2703(b)(1).

The court also found that the 1995 FSA was not a testamentary device. The conservator, in an effort to fulfill its fiduciary obligations, and the other prospective heirs in furtherance of their own interests, accepted a price they believed (on the basis of professional advice) was fair at the time and in the particular circumstances.

Finally, the 1995 FSA satisfied the comparability test because it was based on the price terms reached in the 1994 Agreement, which was based on a survey of comparables. The fact that Rod was able to secure a price of $217.50 per share from FABG in 1997 was attributable to the increase in the Hill Rights during that period, due to a large degree to the increased value of the subsidiary, which Hill had to right to acquire in exchange for his FABG stock.

<u>Analysis of the court's Opinion</u>. Note that the price paid by FABG for the decedent's stock, $217.50 per share, was almost double the $118.00 pre share value reported on the estate tax return. Under I.R.C. §2703, if the 1995 FSA had been disregarded, the value per share for estate tax purposes would have been $217.50, because that was arguably the fair market value of the share. The sale price of an asset so close to the date of death is usually the best evidence of its value for estate tax purposes. It is only the fact that the Tax Court found that the 1995 FSA was controlling, because it satisfied both the requirements under the regulations and case law before the enactment of I.R.C. § 2703 and the three requirements under I.R.C. § 2703, that allowed the estate to successfully use the $118 per share value.

Is this case a blueprint for creating an artificially low value for an asset that is passing to a family member? It is doubtful that the unique fact situation in this case could be duplicated on purpose without the resulting arrangement being treated as a sham. In this case there were several third parties that were parties to the various agreements that led to the 1995 FSA; namely, David Hill, FABG, and the conservator. In addition there was ample evidence of discord among the children. Finally, the conservator was subject to a fiduciary duty to the decedent, and, presumably, to all her prospective heirs. If the other heirs of the decedent thought that the deal struck by the conservator and the prospective heirs with Rod's family was unfair because of the substantial increase in price Rod was able to get from FABG two years later, they could have sued the conservator. Perhaps that is one reason why, as the facts state, the conservator did not personally sign the 1995 FSA, although the District Court approved it.

The case also emphasizes an important aspect of the statutory safe harbor under I.R.C. § 2703, as interpreted by the regulations, that, <u>at the time the right or restriction is entered into to</u>, the terms must be comparable to similar arrangements entered into by persons in an arm's length transaction. Note that the underlined phrase was added to the statutory language by the regulations and was part of a technical correction bill that was never passed. The underlined language makes it clear that, although later unforeseen events may cause the price under the arrangement to be substantially different than the value at the decedent's death, the price under the arrangement will still be controlling if the terms were comparable at the time the arrangement was entered into. However, at the time the agreement was entered into, various factors must be considered, including the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted. The court went to great lengths to point out the benefits the conservator sought to achieve in the 1994 Agreement and did achieve in the 1995 FSA, including protecting the decedent's minority position and providing liquidity to her estate. The court also stressed that it was the unexpected increase in the value of the subsidiary that caused a substantial increase in the Hill Rights, and consequently, the increased price FABG was willing to pay for the stock. Had it been certain that the Hill Rights would increase in value over a short period of time, the arrangement may not have satisfied the comparability test.

A final point made by the court is that in certain circumstances an isolated comparable may be sufficient to satisfy the comparability test. The government had argued that basing the estate tax value on the price in the 1995 FSA, which was in turn based on the 1994 Agreement, an agreement among unrelated parties, did not satisfy the test because the 1994 Agreement was an isolated comparable. The court rejected this interpretation of the regulations, finding that the statement in the regulations, that isolated comparables are not evidence of general business practice, was more a safe harbor and not an absolute requirement that multiple comparables be shown. Nonetheless, the court went on to note that, because the valuation specialist did consider merger multiples for all Midwest region banks in determining that the $118.00 per share price in the 1994 Agreement was reasonable, multiple comparables were in fact considered.

While not discussed by the court, the regulatory exception discussed below did not apply in this case. Although the decedent's family owned considerably less than 50% of the stock of FABG, the 1995 FSA only applied to the decedent and her prospective heirs. For the regulatory exception to apply, the restrictions must apply to the non-family members as well.

g. ***Holman v. Commissioner***, 130 T.C. No. 12 (2008), *aff'd*, 105 AFTR 2d 2010-1802 (8th Cir. 2010)

Facts of the Case. Tom and Kim Holman (Tom and Kim), husband and wife, formed a limited partnership (the partnership) on November 2, 1999, and transferred shares of Dell Computer Corp. (Dell) to the partnership the same day. They each took back an .89% general partnership interest and a 49.04% limited partnership interest. In addition, a trust for the benefit of their children (the trust) transferred shares of Dell to the partnership for a .14% limited partner interest. They had four reasons for forming the partnership: very long-term growth, asset preservation, asset protection, and the education of their four children. In addition, they wanted to disincentivize their children from getting rid of the assets, spending them, or feeling entitled to them. The partnership agreement gave the general partners the exclusive right to manage and control the business and prohibited an assignment of an interest by a limited partner without the consent of all partners except to permitted assignees. The partnership agreement also gave the partnership the right to acquire an assignee interest acquired in violation of the agreement at fair market value based on the assignee's right to share in distributions. The partnership could only be dissolved with the consent of all partners.

On November 8, 1999, Tom and Kim gave limited partner interests (LP units) to the trust and to four uniform transfers to minors act custodianships for the benefit of their children (custodian accounts) having a reported value according to the gift tax returns roughly equal to their $600,000 transfer tax exemptions at the time. On December 13, 1999 the custodian accounts transferred additional shares of Dell to the partnership. On January 4, 2000, Tom and Kim gave LP units to the custodian accounts having a reported value equal to the annual exclusions available to Tom and Kim ($80,000). On January 5, 2001 Tom and Kim transferred additional shares of Dell to the partnership in exchange for additional LP units. Finally, on February 2, 2001, Tom and Kim gave additional LP units to the custodian accounts having a reported value equal to the annual exclusions available to Tom and Kim ($80,000).

The Tax Court described the operation of the partnership as follows: there was no business plan; there were no employees nor any telephone listing in any directory; its assets consisted solely of Dell shares; there were no annual statements; at the time Tom decided to create the partnership he had plans to makes gifts of LP units in 1999, 2000, and 2001; and the partnership had no income and filed no returns for 1999, 2000, and 2001.

The IRS increased the value of the gifts based on the following alternate assertions: the transfer of assets to the partnership were indirect gifts of the Dell shares; the interests were more analogous to interests in a trust than an operating business; I.R.C. § 2703 applied to ignore the restrictions in the partnership agreement; the restrictions on liquidations should be ignored under I.R.C. § 2704(b); and the appropriate discount for lack of control and lack of marketability should be 28%, rather than the taxpayer's 49.25% discount. At trial, the IRS abandoned the trust and I.R.C.§ 2704(b) arguments.

Court's Opinion. The following will deal with the Court's opinion with regard to the application of I.R.C. § 2703(a). The IRS asserted that the right of the partnership to acquire an assignee's interest at a value less its pro rata share of the partnership's net asset value (NAV) should be disregarded under I.R.C. § 2703(a) because it did not satisfy the three requirements under the statutory safe harbor; namely, the right must be a bona fide business arrangement, it must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and its terms must be comparable to similar arrangements entered into by persons in an arm's length transaction. The Court agreed with the government, based on its opinion that the right did not satisfy the bona fide business arrangement and device requirements.

The Court held that there was no closely held business and the reasons for forming the partnership were educating the Holman's children and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the shares, or feeling entitled to the Dell shares. The Court distinguished *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76, because in that case the conservator was seeking to exercise prudent management of his ward's minority interest in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate.

While the Court held that the gifts were not a device to transfer LP units for less than adequate consideration, the right to acquire an assignee's interest was such a device. The Court reasoned that by purchasing a transferred interest for a value less the a pro rata share of the NAV, the value of the non assigning children's LP units would be increased.

Although both parties' experts agreed that the restrictions were common in arm's-length arrangements, the government's expert believed that because of the nature of the partnership, nobody at arm's length would get into the deal. Because the Court found that the right to acquire an assignee's interest was not a bona fide business arrangement and was a device, it did not reach a conclusion as to whether the comparability requirement was satisfied.

<u>Analysis of Court's Opinion</u>. The Court's application of the statutory safe harbor under I.R.C. § 2703 greatly restricts its usefulness in family entities that do not engage in an active trade or business. The Court implies the bona fide business arrangement requirement can only be satisfied if there is a closely held business involved or the reasons for the restrictions are business related. Some commentators have argued that the Court ignores language in the Finance Committee Report that "[b]uy-sell agreements are commonly used to control the transfer of ownership in a closely held business…*to prevent the transfer to an unrelated party*" [emphasis added]. If the Court's premise is that the bona fide business arrangement requirement can only be met if there is a closely held business, which in its opinion does not include an investment in one company's stock, or the reasons for the restrictions are business related, the reasons for having any restrictions are irrelevant in meeting the requirement unless there is a closely held business or the reasons are business related.

Although the Court did not treat the gifts of the LP units themselves as a device, it held that the right to acquire an assignee interest at a value below its proportionate NAV could result in value being transferred to objects of the decedent's bounty for less than adequate consideration. However, the subsequent shift in value to the non-assigning children would not involve a transfer from the parents to the children, but merely a shifting of value among all the non-assigning partners. The result reached by the Court can be avoided by including a true right of first refusal rather than the provision giving the partnership the right to acquire an assignee's interest. Presumably the purchase price in a good faith offer by a third party would be based on a value considerably less than a pro rata share of the NAV.

Finally, as has been noted by other commentators, the willingness of the Court to accept testimony concerning the comparability requirement other than actual buy-sell agreements, which would be difficult to obtain for closely held businesses, is a welcome approach to that issue.

Eighth Circuit Opinion. The taxpayers in *Holman* appealed the Tax Court's decisions with regard to the application of I.R.C. § 2703 and the appropriate lack of marketability discount. The 8th Circuit in a two to one decision upheld the Tax Court on both the I.R.C. § 2703 issue and the valuation issue. The majority believed that the issues were questions of fact, and therefore applied a "clear error" standard of review, while the dissenting judge believed that the issues were questions of law or mixed questions of law and fact and would have applied a "de novo" standard. Consequently, the majority opinion relies heavily on the facts in the case in affirming the Tax Court's holdings.

Majority Opinion. With regard to the bona fide business arrangement test, the Court found that "In the present case, looking at the entirety of the surrounding transactions—including the contemporaneous execution of wills, Mr. Holman's understanding of the potential tax benefits of his actions, Mrs. Holman's educational goals, and the absence of any business activity—we find ample support for the Tax Court's determination. When viewed in this context, there is little doubt that the restrictions included in the Holmans' limited partnership agreement were not a bona fide business arrangement, but rather, were predominately for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children."

At the outset, the Court refuted the taxpayers' argument that the Tax Court had imposed an operating business requirement in order to satisfy the bona fide business arrangement test. Citing earlier cases, the 8th Circuit did postulate that the bona fide business arrangement test was less difficult to satisfy when an active business was involved. According to the Court, context matters. "Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no "business," active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash." The Court characterized the family partnership as a "mere asset container," citing *Estate of Erickson v. Commissioner*, T.C. Memo 2007-107.

The taxpayers cited several Tax Court cases addressing the business purpose element of I.R.C. § 2703(b)(1), involving passive investments. The Court distinguished *Estate of Amlie v. Commissioner*, T.C. Memo 2006-76, where the Tax Court found that a buy-sell agreement was a bona fide business arrangement where a fiduciary had entered into the agreement to ensure the ability to sell stock that represented an otherwise illiquid minority interest in a closely held bank. It also distinguished a line of cases involving investment entities with restrictions imposed to ensure perpetuation of an investment model or strategy. *Estate of Black v. Commissioner*, 133 T.C. 15 (2009); *Estate of Murphy v. United States*, 104 AFTR 2d 2009-7703 (W.D. Ark. 2009); and *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126. In the present case, in contrast to the cited cases, the donors did not purport to hold any particular investment philosophy or possess any particular investing insight. Because the Holmans had no overall, long-term plan, unlike *Schutt* [and presumably the other cited cases], the family membership, educational, and tax reduction purposes overshadowed any claim of a business purpose for the restrictions.

Because the majority found that the first requirement of the statutory exception was not satisfied, it did not deal explicitly with the other two requirements, the device test and the comparability test.

Dissenting Opinion. The dissenting opinion believed that all three requirements of the statutory exception to the application of I.R.C. § 2703(a) applied. The restrictions in the agreement represented a bona fide business arrangement, the device test only applied in the case of a decedent and not a donor, and the comparability test was satisfied. The dissent also believed that the Tax Court and the majority had misapplied the willing buyer, willing seller standard by assuming that the hypothetical buyer owned Holman limited partnership interests.

The dissent believed that the partnership agreement restrictions were a bona fide business arrangement because they were not created for the primary purposes of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner. The dissent also found that the device test only applies to transfers at death, because the statutory language uses the term "decedent" rather than the broader term "transferor," and would have held the regulation that changes the word "decedent" to "transferor" as invalid because it does not give effect to the plain language of the statute. Finally, the dissent would have held the comparability requirement satisfied because the experts for both parties agreed that the transfer restrictions were comparable to those found in agreements entered into at arm's length.

Analysis of 8th Cir. Opinion. If other courts adopt the reasoning of the Tax Court and the 8th Circuit with regard to the bona fide business arrangement requirement of the statutory exception to the application of I.R.C. § 2703(a), appraisers may be forced to disregard restrictions in buy-sell agreements, limited partnership agreements, and LLC operating agreements in connection with entities that hold only passive investments that would be normal in such agreements in connection with an operating business, unless there is a business purpose for the arrangement. For example, in *Amlie*, the business purpose was to provide liquidity to Mrs. Amlie's estate and to protect her minority interest. In *Schutt*, the business purpose was to preserve Mr. Schutt's investment philosophy. On the other hand, in *Holman*, the stated purposes for creating and funding the partnership did not include any particular investment strategy; rather the Holmans wanted to protect the assets from dissipation by their children and to teach them about wealth and the responsibility of that wealth. Certainly, if the word "business" in the first requirement has any meaning, the Tax Court and the 8th Circuit got it right.

This may mean that the bona fide business arrangement test is more difficult to satisfy than the bona fide sale exception to I.R.C. § 2036(a). It appears that as long as there is a legitimate and significant nontax reason for creating and funding the entity and the interests the contributors receive in the entity are proportionate to the fair market value of the assets contributed, the bona fide sale exception is satisfied. Perhaps it is the absence of the word "business" in the bona fide sale exception that causes this apparent difference between the two standards. Keep in mind, even with the application of I.R.C. § 2703(a), the taxpayers still obtained significant discounts.

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.

3. The *True* case: Effect of buy-sell agreements on transfer tax valuation.

a. Facts of the Case. *In Estate of True v. Commissioner*, T.C. Memo 2001-167, decided July 6, 2001, *aff'd*, 94 AFTR 2004-7039 (10th Cir. 2004), Judge Beghe provided taxpayers with a detailed analysis of when the purchase price contained in a buy-sell agreement will be effective for establishing the value of an interest in the entity for transfer tax purposes. The case involved transfers by Dave True in 1993 and his wife, Jean True, in 1994, and transfers from the estate of Dave True, who died on June 4, 1994. Beginning around 1950, Dave True began to amass ownership interests in a number of companies involved in the oil exploration and transportation business and in operating cattle and dude ranches. All but one of the companies were either partnerships or S corporations. By 1994, all but one of the companies were owned by Dave True, his wife, and his three sons, all of whom were active in the businesses. One company, White Stallion Ranch, Inc. ("White Stallion"), was owned 50% by Dave True and his family, and 50% by Dave True's brother, Allen, and his family. All of the companies, other than White Stallion, had buy-sell agreements that provided for a purchase price equal to the tax book value (the book value of the assets of the company determined on a tax accounting basis), after excluding certain assets. All of the agreements, except the one involving White Stallion, required a withdrawing owner to sell and the other owners to purchase the withdrawing owner's interest at the purchase price determined under the agreement. The agreement for White Stallion had a similar provision with respect to each family group; *i.e.*, if any member of Dave True's family withdrew, the remaining members of Dave True's family were required to purchase the withdrawing family member's interest at the purchase price determined under the buy-sell agreement. However, if a family group wanted to dispose of all its interests in White Stallion, the other family group only had a right of first refusal to purchase the shares of White Stallion held by the other family group at the same price contained in a bona fide offer received from a third party.

b. Court's Opinion. There were four issues to be decided by the court:

(1) Did the book value price specified in the buy-sell agreements control the estate and gift tax values of the interests in the True companies (referred to as the "buy-sell agreement issue");

(2) If the True family buy-sell agreements did not control values, what were the estate and gift tax values of the interests (referred to as the "valuation issue");

(3) Did Jean True make gift loans when she transferred interests in the True companies to her sons in exchange for interest-free payments received approximately 90 days after the effective date of the transfers (referred to as the "gift loan issue"); and

(4) Were petitioners liable for valuation understatement penalties under I.R.C. § 6662(a), (g), and (h) (referred to as the "penalty issue")?

Only the buy-sell agreement issue is dealt with here. Although the decision in *True* is based on the law before the enactment of I.R.C. § 2703, which applies special rules in determining the effect of a buy-sell agreement on the value of an interest in a business entity for transfer tax purposes, much of the court's analysis will nevertheless be relevant in applying I.R.C. § 2703 to buy-sell agreements entered into on or after October 9, 1990, the effective date of I.R.C. § 2703.

Judge Beghe first described the development of the legal standards that apply in determining when a buy-sell agreement will determine the estate tax value of an interest in a business entity. Based on the cases decided after the issuance of Treas. Reg. § 20.2031-2(h) in 1958, and Rev. Rul. 59-60, 1959-1 C.B. 237, Judge Beghe applied the so-called *Lauder II* test, which was applied in *Estate of Lauder v. Commissioner*, T.C. Memo 1992-736. Under the *Lauder II* test, the formula price under a buy-sell agreement will be binding for federal estate tax purposes if:

(1) The offering price was fixed and determinable under the agreement;

(2) The agreement was binding on the parties both during life and after death;

(3) The agreement was entered into for bona fide business reasons; and

(4) The agreement was not a substitute for a testamentary disposition.

Judge Beghe noted that after the issuance of Reg. § 20.2031-2(h), the courts shifted their attention to the last two prongs, which had only been alluded to in some of the earlier cases. The last two prongs were treated by courts in the later cases as two separate requirements; *i.e.*, the agreement had to be entered into for a bona fide business reason and it could not be a substitute for a testamentary disposition. The court cited, in addition to the *Lauder* case, *Dorn v. United States*, 828 F.2d 177 (3d Cir. 1987), and *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982).

Under the facts in *True*, the parties agreed that the offering price was fixed and determinable under the agreement and the agreement was entered into for bona fide business reasons (to preserve family ownership and control of the True companies). Despite the IRS' contention that the agreements were not enforceable under state law, Judge Beghe found all the agreements, except the one for White Stallion, were binding during lifetime and after death.

Judge Beghe noted that in evaluating whether a buy-sell agreement was a substitute for a testamentary disposition, greater scrutiny is applied to intra-family agreements restricting stock transfers in closely held businesses than to similar arrangements between unrelated parties. He noted that in *Lauder* the analysis was organized into two categories: those factors indicating that a buy-sell agreement was not the result of arm's-length dealing or was designed to serve a testamentary purpose (referred to as the "testamentary purpose test"), and tests to determine whether a buy-sell agreement's formula price reflected full and adequate consideration in money or money's worth (referred to as the "adequacy of consideration test").

Under the *Lauder II* test, the following factors were indicia that the agreement was not the result of arm's-length dealing or was designed to serve a testamentary purpose:

1. The decedent's ill health when entering into the agreement;

2. The lack of negotiations between the parties before executing the agreement;

3. The lack of (or inconsistent) enforcement of the buy-sell agreement;

4. The failure to obtain comparables or appraisals to determine the buy-sell agreement's formula price;

5. The failure to seek professional advice in selecting the formula price;

6. The lack of a provision in the buy-sell agreement requiring the periodic review of the stated fixed price;

7. The exclusion of significant assets from the formula price; and

8. The acceptance of below-market payment terms for purchase of the decedent's interest.

Under the facts in the *True* case, Dave True's ill health was not a factor (he was not in ill health when the agreements were entered into), and the agreements were either enforced or appropriate waivers were executed when it was appropriate to vary from the terms of the agreements for valid business reasons. However, there were no negotiations between the parties before executing the agreements, there was no effort to obtain comparables or appraisals to determine the appropriate formula price, professional advice was not sought in selecting the formula price, there was no provision requiring a periodic review, and significant assets were excluded from the formula price. Consequently, Judge Beghe opined that Dave True's business arrangements with his children fulfilled his testamentary intent, as evidenced by his will and ancillary estate planning documents.

The second category of factors concerns the adequacy of consideration test. Although Judge Beghe noted that, in general, the adequacy of consideration was determined as of the date the buy-sell agreement was executed, in exceptional circumstances the adequacy of consideration and the conduct of parties after the buy-sell agreement was executed would be examined if intervening events within the parties' control caused a wide disparity between the buy-sell agreement's formula price and fair market value. In the case of the True companies' buy-sell agreements, the tax book value formula for companies that engaged in exploratory drilling for oil and gas and in operating cattle ranches substantially understated the value of the assets held in the various companies. For example, the method of depletion for tax purposes and deductions for feed and other costs incurred to raise livestock created a significant difference in tax book value and financial accounting book value.

Consequently, Judge Beghe concluded that the True family buy-sell agreements were substitutes for testamentary dispositions. He stated:

> To summarize, we have found facts indicating that the buy-sell agreements at issue in these cases (1) were not the result of arm's-length dealings and served Dave True's testamentary purposes and (2) included a tax book value formula price that was not comparable to a price that would be negotiated by adverse parties dealing at arm's-length and would not, over time, be expected to bear a reasonable relationship to the unrestricted fair market value of the ownership interests in the True companies. In *Lauder II*, certain facts regarding how the agreement was entered into allowed us to infer that the buy-sell agreements served testamentary purposes. We then went on to determine whether consideration was full and adequate, to resolve whether the formula price was binding for estate tax purposes. After considering all the circumstances, and particularly the arbitrary manner in which the formula price was selected, we concluded that the agreements were adopted for the principal purpose of achieving testamentary objectives and were not binding for estate tax purposes. [citations omitted]
>
> Similarly, in the cases at hand we have weighed all material facts and concluded that the True companies' buy-sell agreements were substitutes for testamentary dispositions. Therefore, the fourth prong (non-testamentary disposition prong) of the Lauder II test has not been satisfied.

In determining the effect of the buy-sell agreement for gift tax purposes, Judge Beghe noted that because making a gift is a voluntary act, "it is well settled that restrictive agreements, such as the buy-sell agreements at issue in the cases at hand, generally do not control value for federal gift tax purposes." Finally, because the agreements did not represent a bona fide business arrangement and were a device to pass the decedent's shares to the natural objects of his bounty for less than full and adequate consideration, they would have no effect on estate tax value.

Among the various arguments of the taxpayers was the contention that the court was retroactively applying the rules under I.R.C. § 2703 to the True companies' buy-sell agreements, which were executed before the effective date of I.R.C. § 2703. Specifically, prior to the enactment of I.R.C. § 2703, no court had ever required a taxpayer to demonstrate that the buy-sell agreement in question was comparable to similar arm's-length arrangements between unrelated parties. Although the court stated that the arm's-length requirement was only one factor in determining whether a buy-sell agreement was intended to serve as a substitute for a testamentary disposition, even if it treated the arm's-length requirement as a "super factor" in its analysis, it was not a retroactive application of I.R.C. § 2703. Judge Beghe noted that the case law before the enactment of I.R.C. § 2703 demonstrated that the courts were more likely to find that a buy-sell agreement's price determined estate tax value under Reg. § 20.2031-2(h) if the agreement was comparable to that which would be derived (or actually was derived) from arm's-length dealings between adverse parties.

c. Analysis of the Opinion. The *True* case demonstrates that the enactment of I.R.C. § 2703 did not significantly change the rules for determining whether a buy-sell agreement among related parties would establish the value of an interest in a business entity for transfer tax purposes. The first two requirements under I.R.C. § 2703(b), that the agreement be a bona fide business arrangement and not a device to transfer the interest to members of the decedent's family for less than full and adequate consideration in money or money's worth, were already being applied by the courts as separate factors in determining whether a buy-sell agreement's formula price would be effective for establishing the transfer tax value. The third requirement, that the terms of the agreement must be comparable to similar arrangements entered into by persons in arm's-length transactions, could be viewed as a new requirement. However, as Judge Beghe pointed out, evidence of comparable terms in buy-sell agreements among unrelated parties was the means by which taxpayers demonstrated that the first two requirements were satisfied where the entity was family-controlled.

In affirming the Tax Court's decision, the Tenth Circuit specifically overruled *Brodrick v. Gore*, 224 F.2d 892 (10th Cir. 1955), which held that the price under a buy-sell agreement would establish the value for estate tax purposes if the agreement was binding on the estate. The Tenth Circuit also pointed to the fact that Dave True eliminated his daughter from his estate plan once she sold her interests in the various companies as evidence that the buy-sell agreements were testamentary devices.

4. The *Blount* Case: Buy-sell agreement fails to satisfy either the law before 1990 or I.R.C. § 2703. *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005), *aff'g*, T.C. Memo. 2004-116.

a. Facts of the Case. Decedent and his brother-in-law were 50% shareholders of a construction company decedent's father had formed. They entered into a buy-sell agreement in 1981 providing for the purchase of a deceased shareholder's shares at a price determined by the shareholders, or, if no price was so determined, at book value determined at the end of the fiscal year preceding the shareholder's death. The agreement also restricted transfers during lifetime. In 1992, the company adopted an employee stock ownership plan (the "ESOP") and using company contributions the ESOP acquired shares from the company and the other two shareholders. Decedent's brother-in-law died in January 1996. At the time, the company owned $3,000,000 of life insurance on each of the shareholders' lives to fund the agreement. The company's book value on January 31, 1995 was $6,400,000 and the brother-in-law's shares had a book value of approximately

$3,000,000. The company redeemed the brother-in-law's shares for approximately $3,000,000, paying approximately $2,000,000 in cash and issuing a note for the balance.

In October 1996, the decedent discovered he had terminal cancer. He had the company's controller prepare an analysis showing the impact on the company of the redemption of his shares. One analysis showed that a purchase price of $4,000,000, payable in a lump sum, would leave the company with sufficient cash to operate without the need for personal guarantees for the company's performance bonds. In November, decedent and the company entered into a one-page agreement providing for the redemption of his shares at his death for $4,000,000 in cash payable in a lump sum. The 1996 agreement did not refer to the 1981 agreement. Decedent died in September 1997 and the company shortly thereafter redeemed his shares for $4,000,000 as required in the 1996 agreement, using the $3,146,134 life insurance proceeds received because of his death and additional cash on hand. After the redemption, the ESOP owned 100% of the outstanding shares.

At the time of the decedent's death, the value of the company according to the most recent appraisal done for the purposes of the ESOP was $8,000,000, suggesting that the value of the decedent's shares was approximately $6,700,000. In addition, the company's book value was approximately $9,000,000, suggesting that the value of the decedent's shares was approximately $7,500,000. The purchase price pursuant to the 1981 agreement would have been $7,600,000, based on the company's book value on January 31, 1996, had the decedent died before February 1, 1997. The estate reported the value of the decedent's shares on the federal estate tax return as $4,000,000. The IRS, in a notice of deficiency, determined the fair market value to be approximately $7,900,000, resulting in a $2,354,521 deficiency.

The sole issue in the case was the value for federal estate tax purposes of the decedent's shares in the company. Part of the issue was whether the buy-sell agreement, as modified by the 1996 agreement, fixed the value or should be disregarded in determining the value for federal estate tax purposes.

b. <u>Court's Opinion</u>. Judge Gale, the trial judge, found the following:

(1) The 1981 buy-sell agreement, as modified by the 1996 agreement, did not satisfy the requirement under Treas. Reg. § 20.2031-2(h) that the agreement be binding during lifetime, because the decedent could unilaterally amend the agreement, and, therefore, it should be disregarded for purposes of determining the value of the shares for federal estate tax purposes.

(2) Because the 1996 agreement was a substantial modification to the 1981 agreement, the modified agreement was subject to I.R.C. § 2703.

(3) Because the terms of the agreement were not comparable to similar arrangements entered into by persons at arm's length, the agreement should be disregarded.

(4) The value of the decedent's shares was $8,233,583, approximately $300,000 more than the value the IRS reported in the notice of deficiency, based on the company's value on the valuation date (decedent's date of death) of $9,896,134. However, the Tax Court limited the deficiency to the amount in the IRS' notice of deficiency.

Judge Gale dismissed the opinion of one of the taxpayer's experts because it ignored the receipt of the $3,146,134 of life insurance proceeds and other cash and non-operating assets and was based on multiples of earnings of other companies whose characteristics were not similar to those of the company. The other taxpayer's expert's opinion was also found to be faulty because it reduced the value of the company's assets by $750,000 for the company's obligation to buy shares distributed to ESOP participants and excluded the life insurance proceeds in valuing the company because of the company's obligation to purchase the decedent's shares. Judge Gale correctly demonstrated that a willing buyer would take into account both the liability arising from the company's redemption obligation and the shift in proportionate ownership interest of the remaining shareholder resulting from the redemption.

Judge Gale explains the fallacy of the taxpayer's position as follows:

> "By contrast, a hypothetical willing buyer of BCC shares other than decedent's would treat the redemption obligation, on the valuation date, as a corporate liability of BCC, but only in connection with a simultaneous accounting of the impact of the redemption of decedent's shares on the ownership interest inherent in the other shares not being redeemed.
>
> A simplified example will illustrate the fallacy behind the estate's contention that BCC's obligation to redeem decedent's shares should be treated as a liability offsetting a corresponding amount of corporate assets. Assume corporation X has 100 shares outstanding and two shareholders, A and B, each holding 50 shares. X's sole asset is $1 million in cash. X has entered into an agreement obligating it to purchase B's shares at his death for $500,000. If, at B's death, X's $500,000 redemption obligation is treated as a liability of X for purposes of valuing B's shares, then X's value becomes $500,000 ($1 million cash less a $500,000 redemption obligation). It would follow that the value of B's shares (and A's shares) is $250,000 (i.e., one half of the corporation's $500,000 value) upon B's death. Yet if B's shares are then redeemed for $500,000, A's shares are then worth $500,000—that is, A's 50 shares constitute 100-percent ownership of a corporation with $500,000 in cash.
>
> It cannot be correct either that B's one-half interest in $1 million in cash is worth only $250,000 or that A's one-half interest in the remainder shifts from a value of $250,000 preredemption to a value of $500,000 postredemption.
>
> The error with respect to B's shares in the example lies in the treatment of X's redemption obligation as a claim on corporate assets when valuing the very shares that would be redeemed with those assets. With respect to A's shares, a willing buyer would pay $500,000 upon B's death (not $250,000) because he would take account of both the liability arising from X's redemption obligation and the shift in the proportionate ownership interest of A's shares occasioned by the redemption— but never the former without the latter." [Footnotes omitted]

Judge Gale rejected the IRS' contention that the 1996 agreement had supplanted the 1981 agreement, but instead held that it was a modification so that the terms of the 1981 agreement still applied, except to the extent that they were changed by the 1996 modification. Nonetheless, because the taxpayers agreed that the 1996 agreement only required the consent of the decedent and the company and not the ESOP, and because the decedent controlled the company, the decedent had the unilateral ability to modify the modified 1981 agreement, including the restrictions on lifetime transfers. Thus, the modified 1981 agreement was not binding on the decedent during his life.

Because Judge Gale found that the 1996 agreement was a substantial modification to the 1981 agreement, it was subject to I.R.C. § 2703. The modifications were (1) replacing book value as the redemption price with a fixed price of $4,000,000; (2) removing the automatic adjustment mechanism for adjusting the price annually based on book value; (3) eliminating the shareholders' right to set the price each year; and (4) precluding the right of the company to pay in installments. These changes were more than de minimis and affected the value, quality and timing of the shareholders' rights with respect to the shares covered by the agreement. Judge Gale rejected the taxpayer's contention that the modification resulted in a value that more closely approximated the fair market value because, after the redemption of the brother-in-law's shares, the decedent's shares had a value of at least $6,700,000 at the time the 1996 agreement was entered into.

Because the modified agreement did not satisfy all three requirements under the statutory exception to I.R.C. § 2703, it was disregarded in determining the value of the shares for federal estate tax purposes. Although the modified agreement satisfied the second requirement, i.e., it was not a testamentary device to pass the shares to the members of the decedent's family (or the natural objects of the decedent's bounty, as the regulations put it) for less than full and adequate consideration in money or money's worth, because the beneficiaries of the arrangement were the participants in the ESOP, none of whom were found by the court to be the natural objects of the decedent's bounty, the taxpayer failed to demonstrate that the terms of the agreement were similar to arrangements entered into by persons dealing at arm's length. The court noted that the taxpayer had the burden of proof because it failed to raise I.R.C. § 7491, which would have shifted the burden of proof to the IRS under certain circumstances. The court did not have to determine whether the modified agreement was a bona fide business arrangement.

c. Analysis of the Opinion. From a technical standpoint, the court's disregarding the modified buy-sell agreement for purposes of valuing the decedent's shares for federal estate tax purposes appears correct. Under the law before the adoption of I.R.C. § 2703, the buy-sell agreement had to bind a decedent during his lifetime in such a manner that the decedent was not free to dispose of his or her interest in the entity without first offering to sell it to the entity or other owners at the price specified in the agreement. Assuming that the court was correct that the decedent and company were the only parties that had to consent to a modification, this requirement was not met. Even had the court found that the ESOP had to consent to a modification, because the court found the modified agreement was subject to I.R.C. § 2703, the agreement would still be disregarded because the court found the terms were not comparable to an arrangement entered into at arm's length.

Whether the result would have been different had the taxpayer invoked I.R.C. § 7491 is not clear, but certainly the taxpayer would have had a better chance of proving its case if the burden had shifted to the IRS to prove that the terms were not comparable to arrangements entered into at arm's length. In addition, could the fact that the company and the decedent, as the majority shareholder, had a fiduciary duty to the participants in the ESOP, as the other shareholder, have created the necessary facts and circumstances to render the modified agreement an arm's length transaction? As a practical matter, it is unfortunate that the decedent's estate ended up paying additional estate taxes for value that benefited persons who were clearly, at least according to the court, not objects of the decedent's bounty.

d. Planning Implications. At first it may seem that a buy-sell agreement that does not result in a benefit to the natural objects of the decedent's bounty, whether they be family members or others, should establish the value of an interest owned by the decedent in a business entity for federal estate tax purposes as long as it is binding at the decedent's death. However, the *Blount* case is a reminder that the requirements under the law in existence before the adoption of I.R.C. § 2703 must still be met and, if the agreement is subject to I.R.C. § 2703, the requirements under that section for either the statutory exception or regulatory exception must be satisfied. As for pre-1990 law, the modified agreement in *Blount* would have passed muster had the ESOP been a party to the modified agreement unless the court could have found that the decedent also controlled the ESOP. Even though the decedent was one of the three trustees at the time of his death, the fiduciary duty of a trustee, particularly of a qualified retirement plan such as the ESOP, would have precluded such a finding.

With regard to I.R.C. § 2703, when there is no possibility that the benefit of the arrangement will pass to the natural objects of the decedent's bounty, the comparability requirement will be the requirement most likely to be an issue when the price under the agreement is deemed to be below the fair market value of the interest. Most likely, such an arrangement will still be a bona fide business arrangement. Of course, if the decedent and his or her family own less than 50% of the interest in the entity, the regulatory exception will apply and I.R.C. § 2703 will have no effect – only pre-1990 law will apply. Satisfying the comparability requirement will be easier if the taxpayer can shift the burden of proof to the IRS under I.R.C. § 7491. Nonetheless, if possible the lawyer advising the parties to a buy-sell agreement should endeavor to create a documentary record indicating the arm's length nature of the transaction. In *Blount*, the purported reason for arriving at the $4,000,000 purchase price in the modified agreement was to allow the company to continue to operate as it had before the decedent's death without the requirement for personal guarantees on the performance bonds typical of any construction company.

e. Court of Appeals Decision. While the Eleventh Circuit affirmed the Tax Court's holding that the amendment to the buy-sell agreement did not satisfy either the requirements before the enactment of I.R.C. § 2703 or the safe harbor under § 2703, it reversed the Tax Court's addition of the life insurance proceeds to the value of the company. Because of the contractual liability under the amended buy-sell agreement, the Eleventh Circuit concluded that the insurance proceeds were offset dollar-for-dollar by the company's obligation to satisfy its contract with the decedent's estate. In the court's words:

> To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3,000,000 liability strains credulity and defies any sensible construct of fair market value.

What the Eleventh Circuit ignores is the fact that as a result of the company's purchase of the stock owned by the estate, the remaining shareholder's stock increased in value. For example, assume that the value of the company was $10,000,000. The remaining shareholder, the ESOP, owned 13% of the stock before the redemption of the estate's stock. Its pro rata share of the value of the company was $1,300,000. After the company redeemed the estate's stock for $4,000,000, the ESOP now owned 100% of the stock of the company, now presumably worth $6,000,000. Consequently, as a result of the redemption, the ESOP's stock increased in value by $4,700,000. By ignoring the insurance proceeds in valuing the company, the Eleventh Circuit does not take into account the increase in value of the remaining shareholder's stock as a result of the redemption.

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. <u>Income Tax Consequences</u>.

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).

VI. SPECIAL CONSIDERATIONS FOR S CORPORATIONS

A. Introduction.

1. There are additional considerations involved when drafting a buy-sell agreement for an S corporation.

a. The buy-sell agreement may contain provisions to prevent the termination of the S corporation election.

b. The buy-sell agreement may deal with certain elections that may be made by the shareholders for tax purposes.

c. The shareholders may be assured of receiving distributions from the S corporation sufficient to pay income taxes on the income allocated to them.

B. S Corporation Requirements.

1. The S election of a corporation is terminated if shares of its stock are transferred to an ineligible shareholder.

a. Eligible shareholders are:

(1) Individuals (except nonresident aliens);

(2) Estates (but not if unduly prolonged);

(3) Certain trusts; and

(4) After 1997, certain tax-exempt organizations. I.R.C. § 1361(b)(1) as amended by the Small Business Act § 1316.

b. Trusts that qualify as S corporation shareholders are:

(1) Grantor trusts;

(2) Qualified subchapter S trusts (QSSTs);

(3) Testamentary trusts and trusts that were grantor trusts before the death of the grantor for two years after the death of the grantor;

(4) Voting trusts; and

(5) Electing Small Business Trusts (ESBTs). I.R.C. § 1361(c)(2)(A), as amended by the Small Business Act §§ 1302(a) and 1303.

c. Ineligible shareholders include:

(1) Corporations;

(2) Partnerships;

(3) Nonresident aliens; and

(4) Trusts not specifically permitted to hold S corporation shares.

I.R.C. § 1361(b)(1).

2. An S corporation may not have more than 100 shareholders. I.R.C. § 1361(b)(1)(A).

a. A husband and wife are treated as one shareholder for this purpose. I.R.C. § 1361(c)(1)(A)(i).

b. Up to six generations of a family are treated as one shareholder. I.R.C. § 1361(c)(1)(A)(ii).

3. An S corporation may have only one class of stock, but the corporation may have voting and nonvoting common stock as long as there are no differences among the shareholders with respect to rights to dividend distributions and liquidation proceeds. I.R.C. § 1361(b)(1)(D), 1361(c)(4).

4. Financial institutions that use the reserve method of accounting for bad debts, insurance companies, domestic international sales corporations or former domestic international sales corporations, and corporations entitled to a Puerto Rico and Possessions Tax Credit are ineligible for S corporation tax treatment. I.R.C. § 1361(b)(2), as amended by the Small Business Act.

C. <u>Preserving the S Corporation Election</u>.

1. Under the I.R.C., the shareholders holding more than one-half of the shares may elect to terminate the S election. I.R.C. § 1362(d)(1)(b).

a. The buy-sell agreement may require a super-majority or unanimous consent to terminate the S election.

2. The buy-sell agreement also could restrict transfers of shares to ineligible shareholders either by an absolute prohibition or by giving the other shareholders a right of first refusal.

a. It is important to treat a transfer to an ineligible shareholder as void *ab initio* to the extent possible under state law.

b. Although the ineligible shareholder may be treated as a shareholder under state law until the other shareholders can take whatever legal action is required to have the transaction voided, the IRS may be willing to view the transfer as ineffective or to treat the transfer as an inadvertent termination.

(1) In the latter case, the S corporation status would be reinstated retroactively, but the shareholders would have to agree to make any adjustments required by the IRS. I.R.C. § 1362(f).

3. The buy-sell agreement may prohibit loans, stock options or other instruments that would constitute a second class of stock from being issued by the corporation.

D. Elections Available to S Corporations.

1. There are a number of tax elections available to an S corporation.

    a. These elections require the consent of either a majority or all of the affected shareholders.

    b. In some cases, the shareholders may want to agree to a different vote for approval of an election.

    c. While such a provision will not change the requirements under the I.R.C., it will impose liability on a shareholder who later refuses to comply and may entitle the other shareholders to an injunction to force him or her to comply.

2. If a C corporation with earnings and profits converts to an S corporation, it may elect to have distributions treated as distributions of C corporation earnings and profits rather than distributions from the accumulated adjustments account (AAA). I.R.C. § 1368(e)(3).

    a. To make the election, the consent of all affected shareholders is required.

    b. By making the election and distributing all C corporation earnings and profits, the corporation avoids both the tax on excess passive investment income and the termination of the S election. I.R.C. § 1375(a).

    c. Because a corporation's S election terminates automatically if it has C corporation earnings and profits and has excess passive investment income for three consecutive taxable years after it elects S status, the shareholders may want to provide in the agreement that less than a unanimous vote is required to make this election. I.R.C. § 1362(d)(3).

    d. The drawback is, of course, that earnings and profits, which have been subject to tax at the corporate level, will now be taxed at the shareholder level.

3. A corporation that has had its S election terminated in the middle of a taxable year may elect to determine the taxable income of the S corporation year and the C corporation year under normal accounting rules rather than on a pro rata basis. I.R.C. § 1362(e)(3).

    a. Making this election allows the corporation to close its books as of the date of the termination of its S status, which may allow the corporation to place more of its income or loss in the S corporation year than it otherwise would have been allowed.

    b. To make the election, the corporation must have the consent of all persons who were shareholders in the corporation at any time during the S corporation year and all persons who were shareholders in the corporation on the first day of the C corporation year.

    c. The shareholders may want to provide in the agreement that less than a unanimous vote is necessary to make this election.

4. An S corporation may elect to treat distributions after the S corporation status is terminated as distributions of C corporation earnings and profits rather than nontaxable distributions out of the AAA. I.R.C. § 1371(e)(2).

   a. This election allows the corporation to treat distributions as dividends, and thereby avoid the accumulated earnings tax and personal holding company tax.

   b. This election requires the consent of all the shareholders of the S corporation to whom the distributions are made.

   c. The shareholders may want to reduce the percentage required for this election.

5. If a shareholder terminates his or her interest in the corporation during a taxable year, the taxable income of the shareholder is generally determined as a pro rata portion of the corporation's income (or loss) during the entire year based on the number of days he or she was a shareholder during the year.

   a. If the affected shareholders and the terminating shareholder agree, the terminating shareholder's taxable income may be determined by closing the books on the date his or her interest terminated.

      (1) "Affected shareholders" are the shareholder whose interest terminated and all shareholders to whom such shareholder has transferred shares during the taxable year, or if the shareholder has transferred shares to the corporation, the term "affected shareholders" includes all persons who are shareholders during the taxable year. I.R.C. § 1377(a)(2), as amended by the Small Business Act § 1306.

   b. The closing of the books may produce a more favorable tax benefit to a withdrawing shareholder when the character of the gain (or loss) from the disposition of his or her stock differs from the character of the income (or loss) of the corporation allocated to him or her.

      (1) It may also achieve a more equitable allocation of income if the S corporation has a seasonal business.

   c. The agreement could provide that the consent of less than all the affected shareholders is required for this purpose or that the remaining shareholders must agree to the election whenever a shareholder's interest is terminated.

   d. The regulations also permit such an election if 20% or more of the outstanding shares is sold or exchanged during any 30-day period during the corporation's taxable year or the corporation issues shares equal to or greater than 25% of the outstanding shares during any 30-day period during the corporation's taxable year. Treas. Reg. § 1.1368-1(g)(2).

E. <u>Distributions to Pay Taxes</u>.

1. The buy-sell agreement may require that a certain percentage of earnings be distributed to shareholders so that they can pay taxes on the earnings allocated to them.

2. Creating a second class of stock should be avoided by not basing the amount distributed to each shareholder on the particular shareholder's individual tax bracket. See Treas. Reg. § 1.1361-1(l)(2)(v), Example 6.

3. The following formula may be used in the agreement to accomplish this purpose:

   a. The Shareholders agree to cause the corporation to make cash dividend distributions each year to each Shareholder in an amount determined by multiplying by a percentage (the "effective percentage") the amount of such Shareholder's taxable income resulting from the "S-corporation" pass-through allocations of the corporation's income and gain to each Shareholder. The effective percentage shall equal the sum of the federal rate plus the adjusted state rate. The federal rate shall be the highest rate applicable to taxable income of individuals for such year under the Internal Revenue Code. The adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside multiplied by the difference of one (1) minus the federal rate; provided, however, that if there is no deduction allowable under the I.R.C. for such year for state income taxes, the adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside. By way of example, if a Shareholder's taxable income resulting from the "S-corporation" pass-through allocations is $20,000.00, and if the maximum federal rate is thirty-five percent (35%) and the highest rate among the states in which the Shareholders reside is six percent (6%), then the cash dividend distribution to the Shareholder shall be $7,780.00, determined as follows:

      (1) The effective percentage is 38.9% (35% plus 3.9%), because (x) the federal rate is 35%, and (y) the adjusted state rate is 3.9%, which is equal to 6% multiplied by 65%, one minus the federal rate.

      (2) The amount of income from the "S-corporation," which is $20,000.00, is then multiplied by the effective percentage (38.9% or 0.389) to yield $7,780.00, which is the amount of the dividend distribution in this example.

      (3) To prove that this is the correct figure, assume that the $20,000.00 income amount is subject to tax at the highest federal and state rates. The state tax would be equal to $1,200.00, which is 6% times $20,000.00. The amount of the state tax is currently deductible for federal income tax purposes, so that this amount would be deducted from the $20,000.00, leaving an amount of $18,800.00 subject to federal income tax. This amount multiplied by 35% equals $6,580.00, the federal income tax. The sum of the $1,200.00 state income tax amount and the $6,580.00 federal income tax amount equals $7,780.00.

4. In many cases, the alternate minimum tax will eliminate the benefit of the deduction for state income taxes. In this case, the distribution should be the sum of the federal rate and the state rate, without any adjustment for the deduction of state income taxes.

F. <u>One Class of Stock Requirement as It Affects Buy-Sell Agreements</u>.

   1. Under final regulations issued on May 28, 1992 interpreting the one class of stock requirement, a corporation is treated as having only one class of stock if all the outstanding shares of stock of a corporation confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. Treas. Reg. § 1.1361-1(l)(1).

a. Outstanding shares must be reviewed to determine whether all shares confer identical rights to liquidation and distribution proceeds.

b. Other instruments, obligations, and arrangements of the corporation must be analyzed to determine whether they create a second class of stock.

c. Differences in voting rights among shares of stock of a corporation are disregarded. Treas. Reg. § 1.1361-1(l)(1).

2. The determination is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution or liquidation proceeds (referred to as the "governing instruments"). Treas. Reg. § 1.1361-1(l)(2)(i).

a. A commercial contractual arrangement such as a lease, employment agreement, or loan agreement is not a "binding agreement relating to distribution and liquidation proceeds" and thus is not a governing instrument, unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Treas. Reg. § 1.1361-1(l)(2)(i).

3. If stock that is substantially nonvested (within the meaning of Treas. Reg. § 1.83-3(b)) is treated as outstanding, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Treas. Reg. § 1.1361-1(l)(2)(iii)(B).

4. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's outstanding shares of stock confer identical rights. Treas. Reg. § 1.1361-1(l)(2)(iii)(B).

5. Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless both of the following conditions are met:

a. A principal purpose of the agreement is to circumvent the one class of stock requirement; and

b. The agreement establishes a redemption or purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

(1) Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock. Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

(a) A determination of book value will be respected if the book value is determined in accordance with generally accepted accounting principles (including permissible optional adjustments) or the book value is used for any substantial nontax purpose. Treas. Reg. § 1.1361-1(l)(2)(iii)(C).

(b) A good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence. Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

6. Although an agreement may be disregarded for purposes of determining whether there is a second class of stock, payments pursuant to the agreement may have income or transfer tax consequences. Treas. Reg. § 1.1361-1(l)(2)(iii)(A).

7. Agreements that provide for distributions in the current year based on the varying interests of the shareholders in the immediately preceding year during which an ownership change occurred do not result in a second class of stock.

   a. If distributions pursuant to the agreement are not made within a reasonable time after the close of the taxable year in which the ownership change occurs, however, distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock. Treas. Reg. § 1.1361-1(l) (2)(iv).

8. Other types of bona fide agreements to redeem or purchase stock may also be disregarded pursuant to published rulings or other guidance. Treas. Reg. § 1.1361-1(l)(2)(iii)(B).

G. Other Considerations.

1. Choosing the proper agreement.

   a. If an S election has been made, the tax consequences of using either an entity purchase or cross-purchase agreement generally are the same.

   b. Life insurance premiums paid by the corporation will be nondeductible and therefore passed through as income to the individual shareholders.

   c. Life insurance proceeds paid to S corporations will not be subject to the alternative minimum tax, since the alternative minimum tax does not apply to S corporations, and the adjustment for adjusted current earnings does not apply to the individual shareholders that ultimately report the corporation's income on their returns.

   d. The shareholders will receive a step-up in their basis in the shares when the corporation receives the insurance proceeds, although the proceeds will not be subject to income tax unless the transfer-for-value rule applies. I.R.C. §§ 1367(a)(1) and 1366(a)(1).

      (1) The insurance proceeds will not increase the AAA, since they are tax exempt. I.R.C. § 1368(e)(1)(A).

         (a) However, this will only be a problem if the corporation has C corporation earnings and profits.

         (b) Distributions that are treated as dividends from an S corporation that has C corporation earnings and profits in excess of the AAA will be subject to tax as ordinary income to the extent of the earnings and profits. I.R.C. § 1368(c)(2).

      (2) If the corporation is on the cash basis of accounting and the proceeds are received after the termination of the deceased shareholder's interest, only the basis of the remaining shareholders will be increased, provided an election under I.R.C. § 1377(a)(2) is made to close the books for determining taxable income before and after the termination.

         (a) Otherwise, part of the increase may be allocated to the decedent and may be wasted since the shares owned by the decedent will already have a basis equal to fair market value under I.R.C. § 1014.

(b) The redeeming estate or beneficiary may incur a capital loss upon the redemption as a result of the increased basis, because the redemption price would be less than the estate's or beneficiary's basis in the shares redeemed.

(3) If the corporation is on the accrual method, the proceeds will be accrued as of the shareholder's death and, if no election is made to close the books, part of the proceeds will be treated as being received in the second short year after the shareholder's death.

(a) Consequently, the earlier in the year the death occurs, the greater the increase in the basis of the surviving shareholders.

e. If the S corporation has C corporation earnings and profits, a redemption pursuant to an entity purchase agreement can be used to reduce the C corporation earnings and profits.

(1) In a redemption treated as a sale or exchange, a pro rata portion of the C corporation earnings and profits is eliminated.

(2) In a redemption treated as a dividend, distributions are treated as first coming from the AAA unless the corporation elects to treat the distribution as coming first out of C corporation earnings and profits.

(3) Such a reduction would not occur under a cross-purchase agreement.

2. Valuation issues.

a. The formula for determining the purchase price of shares of an S corporation must take into account the unique characteristics of the S corporation.

b. The definition of after-tax earnings should reflect the fact that the taxes are not paid at the corporate level, but are paid at the shareholder level.

c. The fact that a shareholder has paid tax on earnings that may be retained by the corporation should be taken into account in structuring the buy-out.

(1) In many cases, the buy-sell agreement may provide that the withdrawing shareholder or the deceased shareholder's estate or beneficiary will be entitled to a distribution of the S corporation's taxable income attributable to the shares owned by the withdrawing shareholder or decedent.

VII. SPECIAL CONSIDERATIONS FOR PARTNERSHIPS

A. <u>Death of a Partner</u>.

1. Before 1998, the death of a partner did not terminate the partnership's taxable year with respect to that partner unless his or her entire interest was purchased as of the date of death.

2. The Taxpayer Relief Act of 1997 (TRA 97) amended I.R.C. § 706(c)(2)(A) to provide that the taxable year of the partnership closes with respect to a deceased partner at his or her death, providing the same treatment that applies to an S corporation shareholder.

B. Buy-Out of Partner's Interest.

1. Formerly, a partnership was able to liquidate the interest of one of its partners in the partnership in a favorable manner.

a. Under I.R.C. § 736, before RRA 93, the partnership could treat payments for good will as guaranteed payments or distributive shares of the partnership's taxable income, creating a deduction for the other partners equal to the amount paid for the withdrawing partner's interest in the good will of the partnership. See Treas. Reg. § 1.736-1.

b. The same treatment also applied to the payment for the withdrawing partner's interest in the partnership's unrealized receivables.

2. Under RRA 93 § 13262, new I.R.C. § 736(b)(3) has been added to eliminate generally the special treatment for good will and unrealized receivables.

a. The payment to a withdrawing partner for his or her share of good will and unrealized receivables will now be treated as any other payment for the withdrawing partner's share of the partnership's assets, and will not be treated as either a guaranteed payment or as a distributive share.

(1) Consequently, the partners will not receive any reduction in their income from the partnership as payments are made to the withdrawing partner for these items and the withdrawing partner will have ordinary income with respect to payments for his or her share of unrealized receivables.

b. The special treatment still applies if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership.

c. The House Committee Report on RRA 93 states that the new rule does not apply to payments made to a retiring partner for past services.

3. As in the case of distributions generally, a partnership usually does not recognize gain upon the liquidation of one partner's interest in the partnership.

VIII. SPECIAL CONSIDERATIONS FOR PROFESSIONAL CORPORATIONS

A. In General.

1. While many of the considerations discussed earlier in this outline apply to buy-sell agreements for professional corporations, there are certain considerations that may warrant special attention when the entity is a professional corporation.

2. For this purpose, a professional corporation includes medical, dental, legal and accounting practices. Other professional corporations may also have similar characteristics, but are outside the scope of this discussion.

B. The Role of the Buy-Sell Agreement in a Professional Corporation.

1. The buy-sell agreement for a professional corporation is usually interrelated with the employment contracts for the shareholder-employees.

   a. In some cases, provisions ordinarily found in a buy-sell agreement for a nonprofessional corporation may be better placed in the employment agreements for the professional shareholder-employees.

   b. For example, a covenant not to compete will often be placed in the employment agreement because it will affect the severance pay to which the withdrawing shareholder-employee will be entitled, and may not have any effect on the purchase price for his or her stock if that is a nominal amount.

2. In many cases the withdrawing shareholder-employee or the estate of a deceased shareholder-employee will receive a much larger portion of the total consideration being paid to him or her or the estate under the withdrawal or death provision contained in the employment agreement as compared to the buy-sell agreement.

3. In addition, reductions in the total amount to be paid to the withdrawing shareholder-employee for various reasons, such as competition, may affect the amount of the shareholder-employee's severance pay rather than the amount he or she receives for his or her stock.

4. Buy-sell agreements are particularly important to professional corporations since the shareholders are effectively prevented from selling or transferring their shares to anyone other than someone licensed to practice the profession or the corporation itself, greatly reducing the marketability of the corporation's shares.

C. Valuation Issues.

1. A primary issue is distinguishing between the assets of the corporation and the value of the individual shareholder-employee.

   a. It may be that the reputation, particular skill and work habits of the professional shareholder-employees are the most valuable assets involved in the transaction.

2. The assets of the corporation will include:

   a. Accounts receivable;

   b. Work in progress;

   c. Hard assets, including computers, equipment, and real property, such as office buildings (if such real property was ill-advisedly acquired by the corporation instead of by a separate pass-through entity);

   d. Good will, including the location or locations of the business and its reputation;

   e. Going concern value; and

   f. Contractual relationships, particularly in the medical practice area, where managed care contracts and other relationships may have significant ongoing value.

3. It could be argued that, to the extent there are enforceable noncompete agreements in the employment agreements with the shareholder-employees, the value of their reputation, skill, and work ethic is a corporate asset rather than an individual asset.

   a. *See Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998) and *Norwalk v. Commissioner*, T.C. Memo 1998-279, 76 T.C.M. 208 (1998), where the taxpayers were successful in arguing that such intangible assets were personal to the shareholders because there were no noncompete agreements between the corporation and the shareholders.

   b. However, even if there are noncompete agreements, because there is no way to compel continued employment, the corporation may not have much in the way of an asset except to the extent that it prevents the former shareholder-employee from competing.

D. <u>Triggering Events</u>.

1. As with any buy-sell agreement, the parties should pay careful attention to the events that will trigger a purchase and sale of stock.

2. These events will include:

   a. Death;

   b. Disability;

   c. Loss of license;

   d. Retirement;

   e. Termination of employment voluntarily;

   f. Termination of employment involuntarily;

      (1) For cause;

      (2) Not for cause;

   g. Divorce;

   h. Sale of practice; and

   i. Reduced workload.

3. In the case of retirement, the definition of retirement should be thought through and possible age discrimination issues should be considered.

   a. At least one case has held that a partner in a major accounting firm was an employee for purposes of the age discrimination laws. *Simpson v. Ernst & Young*, 65 USLW 2358, 72 Fair Empl. Prac. Cas. (BNA) 343, 20 Employee Benefits Cas. 2088 (6th Cir. 1996).

4. In many professional practices, there is a period during which a shareholder-employee may be permitted or required to reduce his or her workload.

a. If this is the case, the issue arises as to when the shareholder-employee should be required to sell his or her stock back to the corporation:

(1) At the beginning of the phase-out period;

(2) Pro rata over the phase-out period; or

(3) At the end of the phase-out period when the shareholder-employee will retire from practice altogether.

E. Tax Consequences.

1. In many cases, accounts receivable and work in progress will represent the bulk of the value of the assets of the corporation.

a. Because the corporation will generally be on a cash method of accounting, the corporation will recognize gross income as the accounts receivable and work in progress are converted into collections.

b. If there is no corresponding deduction for these items, the corporation will be paying federal income tax on these amounts at a flat 35% rate.

2. A withdrawing shareholder will generally recognize capital gain income to the extent that the purchase price for his or her stock exceeds his or her basis.

3. If the accounts receivable and work in progress converted into collections are used by the corporation to fund severance pay for the withdrawing shareholder-employee, the corporation will have a deduction to offset the income recognized.

a. The withdrawing shareholder-employee will recognize ordinary income when he or she receives severance pay, and the severance pay will also be subject to FICA taxes, including the 1.45% hospital insurance tax that applies to all compensatory income.

b. The corporation will also be subject to FICA tax on severance payments made to the withdrawing shareholder-employee.

4. Under I.R.C. § 1060(e), if the withdrawing shareholder-employee owns 10% or more by value of the stock of the corporation, information concerning any employment contract, covenant not to compete, royalty or lease agreement, or other agreement between the corporation and the withdrawing shareholder will be required to be furnished to the IRS once regulations are issued.

a. Regardless of whether the Treasury issues regulations requiring the furnishing of this information, the IRS may recharacterize payments under a covenant not to compete or consulting agreement as payments for the withdrawing shareholder-employee's stock, and thereby deny the corporation a deduction for the payment.

(1) *See, e.g., Heritage Auto Center, Inc. v. Comm'r*, T.C. Memo 1996-21, where the IRS was successful in having a substantial amount that the parties had allocated to a covenant not to compete recharacterized as good will and going concern value.

(a) The case arose before the effective date of I.R.C. § 197, which now permits these items to be amortized over 15 years.

b. If payments under a covenant not to compete or a consulting agreement are going to withstand the IRS's scrutiny, the withdrawing shareholder-employee should be in a position that he or she could compete with the corporation (e.g., he or she is in relatively good health) or could provide consulting services to the corporation (e.g., he or she is still available for consultation).

(1) In the case of a medical practice, a consulting agreement may violate the fraud and abuse rules.

F. Potential Sale of Practice.

1. When negotiating the buy-sell and employment agreement, the parties should deal with the potential sale of the entire practice.

a. During the 1990's, purchases of medical practices by hospitals and practice management companies were common.

2. The agreements could deal with the sale of the practice in three ways:

a. No provision;

b. A requirement that representations be given when a purchase of stock is made concerning whether there is a potential sale of the practice under consideration;

c. The agreement could provide for an adjustment of the purchase price for the stock or the amount of severance pay if a sale occurs within a certain period.

3. Those shareholder-employees who have more service with the corporation may feel that they should receive a greater portion of any consideration received for the sale of the practice than newer shareholder-employees.

a. This position would be based on the fact that those shareholder-employees who have worked for the corporation for a longer period of time have provided the value (i.e., good will, contractual relationships, etc.) sought after by potential purchasers.

b. Newer shareholder-employees are apt to disagree with this point of view.

G. Buy-Ins and Buy-Outs.

1. It is probably obvious that the amount and method by which a new shareholder-employee buys into the corporation must be coordinated with how he or she is later bought out.

2. It may be desirable to have a very low value for the stock, so that a new shareholder-employee is not required to purchase stock with a significant amount of after-tax dollars.

a. If, instead of purchasing stock, the new shareholder-employee's salary is reduced for a period of time to take into account the value of the accounts receivable and work in progress that the corporation has at the time the shareholder-employee first becomes a shareholder, the new shareholder-employee will be acquiring his or her interest in those items with pre-tax dollars.

b. Although the new shareholders are not recognizing taxable income on the amount of salary reduction used to purchase their interests in the accounts receivable and work in progress, the old shareholders are recognizing ordinary income because of the corresponding increase in their salaries.

c. In the final analysis the overall tax cost may not be significantly different regardless of how the buy-in and buy-out are structured.

(1) If the new shareholders purchase an interest in the accounts receivable and work in progress with after-tax dollars, they will obtain a corresponding increase in their basis in the stock, and later when their stock is redeemed they will recognize capital gain rather than ordinary income.

(2) In addition, the old shareholders could recognize capital gain income rather than ordinary income by having the new shareholders purchase their stock from the old shareholders rather than directly from the corporation.

(a) If the new shareholders reduce their compensation in order to obtain an interest in the corporation's accounts receivable and work in progress, the old shareholders will have additional compensation income.

3. If a substantial portion of the buy-in consideration will be through salary reductions, the buy-out should be done through severance pay.

a. It is usually advisable to have the payments to a withdrawing shareholder-employee treated as severance pay rather than deferred compensation.

(1) Deferred compensation may cause provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to apply.

(2) In addition, if the arrangement provides for deferred compensation, FICA would have to be paid on the amount when it is considered deferred.

(a) Although it is likely that the shareholder-employee's other compensation would exceed the Social Security wage base ($127,200 in 2017), the deferred compensation would still be subject to the 1.45% hospital insurance tax that would apply to both the employer and employee.

b. A severance pay arrangement should not be treated as a deferred compensation arrangement.

(1) A severance pay arrangement will not be subject to ERISA if it is not contingent directly or indirectly on the employee's retiring, it provides for payments for no longer than two years, and the amount does not exceed two times the average annual compensation of the individual for the prior two years. ERISA § 2510.3-2(b).

c. A severance pay plan will be treated as a deferred compensation plan subject to the requirements of I.R.C. § 409A unless:

(1) It satisfies the requirements for the short term deferral exclusion, i.e., the payment is made within two-and-a-half months after the end of the

calendar year in which the right to the payment is no longer subject to a substantial risk of forfeiture; or

(2) It is due to an involuntary termination or during an early retirement window and is paid by the end of the second calendar year following termination and does not exceed two times the lesser of the individual's compensation for the previous calendar year or the limit on compensation under I.R.C. 401(a)(17) ($ 270,000 in 2017).

4. Once it is determined that severance pay will be paid to withdrawing shareholder-employees, the next issue is the method of determining the amount.

a. Severance pay could be based on some portion of the accounts receivable and work in progress.

(1) If the severance pay is based on some portion of the accounts receivable and work in progress attributable to the service of the withdrawing shareholder-employee, reductions for the cost of collection, bad debts, and reduced payments, particularly in the medical area under managed care contracts, should be taken into account.

(2) Basing the severance pay on amounts actually collected would eliminate any uncertainty as to the value of the accounts receivable or work in progress.

b. The severance pay could be based on a percentage of the average compensation paid to the shareholder-employee over some period of time ending on the date of the withdrawal.

(1) This has the advantage of simplicity and certainty, but may not necessarily reflect the value of the shareholder-employee's services to the corporation.

(2) However, in some cases it may reflect the value of the shareholder-employee's contribution to the corporation, since it is based on what the corporation has been paying to the shareholder-employee in the period immediately before his or her withdrawal.

c. Some professional corporations choose to pay withdrawing shareholder-employees an additional amount of severance pay that equals the forfeitable portion of that employee's account balance in any qualified retirement plans.

IX. CONSIDERATIONS IN VALUING INTERESTS IN CLOSELY HELD BUSINESSES

A. Valuation Principles for Federal Estate and Gift Tax Purposes.

1. I.R.C. §§ 2031 and 2512 and the regulations thereunder provide the guidelines for valuing interests in closely held businesses.

2. The value of property or an interest in property for estate and gift tax purposes is the price at which such property or interest in property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. Treas. Reg. § 20.2031-1(b).

3. Revenue Ruling 59-60, 1959-1 C.B. 237, sets forth the following factors to be considered in determining the fair market value of an interest in a closely held business:

   a. The nature of the business and the history of the enterprise from its inception.

   b. The economic outlook in general and the condition and outlook of the specific industry in particular.

   c. The book value of the shares and financial condition of the business.

   d. The earning capacity of the company.

   e. The dividend-paying capacity of the company.

   f. The existence of good will or other intangible value.

   g. Prior sales of the company's shares and the size of the block of the shares to be valued.

   h. The market price of shares of corporations engaged in the same or similar line of business having their shares actively traded in a free and open market, either on an exchange or over the counter.

B. Discounts.

1. A minority interest or lack of control discount may apply to a minority interest in a closely held business (including nonvoting stock and limited partnership interests) because a willing buyer would pay less for an interest in a business in which he or she does not have voting control.

   a. Under the laws of most states, the holder of a minority interest in a corporation cannot direct the payment of dividends, compel liquidation, elect directors or officers, set salaries, or set corporate policy in general.

2. A discount for lack of marketability may also be available in the case of a closely held business, but in many cases the discount for a minority interest includes a discount for lack of marketability.

   a. The discount for lack of marketability takes into account the difficulty a seller of the interest would have in finding a willing buyer and the costs associated with selling the interest.

3. In the past the IRS has restricted the use of minority discounts in family situations. Rev. Rul. 81-253, 1981-2 C.B. 187.

   a. When a member of a family transferred a minority interest in an entity controlled by family members to another family member, the IRS held that the rationale for a minority discount did not apply.

   b. The courts rejected this position when challenged by taxpayers. *See, e.g.*, *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Est. of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981); *Est. of Andrews v. Comr.*, 79 T.C. 938 (1982).

c. Legislation proposed in 1987 would have eliminated minority discounts in family-controlled entities, but this provision did not become part of the Revenue Act of 1987.

d. The legislative history and the regulations issued with respect to I.R.C. § 2701 (the anti-freeze provision) and I.R.C. § 2704 make clear that minority discounts are available in a family-held business.

e. Finally, in Rev. Rul. 93-12, 1993-1 C.B. 202, the IRS reversed its former position and held that in determining the value of shares in a family-held business, family control would be disregarded in applying a minority discount for lack of control.

(1) The facts involved a gift by a parent of 20% of the outstanding shares of a closely held corporation to each of the parent's five children.

C. <u>Premiums</u>.

1. If a person has voting control, a premium may be added to the value of his or her interest in the business. *Estate of Salsbury*, 34 T.C.M. 1441 (1975).

2. The Tax Court has upheld the IRS's position that the transfer by a majority shareholder of 1.76% of the outstanding stock of a corporation just before her death, which reduced her to minority shareholder status, would be ignored for purposes of placing a premium on the value of the shares she owned at her death for estate tax purposes. *Estate of Murphy*, 60 T.C.M. 645 (1990).

3. On the other hand, in *Estate of Frank*, 69 T.C.M. 2255 (1995), transfers of shares shortly before death were effective in obtaining a minority interest discount. One noticeable difference between *Frank* and *Murphy* was that in *Frank* the decedent reduced his percentage of ownership from 50.3% to 32.1%.

4. A valuation premium may also be imposed on voting interests as opposed to non-voting interests. Prior to a 1999 case, *Estate of Richard R. Simplot v. Commissioner* (112 T.C. 130 (1999)), the generally held opinion was that the appropriate expression of a premium for voting rights was as a percentage of the equity value of the interest. However, the Tax Court's decision in that case raised the possibility that a voting premium will be measured as a percentage of the equity value of the entity as a whole. The facts in *Simplot* involved a decedent who died owning 23.55% of the voting stock of J.R. Simplot Co. (the Company), and 2.79% of the Company's nonvoting stock, together totaling 2.8% of all the Company's stock. The ratio between the Company's voting and nonvoting stock was approximately 1:1850, as opposed to the more typical 1:20 ratio used by most practitioners. Although the case raised several different valuation issues, the only major difference between the positions of the taxpayer and the government was on the issue of the appropriate premium, if any, to be added to the value of the decedent's voting stock. The court rejected the taxpayer's argument that no premium was applicable because the decedent held only a minority interest, and instead applied a premium of 3% of the Company's entire equity value to the value of the corporation's voting shares determined on a pro-rata basis. The Tax Court reasoned that a hypothetical buyer of the voting stock held by the decedent would consider the possibility that he or she would be able at some future time to acquire a controlling interest in the Company, or, at least, would become the holder of the largest voting block.

However, note that the *Simplot* outcome may well be an anomaly—a reaction to a situation where the total number of voting shares was such a small percentage of the total shares (.0540763%) that the court was forced to adopt another method for determining the appropriate premium. The result in *Simplot* could also reflect the court's frustration with the failure of the taxpayer's experts to acknowledge any premium at all for the voting rights and, therefore, to offer a method of their own for determining the premium, or to suggest that, if a premium were appropriate, it should be determined using the traditional method of determining a premium for voting rights, i.e., a percentage of each share's pro rata share of the Company's equity value.

Whether the *Simplot* rationale will apply in other factual circumstances should not be of material consequence for most closely held corporations. Many practitioners, when converting voting stock to voting and nonvoting stock, advise that at least 5% of the corporation's equity be retained in voting stock. Therefore, if the *Simplot* court's method were applied to require an additional 3% of the corporation's total equity value be added to the value of the voting shares calculated as a pro rata share of the corporation's equity value, there would be a premium of 60% of each share's pro rata share of the equity value added to each share, since the additional 3% of the corporation's value would represent 60% of the value of the voting stock, based on its share of the equity. For example, if a corporation's equity structure consisted of 100 voting shares and 1900 non-voting shares, and it had an equity value of $2,000,000, each voting share's percentage of the equity value would be $1,000 (5% x $2,000,000)/100 shares). If 3% of the corporation's total equity value ($60,000) was added to the value of the voting shares, the result would be a value of $1,600 per share ((5% x $2,000,000) + $60,000)/100 shares). Although such a premium would not be desirable, it might be acceptable if the older family members have been able to transfer the nonvoting shares to younger family members at a significant discount while retaining control of the entity. Of course, the larger the percentage of voting shares the smaller the premium that will be allocated to each voting share. For example, if the voting shares represented 20% of a corporation's equity structure (400 shares in the example above), a 3% *Simplot*-type premium would result in a premium of only 15% (in the example above, ((20% x $2,000,000) + $60,000)/400 shares = $1,150).

On the other hand, the *Simplot* outcome may have a more severe impact in the case of a limited partnership. The general partner or partners usually hold no more than a 1% equity interest in the limited partnership. The addition of a premium equal to 3% of the value of the entity to the 1% general partnership interest would result in a premium equal to 300% of the value of the general partnership interest's pro rata share of the equity value before the premium. Nonetheless, a family may be willing to accept such a result if the older family members have been able to transfer the limited partnership interests to younger family members at a significant discount while retaining control of the partnership.

<u>Ninth Circuit Opinion</u>. The Court of Appeals for the Ninth Circuit reversed the judgment of the Tax Court. *Simplot v. Commissioner*, 2001 U.S.T.C. 60,405 (2001). There was a dissenting opinion. The majority found three errors in the Tax Court's opinion. First, the Tax Court constructed particular possible purchasers, rather than a purely hypothetical willing buyer. Second, the Tax Court divided the premium for all voting shares as a block (representing complete control) among each share, without taking into account the fact that the voting shares held by the decedent did not represent control. Third, the Tax Court did not demonstrate that even a controlling block of stock would have been assured of an increased economic advantage worth paying for.

5. The *Chenoweth* case, which also concerns a control premium, has potential implications for planning. *Estate of Chenoweth*, 88 T.C. 1577 (1987).

The case involved the estate of a sole shareholder of a corporation. Fifty-one percent of the shares in the corporation was left to the decedent's surviving wife; 49% was left to his daughter by a prior marriage. The estate claimed that the value of the 51% interest passing to the surviving spouse should include a control premium of 38.1% for the purpose of computing the marital deduction. The IRS argued that the interest passing to the surviving spouse should be valued in the same manner as for computing the value of the gross estate, in other words, 51% of the value of the business. The Tax Court agreed with the estate that the value of the 51% interest for purposes of the marital deduction should include a control premium.

The court noted that the estate tax is an excise tax imposed upon the right of the decedent to transmit property at death and is measured by the value of the property that is transmitted at death. Therefore, for purposes of inclusion in the decedent's gross estate under I.R.C. § 2031, assets are to be valued at their worth at the moment of death and usually without reference to the destination of those assets. The court then turned to the valuation of assets for purposes of the marital deduction under I.R.C. § 2056. Under that section, the nature and value of the interest that passes to the surviving spouse is important for measuring the amount of the marital deduction available to the estate.

In reaching its conclusion, the court considered two cases that presented similar issues. The *Provident* case also concerned the value of shares passing to a surviving spouse. *Provident National Bank v. United States*, 581 F.2d 1081 (3d Cir. 1978). The testator had directed in his will that the shares were to be exchanged for preferred shares. The estate claimed that the value of these shares should be increased to reflect this feature. The government argued that the value of the shares should be a pro rata amount of the value of the corporation. The Third Circuit reversed the District Court's grant of summary judgment in favor of the government, holding that the value of the shares passing to the spouse must take into account the exchange requirement. The court also held that the value of the decedent's assets must be computed in the same manner for purposes of both I.R.C. § 2031 and I.R.C. § 2056. Therefore, if the value of the shares passing to the surviving spouse were increased as a result of the exchange feature, the value of the other shares would be proportionately decreased.

The *Ahmanson* case involved the value of shares of a closely held corporation passing to a charitable organization. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). Because the shares passing to the charity represented a minority interest, the court agreed with the government that the value of the shares for purposes of calculating the charitable deduction should reflect a minority discount. The *Ahmanson* case did not go on to hold that there should be a corresponding increase in the value of the other shares of the same corporation included in the estate. In other words, the sum of the parts may be less than the whole. The Tax Court in the *Chenoweth* case agreed with *Ahmanson* in this regard. While the Tax Court believed that the sum of the parts could not equal more than the whole, it held that the sum of the parts may be less than the whole. Specifically, the increase in value of shares passing to the surviving spouse because of the control premium may be less than the decrease in the value of the shares passing to the daughter because of the minority discount.

The *Chenoweth* case offers planning opportunities in connection with the distribution of shares of a family-held business. Assume that the value of a corporation wholly owned by a decedent at his or her death in 2015 is equal to $15,000,000 and this is the only asset in the decedent's estate. Assume also that he or she leaves 51% of the shares to his or her surviving spouse and the balance to his or her children (or perhaps in a trust for the benefit of his or her children). The gift of shares is the only one made to the children. It is conceivable that the value of the shares passing to the surviving spouse would exceed $7,500,000 as a result of the control premium and the value of the stock passing to the children or trust would be less than $5,000,000 as a result of a minority discount. There would be no estate tax payable at the death of the decedent, since the tax on the remaining taxable estate after the marital deduction would be offset by the 2018 applicable exclusion amount of $5.600,000. Sometime after the death of the decedent, the surviving spouse would sell or give some of his or her shares to his or her children so that the control premium would no longer apply for valuing the stock retained by the surviving spouse at his or her death. A significant part of the value of the corporation (represented by the control premium) would have been shifted to younger generations without being subject to either estate or gift tax.

X. SALE TO AN ESOP

A. Introduction.

1. A sale to an employee stock ownership plan (ESOP) can offer a tax-favored strategy for a business owner or owners to exit a C corporation without incurring any current tax on the unrealized appreciation in the value of the corporation that would normally be subject to a double layer of tax.

2. An ESOP is a qualified retirement plan in the form of a stock bonus plan or a stock bonus/money purchase pension plan that satisfies the requirements under I.R.C. § 401(a) and is designed to invest primarily in employer securities. I.R.C. § 4975(e)(7).

a. The term "employer securities" means common stock that is either readily tradable on an established securities market, or, if there is none, common stock having the greatest voting and dividend rights (or preferred stock convertible to such common stock). I.R.C. §§ 4975(e)(8), 409(l).

b. "Primarily" is construed to be more than 50% of the plan's investments, and allows leeway in reaching that percentage based on such factors as the availability of employer stock for purchase and prudence considerations. DOL Op. No. 83-6A; *Moench v. Robertson*, 62 F.3d 553 (3rd Cir. 1995), *cert. denied*, 516 U.S. 1115 (1996).

3. Significant requirements under the Internal Revenue Code include:

a. The plan must be for the exclusive benefit of employees. I.R.C. § 401(a)(2).

b. The plan must meet the coverage, participation, and vesting requirements applicable to all qualified retirement plans. I.R.C. §§ 401(a)(3), 410, 411.

c. The plan must not discriminate in favor of highly compensated employees. I.R.C. § 401(a)(4).

d. If more than 60% of the account balances inure to the benefit of key employees, the plan will be considered "top heavy," requiring minimum contributions for all participants and more rapid vesting. I.R.C. § 416.

e. The fiduciaries of the plan, such as the plan trustees, are subject to the fiduciary rules of the Employee Retirement Income Security Act of 1974 (ERISA).

4. Limitations on contributions and annual additions.

a. Unless the ESOP is leveraged, the corporation's contributions are limited to 25% of the aggregate compensation of all participants (for plan years after 2001), but only including the compensation of each participant up to $270,000 for 2017 (this amount is adjusted for cost-of-living increases). I.R.C. §§ 404(a)(3)(A), 404(l), 401(a)(17)(B), and 404(a)(7).

b. Annual additions to an individual participant's account may not exceed the lesser of:

(1) 100% of compensation, again not to exceed $270,000 for 2017; or

(2) $54,000 for 2017 (this amount is also adjusted for cost-of-living increases).

I.R.C. § 415(c), (d). Notice 2016-62, 2016-46 IRB 725.

c. For purposes of applying the annual addition limitation, when stock acquired by the ESOP with qualifying loan proceeds is subsequently allocated to a participant's account, it is valued at the original cost to the ESOP and not at its then fair market value. Treas. Reg. §§ 1.415-6(g)(5), 54.4975-11(a)(8)(ii).

(1) Consequently, the actual value of the annual addition to a participant's account may exceed the 100%/$54,000 limitation.

d. If a qualifying loan is in place and no more than one-third of the total allocations are made to the accounts of highly compensated employees, forfeitures of stock acquired with loan proceeds and allocated to a participant's account, as well as interest paid on the loan, are not counted in applying the annual addition limit. I.R.C. § 415(c)(6).

e. Employer contributions can be made in any amount necessary to amortize the ESOP loan, although the deduction is limited to the amount that can be added to the participant's account pursuant to the annual addition limitations, plus interest paid on the loan. I.R.C. § 404(a)(9)(A) and (B).

f. A loan to an ESOP is exempt from the prohibited transaction rules if the proceeds are used within a reasonable time to acquire qualifying employer securities, repay the loan, or repay a prior loan; provided that it satisfies certain requirements. I.R.C. § 4975(d)(3); Treas. Reg. § 54.4975-7(b)(4).

g. A C corporation can deduct the amount of dividends it pays on its stock held in the ESOP if the dividends are paid in cash directly to the ESOP participants or to the ESOP.

(1) In the latter case, the ESOP must:

(a) Pass them through to the ESOP participants within ninety days of the close of the plan year in which the dividends were received;

(b) At the election of the participants or their beneficiaries, reinvest them in qualifying employer securities; or

(c) Use them to repay an ESOP loan. I.R.C. § 404(k).

B. Tax-Free Rollover of Gain.

1. Under I.R.C. § 1042, a taxpayer (other than a C corporation) will not recognize long-term capital gain on the sale of qualified securities to an ESOP sponsored by a non-publicly traded C corporation if the following requirements are met:

a. Immediately after the sale the ESOP must hold at least:

(1) 30% of the total number of outstanding shares of each class of stock (other than non-convertible preferred stock) of the corporation that issued the qualified securities; or

(2) 30% of the total value of all stock (other than non-convertible preferred stock) of the corporation that issued the qualified securities.

I.R.C. § 1042(b).

b. Within a 15-month period beginning three months prior to the date of sale, "qualified replacement property" (QRP) is purchased by the seller. I.R.C. § 1042(a)(2), (c)(3).

(1) The seller must recognize gain to the extent the sale proceeds are not so used.

(a) For example, if the seller sells qualified securities with an adjusted basis of $50,000 for $200,000 and then uses $150,000 of the sale proceeds to purchase QRP, the seller will be required to recognize $50,000 of the $150,000 gain currently. I.R.C. § 1042(a), flush language.

2. The tax-free treatment must be elected by the seller in writing on a timely-filed (including extensions) income tax return for the taxable year in which the sale occurs. I.R.C. § 1042(a)(1); Temp. Reg. § 1.1042-1T, Q&A-3.

3. The ESOP sponsor must consent to being subject to a 10% premature disposition tax that will apply if, within three years after the acquisition, the ESOP disposes of the stock, and:

a. The ESOP owns less stock than it did immediately after the ESOP's purchase, or

b. The value of qualified securities held by the ESOP falls below 30% of the total value of all employer securities as of the date of disposition.

I.R.C. §§ 1042(b)(3), 4978.

The excise tax is not applicable if the disposition is made because of the death or disability of an employee, the retirement of an employee after age 59½, or the separation of an employee from service. I.R.C. § 4978(d).

4. The ESOP sponsor must also consent to a 50% prohibited allocation excise tax if the purchased stock is allocated to any member of the "prohibited group." I.R.C. §§ 1042(b)(3), 4979A.

a. The prohibited group includes:

(1) The seller who transferred the stock to the ESOP;

(2) Persons who are related to the seller; and

(3) Any person who owns, directly or indirectly, more than 25% of any class of outstanding stock of the corporation which issued the securities, or 25% of the total value of any class of outstanding stock of the corporation

which issued the securities, either during the one-year period ending on the date of sale, or, on the date on which the qualified securities are allocated to ESOP participants.

I.R.C. § 409(n).

b. A *de minimis* rule permits allocations of up to 5% of the employer securities to the seller's lineal descendants in the aggregate. I.R.C. § 409(n)(3)(A).

c. Members of the prohibited group who are more than 25% shareholders, either directly or through attribution, must be permanently excluded from participating in allocations attributable to the sale.

(1) Other members of the prohibited group may receive allocations of such stock after the final allocation attributable to any debt incurred to acquire the stock is made or, if later, ten years after the date of the sale. I.R.C. § 409(n)(1), (n)(3)(C).

5. The term "qualified securities" means common stock issued by the employer which:

a. Has a combination of voting and dividend rights at least equal to the class(es) of common stock of the issuing corporation with the greatest dividend and voting rights, or certain non-callable preferred stock which is convertible into such common stock;

b. Is issued by a domestic C corporation with no outstanding stock that is readily tradable on an established securities market;

c. Has been held by the seller for at least three years prior to its sale to the ESOP; and

d. Was not received in a distribution from a qualified retirement plan or a transfer under an option or other right to acquire stock to which I.R.C. § 83, 422, or 423 (or I.R.C. § 422 or 424, as in effect before 1991) applied.

e. Securities sold by an underwriter in the ordinary course of business do not qualify as qualified securities. I.R.C. § 1042(c)(5).

I.R.C. §§ 1042(b)(4), (c)(1), 409(l).

6. QRP must be securities such as stock, stock subscription rights, options, or bonds, debentures, notes, or certificates or other evidence of indebtedness issued with interest coupons or in registered form (but not securities issued by a government or a political subdivision thereof). I.R.C. §§ 1042(c)(4), 165(g).

a. The securities must be issued by a domestic operating corporation (*i.e.*, more than 50% of the corporation's assets must be used in the active conduct of a trade or business at the time the securities are purchased or before the close of the 15-month replacement period) other than the corporation that issued the stock involved in the non-recognition sale and its control group members. I.R.C. § 1042(c)(4).

(1) Financial institutions described in I.R.C. § 581 (*i.e.*, banks) and insurance companies are treated as operating corporations. I.R.C. § 1042(c)(4)(B)(ii).

(2) The issuing corporation cannot have passive income exceeding 25% of its gross receipts for the taxable year preceding the year in which the seller purchased the security. I.R.C. § 1042(c)(4)(A)(i).

7. The seller's cost basis in the QRP is reduced by the amount of unrecognized gain, with the basis allocated among multiple QRPs, if applicable. I.R.C. § 1042(d).

8. The seller is required to recapture the unrecognized gain on the subsequent disposition of the QRP, unless the disposition is by reason of death, gift, certain reorganizations, or another qualifying § 1042 sale. I.R.C. § 1042(e).

a. In determining the character of the gain recaptured, the holding period of the employer securities sold is "tacked on" to the holding period of the QRP. I.R.C. § 1223(13).

b. Previously unrecognized gain is recaptured only to the extent that the sale proceeds exceed the basis of the QRP.

(1) For example, if, in a qualifying § 1042 transaction, the seller sells qualified securities with an adjusted basis of $100,000 and a fair market value of $300,000, and within the replacement period, uses all of the proceeds to purchase QRP, the cost basis of the QRP ($300,000) is reduced under I.R.C. § 1042(d) by the amount of the unrecognized gain ($200,000), to leave the QRP with a basis of $100,000. If the value of the QRP subsequently decreases to $150,000, then upon its disposition, the seller will be required to recapture only $50,000 of the previously unrecognized gain.

C. Additional Considerations.

1. Additional requirements for an ESOP.

a. An ESOP cannot be integrated with social security contributions or benefits. Treas. Reg. § 54.4975-11(a)(7)(ii).

b. An ESOP participant must have the right to demand a distribution of employer securities.

(1) In certain cases, however, the employer may distribute cash in lieu of stock or compel a participant to sell any distributed stock back to the employer for a fair value. I.R.C. § 409(h).

c. Unless the employee elects otherwise, the distributions from an ESOP must begin no later than one year after the close of the plan year in which the employee separates from service by reason of retirement, disability, or death; or the fifth plan year following the plan year in which the participant otherwise separates from service. I.R.C. § 409(o)(1)(A).

(1) Unless the employee elects otherwise, the distributions must be made in substantially equal periodic payments at least annually over a period not to exceed five years, although delays are permitted for securities financed with an outstanding loan or if the participant's account balance exceeds $500,000, in which case an additional year is added for each $100,000 (up to five) by which the account balance exceeds $500,000. I.R.C. § 409(o)(1)(B), (C).

d. An annual independent appraisal is required for employer securities that are not readily tradable on an established securities market. I.R.C. § 401(a)(28)(C).

e. Where the employer's stock is publicly traded, ESOP participants must have the right to direct the plan as to how the voting rights on allocated ESOP shares are to be exercised.

(1) Otherwise, the participants need only to be able to direct the voting with respect to all matters that involve a merger, consolidation, recapitalization, reclassification, liquidation, dissolution, or sale of substantially all the corporation's operating assets. I.R.C. §§ 409(e)(3), 401(a)(22).

2. Put options.

a. Where ESOP participants receive stock that is not readily tradable on an established market, they must also receive a "put option" exercisable against the employer under a fair valuation formula. I.R.C. § 409(h)(1)(B).

(1) The put option period must extend for at least 60 days following the date stock is distributed and, if not exercised within the initial 60-day period, for at least an additional 60 days in the following plan year. I.R.C. § 409(h)(4).

(2) A bank employer prohibited from redeeming or purchasing its own stock does not have to provide the put option if participants have the right to receive their distributions in cash. I.R.C. § 409(h)(3).

(3) An ESOP sponsored by an S corporation can have an immediate call upon shares distributed to participants to allow the corporation to protect its S status. I.R.C. § 409(h)(2)(B).

(4) A non-publicly traded employer that restricts the ownership of its stock to its employees and qualified retirement plans through a provision in its charter or bylaws may require former employees to redeem distributed securities at a fair value. I.R.C. § 409(h)(2)(B).

b. When the balance to the credit of a participant's account is distributed within one taxable year, and the put option is subsequently exercised by the participant, payment for the shares must be made in substantially equal installments (not less frequently than annually) over a period beginning not more than 30 days after the exercise of the put option and not exceeding five years.

(1) The employer must provide adequate security for the unpaid installment payments and pay a reasonable rate of interest on the outstanding balance. I.R.C. § 409(h)(5).

(2) Where a put option is exercised as part of an installment distribution, an employer must pay the option price no later than 30 days after the exercise of the put option. I.R.C. § 409(h)(6).

D. Planning Considerations.

1. Is the ESOP a good fit for the corporation?

2. Does the corporation have sufficient payroll to allow sufficient deductible contributions to pay off any loan used to acquire the stock?

3. Are there key employees who can take over the management of the business?

4. Is the client willing to pay the cost of legal fees, accounting expenses, trustee's fees, appraisal costs and other expenses associated with adopting and maintaining an ESOP?

5. Is the client willing to have a "public" shareholder, in the nature of the ESOP, and to become subject to more stringent scrutiny on how the client and his or her family are compensated and otherwise benefit financially from the corporation?

XI. SAMPLE AGREEMENTS

A. Disclaimer.

The enclosed forms are prepared for illustration purposes only. The forms are prepared considering the law of Virginia as of July 1, 2016, and they do not take into account the differences between the law of Virginia and the law of other states. No form contained in these materials should be used unless, after careful review, it is the professional judgment of the responsible attorney that the use of the particular form will accomplish the specific objectives and intentions of the attorney's client. The author assumes no liability for the results of the use of any form contained in these materials in any case.

B. Buy-Sell Agreement For C Corporation.

THIS BUY-SELL AGREEMENT, dated as of _______________, 20___, by and among __________________, and __________________ (collectively referred to as the "Shareholders" or individually as a "Shareholder"), and _______________________________________, a Virginia corporation (herein called the "Corporation"), provides:

RECITALS:

1. The Shareholders are the owners of all of the issued and outstanding capital shares of the Corporation.

2. In order to promote the successful and harmonious ownership and management of the Corporation, the Shareholders and the Corporation wish to set forth certain restrictions with respect to the transfer of the capital shares of the Corporation now or hereafter issued and outstanding (all herein called "Shares"), under the terms and conditions set forth below.

AGREEMENT:

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual covenants herein contained, the parties hereto hereby agree as follows:

1. Encumbrances. No Shareholder shall pledge or otherwise encumber any of the Shares owned by him without the prior written consent of the Corporation and each other Shareholder.

2. Disposition During Lifetime. If a Shareholder during his lifetime should desire to dispose of all or any part of the Shares owned by him, he shall first offer in writing to sell to the Corporation such Shares at a purchase price per Share no greater than that set forth in Section 5 hereof and on terms of purchase no less favorable than those set forth in Section 6 hereof. The Corporation shall have the right to accept such offer by written notice delivered to such Shareholder at any time during the following 30 days. The approval of a majority of the Shares outstanding other than those held by the offering Shareholder shall be necessary and sufficient to authorize such acceptance on the part of the Corporation. If the Corporation shall fail to accept the offer within the 30-day period, such Shares may during the following 60 days be disposed of free of the restrictions imposed by this Agreement; provided, that the purchase price shall not be less than and the terms of purchase for such Shares shall not be more favorable than the purchase price and the terms of purchase that would have been applicable to the Corporation had it purchased the same; provided further, that prior to such transfer, the purchaser and the Corporation's President shall have executed Exhibit A attached hereto, in which event the purchaser shall be deemed to be a Shareholder within the meaning of this Agreement and bound by the terms and conditions hereof; and provided further, that any such Shares not so disposed of within the 60-day period shall thereafter again become subject to the terms of this Section.

3. Death. Upon the death of any Shareholder, the personal representative of the deceased Shareholder's estate shall sell to the Corporation, and the Corporation shall purchase from the personal representative of the deceased Shareholder's estate, all Shares owned by the deceased Shareholder at his death, for the purchase price set forth in Section 5 hereof and on the terms of purchase set forth in Section 6 hereof.

4. Dissolution and Liquidation of Corporation. In lieu of any obligation of the Corporation to purchase a Shareholder's Shares under Section 3 hereof, the Corporation may elect to dissolve and completely liquidate. The approval of a majority of the Shares outstanding other than those held by the deceased Shareholder's estate shall be necessary and sufficient to authorize such election on the part of the Corporation. Such election shall be effective only if written notice thereof is delivered to the deceased Shareholder's personal representative within thirty (30) days of the date of qualification of such representative. If such election becomes effective, all Shareholders shall vote and do all such other acts as are necessary or desirable to completely liquidate the Corporation in accordance with the provisions of the Virginia Stock Corporation Act.

5. Purchase Price. The purchase price per Share for any Shares purchased by the Corporation pursuant to Section 3 hereof, and the maximum purchase price for any Shares purchased pursuant to Section 2 hereof, shall be determined as follows:

(a) The Shareholders may unanimously consent in writing as to the purchase price per Share by executing an addendum to this Agreement signed by all the Shareholders setting forth the purchase price per Share and the term for which such addendum is effective. Such addendum shall only be effective for the term stated. Such addendum shall be in substantially the following form:

> *The purchase price per Share as determined under Section 5 of the Buy-Sell Agreement dated _____________, 20___, shall be _____________________ Dollars ($__________). This addendum shall only be effective from ___________________ through ________________ [term of effectiveness].*
>
> *Date: _______________*

[Signatures of Shareholders]

(b) If the Shareholders fail to enter into an addendum as provided in subsection (a) above, or such addendum is no longer effective, the purchase price per Share shall equal the book value of the Corporation divided by the number of Shares outstanding as of the last day of the month immediately preceding the month in which an option or obligation to purchase Shares arises. The "book value" of the Corporation shall be the book value of its assets less its liabilities, as determined by the accountant or accountants then serving the Corporation under the method of accounting under which the Corporation's book are normally maintained; provided, that the accounts receivable and liabilities of the Corporation in all events shall be determined under the accrual method of accounting and the value of marketable securities shall be determined under Treas. Reg. § 20.2031-2; provided further, that the cash surrender value of any life insurance policies insuring a particular Shareholder that are owned by the Corporation, but not the excess of any proceeds receivable under such policies over their cash surrender value, shall be included as an asset of the Corporation.

6. Purchase Terms. The terms of purchase for any purchase of Shares under Section 3 hereof, and the least favorable terms of purchase for any purchase of Shares under Section 2 hereof, shall be as follows:

(a) The settlement date for such purchase shall be such date as may be mutually agreed upon by the Corporation and the selling Shareholder or his personal representative, as the case may be (the "Seller"), but in no event shall the date of settlement be later than (i) in the case of a purchase pursuant to Section 2, the 60th day following the day on which the offer is accepted and (ii) in the case of a purchase pursuant to Section 3, the 60th day following the day on which the deceased Shareholder's personal representative qualifies.

(b) On the date of settlement, the Seller shall transfer, assign and deliver to the Corporation good and marketable title to the Shares being purchased, free and clear of all liens, encumbrances and security interests, and the Purchaser shall pay the greater of (i) ten percent (10%) of the aggregate purchase price or (ii) in the case of a purchase pursuant to Section 3 hereof, all life insurance proceeds, if any, that are received by the Corporation as a lump sum payment as a result of the death of the Seller. The balance of the aggregate purchase price shall be represented by a promissory note of the Corporation in form and substance the same as that attached hereto as Exhibit B, executed and delivered by the Corporation on the settlement date.

7. Revaluation of Assets. If at a time when the Corporation is entitled to exercise an option to purchase Shares under this Agreement, it is prohibited from purchasing any or all such Shares under the Virginia Stock Corporation Act or any loan agreement or similar restrictive agreement, the Corporation and the Shareholders will, to the extent permitted by law, take appropriate action to adjust the value of its assets from book value to a fair market valuation based on accounting practices and principles that are reasonable in the circumstances, and if such action cannot be taken or does not create sufficient value to permit the Corporation to purchase all such Shares, then the Corporation shall be entitled to purchase only the number of Shares it is permitted to purchase.

8. Insurance Policies. In order to fund any of its obligations under this Agreement, the Corporation may obtain life insurance policies with respect to one or more of the Shareholders in such amounts and with such carriers as the Board of Directors of the Corporation from time to time determines to be desirable.

9. Stock Dividends, etc. In the event that after any determination of the purchase price per Share pursuant to Section 5 hereof, but before the settlement of a purchase of Shares to which such purchase price applies, the Corporation issues any Shares in addition to, in exchange or substitution for, in reduction of or otherwise on account of the Shares outstanding at the time such determination became effective (whether by stock dividend, stock split, recapitalization or otherwise), such purchase price shall be adjusted as necessary to take into account the issuance of such Shares, and such Shares as are issued to the Seller shall be included in the Shares purchased by the Corporation.

10. Shareholders' Agreement. This Agreement constitutes and is enforceable as an "agreement among the shareholders" of the Corporation within the meaning of Virginia Code § 13.1-671.1. To the extent the provisions of this Agreement are not in accordance with the Virginia Stock Corporation Act, as amended and in force from time to time, it is the intention of the parties hereto that the provisions contained herein shall govern. In particular but not by way of limitation, in those instances in which this Agreement permits the Corporation to take action upon the authorization of certain Shareholders, such authorization shall be necessary and sufficient for due and proper corporate approval of such action, without the need for further authorization by the Board of Directors, the other Shareholders or otherwise in order to be valid.

11. Legend. There shall be placed on all certificates for Shares the following legend:

> *Any disposition or encumbrance of this instrument and the rights evidenced hereby is restricted and subject to the terms of an Agreement dated as of __________, 20___, a copy of which is on file at the principal office of the Corporation. Such Agreement complies with and is enforceable under Virginia Code § 13.1-671.1.*

12. Termination of Agreement. Unless sooner terminated by the written mutual agreement of the parties, this Agreement and the rights and obligations hereunder shall terminate as to each Shareholder at such time as he no longer owns any Shares in the Corporation.

13. Effect of Agreement. In the case of an incapacitated or deceased Shareholder, the term "Shareholder" shall be deemed to refer to his legal guardian or personal representative when appropriate. This Agreement shall be binding on and inure to the respective benefit of the parties, their successors, permitted assigns, estates and personal representatives.

14. Additional Shareholders. The Corporation shall not issue additional Shares from time to time hereafter unless and until (i) Shareholders holding at least two-thirds of the then outstanding voting Shares consent to such issue, and (ii) the issuee has become bound as a Shareholder hereunder. Any such issuee shall become bound as a Shareholder hereunder upon the execution by such issuee and the Corporation's President of Exhibit A attached hereto.

15. Amendments. This Agreement may be amended to bind any transferee or issuee of Shares as a Shareholder hereunder by the transferee or issuee and the Corporation's President executing Exhibit A attached hereto. No other change, modification or amendment of this Agreement shall be valid or binding unless in a writing signed by all the parties hereto.

16. Equitable Relief. The parties hereto agree that the obligations and performances of each party hereto set forth herein are of a special and unique character which, if breached, shall cause loss that is largely intangible but nonetheless real and irreparable. Accordingly, each party hereto agrees that the respective obligations and performances provided for herein may be enforced by an injunction or other equitable relief, in addition to any other rights or remedies that may be available under this Agreement or at law.

17. Attorneys' Fees. If any party brings any action to enforce any provisions of this Agreement, whether at law, in equity or otherwise, the party who substantially prevails in such action shall be entitled, in addition to any

other rights or remedies available to him or it, to collect from the other party or parties the reasonable costs and expenses incurred in the investigation preceding such action and the prosecution of such action, including but not limited to reasonable attorneys' fees.

18. Governing Law. This Agreement shall be interpreted in accordance with and governed by the laws of the Commonwealth of Virginia applicable to agreements made and to be performed entirely within such Commonwealth.

19. Notices. All notices, consents and other communications to and between the respective parties hereto pursuant to the terms of this Agreement shall be in writing and shall be deemed to have been given, delivered or made, when mailed by registered or certified mail, postage pre-paid, and return receipt requested, to the Corporation at its principal office and to a Shareholder at his residence address as shown upon the records of the Corporation.

20. Entire Agreement. This Agreement, along with the attached exhibits, sets forth all of the promises, agreements, conditions and understandings between the parties respecting the subject matter hereof and supersedes all negotiations, conversations, discussions, correspondence, memoranda and agreements between the parties concerning such subject matter.

IN WITNESS WHEREOF, the parties have executed this Agreement in more than one counterpart, each of which is an original.

SHAREHOLDERS

____
[name]

____
[name]

[NAME OF CORPORATION]

By:___________________________________
[name], President

EXHIBIT A

ADDITIONAL SHAREHOLDERS

Each person signing below as a "Shareholder" agrees that he or she is bound as a Shareholder within the meaning of that certain Buy-Sell Agreement dated ____________________, 20___ governing the disposition of the outstanding capital shares of___________________________, a Virginia corporation, as amended and in force from time to time, and agrees to perform all obligations of a Shareholder thereunder.

1. ______________________________________
Print Shareholder's Name

____
Shareholder's Signature

____
Signature of President

____
Date

____
2. Print Shareholder's Name

____
Shareholder's Signature

____
Signature of President

____
Date

3. ______________________________________
Print Shareholder's Name

____
Shareholder's Signature

____
Signature of President

____
Date

EXHIBIT B

PROMISSORY NOTE

$____________________ Richmond Virginia

_____________________, 20___

FOR VALUE RECEIVED, ________________, a Virginia corporation (the "Maker"), promises to pay to __________________ (the "Payee") the principal sum of ______________ DOLLARS ($_________), together with interest on the unpaid principal balance at a rate per annum equal to the "applicable Federal rate," as defined in Section 1274(d) of the Internal Revenue Code of 1986, as amended, such interest to be at a rate of _______ percent (%) per annum. Such interest and principal shall be due and payable as follows:

> A series of five (5) equal amortized installments of principal and interest in the amount of $________ shall be due and payable commencing six months from the date hereof and continuing every six months thereafter to and including the fifth (5th) anniversary date of this Note. On the fifth (5th) anniversary of this Note, the entire unpaid principal balance, together with all outstanding interest thereon, shall be due and payable in full. Payments shall first be applied to interest accrued on the unpaid principal balance and the remainder to the reduction of principal.

This Note is payable at the offices of the Corporation, ___________________________, or such other place as the Payee may designate in writing from time to time.

The Maker reserves the right of anticipation in whole or in part, at any time and from time to time without penalty or premium.

If default occurs in the payment of all or any part hereof, or any interest thereon when and as the same may become due and payable, and any such default shall not have been cured within ten (10) days after the receipt of written notice thereof by the Payee to the Maker, or if the Maker admits in writing that it is unable to pay its debts as they become due, or files a petition in bankruptcy, or has filed against it a petition in bankruptcy which is not dismissed within ninety (90) days, or makes an assignment for the benefit of its creditors, the entire principal hereof then unpaid, together with all interest accrued thereon, shall, at the option of the Payee, become forthwith due and payable.

Presentation, demand, protest, notices of dishonor and of protest, the benefits of the homestead exemptions, and all defenses and pleas on the ground of any extension or extensions of time of payment or of the due dates of this Note, in whole or in part, before or after maturity, with or without notice, are hereby waived by the Maker. The Maker further agrees to pay all reasonable expenses incurred in collecting this obligation, including reasonable attorneys' fees, should this obligation or any part thereof not be paid when due.

Notwithstanding anything herein to the contrary, separate suits may be brought hereunder as causes of action accrue, and the bringing of suit or suits upon one or more causes of action shall not prejudice or bar the bringing of subsequent suits on any other cause or causes of action against the Maker, whether theretofore or thereafter accruing.

WITNESS the following signature.

[NAME OF CORPORATION]

By:____

[name], President

C. Buy-Sell Agreement for S Corporation

THIS BUY-SELL AGREEMENT, dated as of _______________, 20___, by and among __________________, and __________________ (collectively referred to as the "Shareholders" or individually as a "Shareholder"), and _________________________________, a Virginia corporation (herein called the "Corporation"), provides:

RECITALS:

A. The Shareholders are the owners of all of the issued and outstanding capital shares of the Corporation.

B. In order to promote the successful and harmonious ownership and management of the Corporation, the Shareholders and the Corporation wish to set forth certain restrictions with respect to the transfer of the capital shares of the Corporation now or hereafter issued and outstanding (all herein called "Shares"), under the terms and conditions set forth below.

AGREEMENT:

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual covenants herein contained, the parties hereto hereby agree as follows:

1. Encumbrances; Transfers. No Shareholder shall pledge or otherwise encumber any of the Shares owned by him without the prior written consent of the Corporation and the other Shareholders. No Shareholder shall transfer or agree to transfer any Shares owned by him by contract, will or other instrument to a person or entity that shall cause revocation of the Corporation's S Corporation status under the Internal Revenue Code of 1986, as amended (the "Code"), without the prior written consent of all Shareholders. If any Shareholder agrees or attempts to transfer by contract, will or other instrument any Shares of the Corporation to any person or entity which would cause the revocation of the Corporation's "S" status, any such transfer shall be void *ab initio*.

2. Disposition During Lifetime. If a Shareholder during his lifetime should desire to dispose of all or any part of the Shares owned by him, he shall first offer in writing to sell to the other Shareholders (proportionately, based upon the percentage of the remaining Shares owned by each such other Shareholder) such Shares at a purchase price per Share no greater than that set forth in Section 5 hereof and on terms of purchase no less favorable than those set forth in Section 6 hereof. The other Shareholders shall have the right to accept such offer by written notice delivered to the selling Shareholder at any time during the following 30 days. If any Shares remain unpurchased at the end of such 30-day period, the unpurchased Shares shall be offered for sale on the same terms to the other Shareholders who purchased all shares offered to them in the immediately preceding 30-day period. This procedure shall be repeated until no Shares remain unpurchased or no Shareholder having a right to purchase Shares exercises his right to purchase all Shares offered to him. After this procedure is repeated to conclusion, any Shares that remain unpurchased may during the following 60 days be disposed of free of the restrictions imposed by this Agreement; provided, that the purchase price shall not be less than and the terms of purchase for such Shares shall not be more favorable than the purchase price and the terms of purchase that would have been applicable to the other Shareholders had they purchased the same; provided further, that prior to such transfer, the purchaser and the Corporation's President shall have executed Exhibit A attached hereto, in which event the purchaser shall be deemed to be a Shareholder within the meaning of this Agreement and bound by the terms and conditions hereof; and provided further, that any such Shares not so disposed of within the 60-day period shall thereafter again become subject to the terms of this Section.

3. Death. Upon the death of any Shareholder, the personal representative of the deceased Shareholder's estate shall sell to the other Shareholders (proportionately, based upon the percentage of the remaining Shares owned by each such other Shareholder), and the other Shareholders shall purchase from the personal representative of the deceased Shareholder's estate, all Shares owned by the deceased Shareholder at his death, for the purchase price set forth in Section 5 hereof and on the terms of purchase set forth in Section 6 hereof. Notwithstanding the foregoing, this Section shall not apply if, upon the death of a Shareholder, such Shareholder directs that his Shares

be transferred to his spouse or any of his descendants, or to a trust the only beneficiaries of which are one or more of his spouse and his descendants.

4. Dissolution and Liquidation of Corporation. In lieu of any obligation of the other Shareholders to purchase a Shareholder's Shares under Section 3 hereof, the Corporation may elect to dissolve and completely liquidate. The approval of a majority of the Shares outstanding other than those held by the deceased Shareholder's estate shall be necessary and sufficient to authorize such election on the part of the Corporation. Such election shall be effective only if written notice thereof is delivered to the deceased Shareholder's personal representative within thirty (30) days of the date of qualification of such representative. If such election becomes effective, all Shareholders shall vote and do all such other acts as are necessary or desirable to completely liquidate the Corporation in accordance with the provisions of the Virginia Stock Corporation Act.

5. Purchase Price. The purchase price per Share for any Shares purchased by the Shareholders pursuant to Section 3 hereof, and the maximum purchase price for any Shares purchased pursuant to Section 2 hereof, shall be determined as follows:

(a) The Shareholders may unanimously consent in writing as to the purchase price per Share by executing an addendum to this Agreement (which may be attached to this Agreement) signed by all the Shareholders setting forth the purchase price per Share and the term for which such addendum is effective. Such addendum shall only be effective for the term stated. Such addendum shall be in substantially the following form:

> *The purchase price per Share as determined under Section 5 of the Buy-Sell Agreement dated ____________, 20___, shall be __________________ Dollars ($__________). This addendum shall only be effective from __________________ through ________________ [term of effectiveness].*
>
> *Date: _______________*
>
> *[Signatures of Shareholders]*

(b) If the Shareholders fail to enter into an addendum as provided in subsection (a) above; if such addendum is no longer effective; or if the fair market value of the Shares at issue (expressed as a price per Share and as determined pursuant to subsection (c) below) is less than the price per Share to which the Shareholders have agreed; then the purchase price per Share shall be determined pursuant to subsection (c) below as of the last day of the month immediately preceding the month in which an option or obligation to purchase Shares arises.

(c) The fair market value of any particular Shares shall be expressed as a price per share, which shall be determined by dividing the number of Shares then outstanding into the appraised fair market value of the Corporation, then applying any discount applicable to the Shares at issue. Any appraisal of the fair market value of the Corporation required by this Agreement shall be made as expeditiously as possible by a disinterested appraiser selected by the Corporation. Any appraisal of the Corporation shall indicate the extent, if any, to which a minority, lack-of-control, marketability, blockage, or other discount should apply to particular Shares. Should any party (the "Objecting Party") disagree with a valuation of his Shares that results from an appraisal made by an appraiser selected by the Corporation, another appraisal shall be made as expeditiously as possible by a disinterested appraiser selected by the Objecting Party. If the two appraised values of the Objecting Party's Shares differ by an amount that is less than five percent (5%) of the lower appraised value of such Shares, then the average of the two appraised values shall be the value of the Shares for purposes of this Agreement. If the two appraised values of the Objecting Party's Shares differ by an amount that is greater than five percent (5%) of the lower appraised value of such Shares, then the two disinterested appraisers shall select a third disinterested appraiser, who shall determine the fair market value of the Corporation pursuant to the first two sentences of this paragraph. The valuation made by the appraiser or appraisers finally chosen (or the average valuation described above) shall be conclusive and binding on all parties. All costs of an appraiser mutually selected by the Objecting Party and the Corporation or the two disinterested appraisers shall be shared equally by the Objecting Party and the Corporation. All costs of an individually selected appraiser shall be borne by the party selecting such appraiser.

6. Purchase Terms. The terms of purchase for any purchase of Shares under Section 3 hereof, and the least favorable terms of purchase for any purchase of Shares under Section 2 hereof, shall be as follows:

(a) The settlement date for such purchase shall be such date as may be mutually agreed upon by the purchasing Shareholder (the "Purchaser") and the selling Shareholder or his personal representative, as the case may be (the "Seller"), but in no event shall the date of settlement be later than (i) in the case of a purchase pursuant to Section 2, the 60th day following the day on which the offer is accepted and (ii) in the case of a purchase pursuant to Section 3, the 60th day following the day on which the deceased Shareholder's personal representative qualifies.

(b) On the date of settlement, the Seller shall transfer, assign and deliver to the Purchaser good and marketable title to the Shares being purchased, free and clear of all liens, encumbrances and security interests, and the Purchaser shall pay the greater of (i) ten percent (10%) of the aggregate purchase price or (ii) in the case of a purchase pursuant to Section 3 hereof as a result of the Shareholder's death, all life insurance proceeds, if any, that are received by the Purchaser as a lump sum payment as a result of the death of the Seller. The balance of the aggregate purchase price shall be represented by a promissory note of the Purchaser in form and substance the same as that attached hereto as Exhibit B, executed and delivered by the Purchaser on the settlement date.

7. Required and Prohibited Acts. Each Shareholder shall do or cause all the following to be done until such person is no longer a Shareholder of the Corporation:

(a) Cause the Corporation to operate as an "S corporation" under Section 1361 et seq. of the Code, unless all the Shareholders mutually agree otherwise in writing.

(b) Not consent to the revocation of the Corporation's "S corporation" status under the Code, without the prior written consent of all the Shareholders.

(c) Not transfer or agree to transfer any Shares owned by him by contract, will, or otherwise to any person or entity which shall cause the revocation of the Corporation's "S corporation" status under the Code, without the prior written consent of all the Shareholders.

(d) Not take or permit any other action which would result in the termination or revocation of the Corporation's "S corporation" status, including but not limited to causing the Corporation to issue or accepting from the Corporation any notes, stock options or other instruments that would constitute a second class of stock under Section 1361(b)(1)(D) of the Code or the regulations thereunder.

(e) If the Internal Revenue Service ("IRS") finds that the Corporation's "S corporation" status has been inadvertently terminated, consent to all adjustments required by the IRS as a condition to waiving the tax effect of the terminating event or events pursuant to Section 1362(f) of the Code.

(f) If (i) any Shares are transferred, (ii) such transfer results in the complete termination of a Shareholder's interest in the Corporation at a time during which the Corporation is an "S corporation," (iii) the effective date of such transfer occurs during the Corporation's taxable year, and (iv) any Shareholder so requests, then all the Shareholders shall take appropriate action to make an effective election under Section 1377(a)(2) of the Code to close the Corporation's books on the effective date of transfer.

(g) If (i) the Corporation's "S corporation" status terminates during the course of its taxable year for any reason, and (ii) any Shareholder so requests, then all the Shareholders shall take appropriate action to make an effective election under Section 1362(e)(3) of the Code to close the Corporation's books on the date immediately preceding the date on which the termination of "S corporation" status occurs.

8. Distributions. The Shareholders agree to cause the Corporation to make cash dividend distributions each year to each Shareholder in an amount determined by multiplying by a percentage (the "effective percentage") the amount of such Shareholder's taxable income resulting from the "S-corporation" pass-through allocations of the Corporation's income and gain to each Shareholder. The effective percentage shall equal the sum of the federal rate plus the adjusted state rate. The federal rate shall be the highest rate applicable to taxable income of individuals for

such year under the Code. The adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside multiplied by the difference of one (1) minus the federal rate; provided, however, that if there is no deduction allowable under the Code for such year for state income taxes, the adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside. By way of example, if a Shareholder's taxable income resulting from the "S-corporation" pass-through allocations is $20,000.00, and if the maximum federal rate is thirty-five percent (35%) and the highest rate among the states in which the Shareholders reside is six percent (6%), then the cash dividend distribution to the Shareholder shall be $7,780.00, determined as follows:

(a) The effective percentage is 38.9% (35% plus 3.9%), because (x) the federal rate is 35%, and (y) the adjusted state rate is 3.9%, which is equal to 6% multiplied by 65% being one (1) minus the federal rate.

(b) The amount of income from the "S-corporation," which is $20,000.00, is then multiplied by the effective percentage (38.9% or 0.389) to yield $7,780.00, which is the amount of the dividend distribution in this example.

(c) To prove that this is the correct figure, assume that the $20,000.00 income amount is subject to tax at the highest federal and state rates. The state tax would be equal to $1,200.00, which is 6% times $20,000.00. The amount of the state tax is currently deductible for federal income tax purposes, so that this amount would be deducted from the $20,000.00, leaving an amount of $18,800.00 subject to federal income tax. This amount multiplied by 35% equals $6,580.00, the federal income tax. The sum of the $1,200.00 state income tax amount and the $6,580.00 federal income tax amount equals $7,780.00.

9. Revaluation of Assets. If at a time when the Corporation is entitled to exercise an option to purchase Shares under this Agreement, it is prohibited from purchasing any or all such Shares under the Virginia Stock Corporation Act or any loan agreement or similar restrictive agreement, the Corporation and the Shareholders will, to the extent permitted by law, take appropriate action to adjust the value of its assets from book value to a fair market valuation based on accounting practices and principles that are reasonable in the circumstances, and if such action cannot be taken or does not create sufficient value to permit the Corporation to purchase all such Shares, then the Corporation shall be entitled to purchase only the number of Shares it is permitted to purchase.

10. Insurance Policies. In order to fund any of their obligations under this Agreement, the Shareholders may obtain life insurance policies insuring the lives of the other Shareholders.

11. Stock Dividends, etc. If after any determination of the purchase price per Share pursuant to Section 5 hereof, but before the settlement of a purchase of Shares to which such purchase price applies, the Corporation issues any Shares in addition to, in exchange or substitution for, in reduction of or otherwise on account of the Shares outstanding at the time such determination became effective (whether by stock dividend, stock split, recapitalization or otherwise), such purchase price shall be adjusted as necessary to take into account the issuance of such Shares, and such Shares as are issued to the Seller shall be included in the Shares purchased by the other Shareholders.

12. Shareholders' Agreement. This Agreement constitutes and is enforceable as an "agreement among the shareholders" of the Corporation within the meaning of Virginia Code § 13.1-671.1. To the extent the provisions of this Agreement are not in accordance with the Virginia Stock Corporation Act, as amended and in force from time to time, it is the intention of the parties hereto that the provisions contained herein shall govern. In particular but not by way of limitation, in those instances in which this Agreement permits the Corporation to take action upon the authorization of certain Shareholders, such authorization shall be necessary and sufficient for due and proper corporate approval of such action, without the need for further authorization by the Board of Directors, the other Shareholders or otherwise in order to be valid.

13. Legend. There shall be placed on all certificates for Shares the following legend:

Any disposition or encumbrance of this instrument and the rights evidenced hereby is restricted and subject to the terms of an Agreement dated as of __________________, 20___, a copy of which is on file at the principal office of the Corporation. Such Agreement complies with and is enforceable under Section 13.1-671.1 of the Virginia Code.

14. Termination of Agreement. Unless sooner terminated by the written mutual agreement of the parties, this Agreement and the rights and obligations hereunder shall terminate as to each Shareholder at such time as he no longer owns any Shares in the Corporation.

15. Effect of Agreement. In the case of an incapacitated or deceased Shareholder, the term "Shareholder" shall be deemed to refer to his legal guardian or personal representative when appropriate. This Agreement shall be binding on and inure to the respective benefit of the parties, their successors, permitted assigns, estates and personal representatives.

16. Additional Shareholders. The Corporation shall not issue additional Shares from time to time hereafter unless and until (i) Shareholders holding at least two-thirds of the then outstanding voting Shares consent to such issue, and (ii) the issuee has become bound as a Shareholder hereunder. Any such issuee shall become bound as a Shareholder hereunder upon the execution by such issuee and the Corporation's President of Exhibit A attached hereto.

17. Amendments. This Agreement may be amended to bind any transferee or issuee of Shares as a Shareholder hereunder by the transferee or issuee and the Corporation's President executing Exhibit A attached hereto. No other change, modification or amendment of this Agreement shall be valid or binding unless in a writing signed by all the parties hereto.

18. Equitable Relief. The parties hereto agree that the obligations and performances of each party hereto set forth herein are of a special and unique character which, if breached, shall cause loss that is largely intangible but nonetheless real and irreparable. Accordingly, each party hereto agrees that the respective obligations and performances provided for herein may be enforced by an injunction or other equitable relief, in addition to any other rights or remedies that may be available under this Agreement or at law.

19. Attorneys' Fees. If any party brings any action to enforce any provisions of this Agreement, whether at law, in equity or otherwise, the party who substantially prevails in such action shall be entitled, in addition to any other rights or remedies available to him or it, to collect from the other party or parties the reasonable costs and expenses incurred in the investigation preceding such action and the prosecution of such action, including but not limited to reasonable attorneys' fees.

20. Governing Law. This Agreement shall be interpreted in accordance with and governed by the laws of the Commonwealth of Virginia applicable to agreements made and to be performed entirely within such Commonwealth.

21. Notices. All notices, consents and other communications to and between the respective parties hereto pursuant to the terms of this Agreement shall be in writing and shall be deemed to have been given, delivered or made, when mailed by registered or certified mail, postage pre-paid, and return receipt requested, to the Corporation at its principal office and to a Shareholder at his residence address as shown upon the records of the Corporation.

22. Entire Agreement. This Agreement, along with the attached exhibits, sets forth all of the promises, agreements, conditions and understandings between the parties respecting the subject matter hereof and supersedes all negotiations, conversations, discussions, correspondence, memoranda and agreements between the parties concerning such subject matter.

IN WITNESS WHEREOF, the parties have executed this Agreement in more than one counterpart, each of which is an original.

SHAREHOLDERS

____
[name]

____
[name]

[NAME OF CORPORATION]

By:___________________________________
[name], President

D. Buy-Sell Agreement For Family-Owned Business

THIS BUY-SELL AGREEMENT, which is effective as of ______________, 20___, by and among the undersigned shareholders (collectively referred to as the "Shareholders" or individually as a "Shareholder"), and ________________, a Virginia corporation (herein called the "Corporation"), provides:

RECITALS:

A. The Shareholders are the owners of all of the issued and outstanding capital shares of the Corporation.

B. In order to promote the successful and harmonious ownership and management of the Corporation, the Shareholders and the Corporation wish to set forth certain restrictions with respect to the transfer of the capital shares of the Corporation now or hereafter issued and outstanding (all herein called "Shares"), under the terms and conditions set forth below.

AGREEMENT:

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual covenants herein contained, the parties hereto hereby agree as follows:

1. Encumbrances; Transfers. No Shareholder shall pledge or otherwise encumber any of the Shares owned by him without the prior written consent of the Corporation and the other Shareholders. No Shareholder shall transfer or agree to transfer any Shares owned by him by contract, will or other instrument to a person or entity that shall cause revocation of the Corporation's S Corporation status under the Internal Revenue Code of 1986, as amended (the "Code"), without the prior written consent of all Shareholders. If any Shareholder agrees or attempts to transfer by contract, will or other instrument any Shares of the Corporation to any person or entity which would cause the revocation of the Corporation's "S" status, any such transfer shall be void *ab initio*.

2. Disposition During Lifetime. If a Shareholder during his lifetime should desire to dispose of all or any part of the Shares owned by him, he shall first offer in writing to sell to the Corporation such Shares at a purchase price per Share no greater than that set forth in Section 4 hereof and on terms of purchase no less favorable than those set forth in Section 5 hereof. The Corporation shall have the right to accept such offer by written notice delivered to such Shareholder at any time during the following 30 days. The approval of a majority of the voting Shares outstanding other than those held by the offering Shareholder shall be necessary and sufficient to authorize such acceptance on the part of the Corporation. If the offering Shareholder owns all the voting Shares, the approval of a majority of the non-voting Shares outstanding other than those held by the offering Shareholder shall be necessary and sufficient to authorize such acceptance on the part of the Corporation. If the Corporation shall fail to accept the offer within the 30-day period, such Shares may during the following 60 days be disposed of free of the restrictions imposed by this Agreement; provided, that the purchase price shall not be less than and the terms of purchase for such Shares shall not be more favorable than the purchase price and the terms of purchase that would have been applicable to the Corporation had it purchased the same; provided further, that prior to such transfer, the purchaser and the Corporation's President shall have executed Exhibit A attached hereto, in which event the purchaser shall be deemed to be a Shareholder within the meaning of this Agreement and bound by the terms and conditions hereof; and provided further, that any such Shares not so disposed of within the 60-day period shall thereafter again become subject to the terms of this Section. This Section shall not apply if a Shareholder transfers Shares to:

(a) ____________________;

(b) One or more descendants of ______________________ or a trust for the benefit of one or more descendants of _________________________;

(c) A trust for the benefit of ________________ and one or more descendants of _______________;

(d) A trust for the benefit of the spouse of the Shareholder and one or more descendants of _____________________; provided that the corpus of such trust shall not be distributable to the spouse of the Shareholder, except to the extent that such a distribution is necessary to qualify the trust for the federal gift or estate tax marital deduction.

3. Death. Upon the death of any Shareholder, the deceased Shareholder's estate shall sell to the Corporation, and the Corporation shall purchase from the deceased Shareholder's estate, all Shares owned by the deceased Shareholder at his death, for the purchase price set forth in Section 4 hereof and on the terms of purchase set forth in Section 5 hereof. This Section shall not apply upon the death of ___________________ or ___________________. This Section shall not apply if a child of _________________ provides, upon his or her death, for the transfer of Shares to: (a) one or more descendants of __________________; (b) a trust for the benefit of one or more descendants of ______________; or (c) a trust described in Section 2(d) above.

4. Purchase Price. The maximum purchase price per Share for any Shares purchased pursuant to Section 2 hereof, shall be one half of the result obtained when the appraised value of the Corporation (determined pursuant to Section 6 below) is divided by the number of outstanding Shares and any applicable valuation discount (as determined by the appraiser(s) described in Section 6) is applied to the Shares that are to be purchased.

5. Purchase Terms. The terms of purchase for any purchase of Shares hereunder, and the least favorable terms of purchase for any purchase of Shares under Section 2 hereof, shall be as follows:

(a) The settlement date for such purchase shall be such date as may be mutually agreed upon by the Corporation and the selling Shareholder or his personal representative, as the case may be (the "Seller"), but in no event shall the date of settlement be later than (i) in the case of a purchase pursuant to Section 2, the 60th day following the day on which the offer is accepted, and (ii) in the case of a purchase pursuant to Section 3, the 60th day following the day on which the deceased Shareholder's personal representative qualifies.

(b) On the date of settlement, the Seller shall transfer, assign and deliver to the Corporation good and marketable title to the Shares being purchased, free and clear of all liens, encumbrances and security interests, and the Purchaser shall pay the greater of (i) ten percent (10%) of the aggregate purchase price or (ii) in the case of a purchase pursuant to Section 3 hereof, all life insurance proceeds, if any, that are received by the Corporation as a lump sum payment as a result of the death of the Seller. The balance of the aggregate purchase price shall be represented by a promissory note of the Corporation in form and substance the same as that attached hereto as Exhibit B, executed and delivered by the Corporation on the settlement date.

6. Appraisal. Any appraisal of the Corporation required by this Agreement shall be made as expeditiously as possible by a disinterested appraiser selected by the Corporation. Any appraisal of the Corporation shall indicate the extent, if any, to which a minority, lack of control, marketability, blockage, or other discount should apply to particular Shares. Should any party (the "Objecting Party") disagree with a valuation of his Shares that results from an appraisal made by an appraiser selected by the Corporation, another appraisal of the Corporation shall be made as expeditiously as possible by a disinterested appraiser selected by the Objecting Party. If the two appraised values of the Objecting Party's Shares differ by an amount that is less than five percent (5%) of the lower appraised value of such Shares, then the average of the two appraised values shall be the value of the Shares for purposes of this Agreement. If the two appraised values of the Objecting party's Shares differ by an amount that is greater than five percent (5%) of the lower appraised value of such Shares, then the two disinterested appraisers shall select a third disinterested appraiser, who shall determine the fair market value of the Corporation pursuant to the first two sentences of this paragraph. The valuation made by the appraiser or appraisers finally chosen (or the average valuation described above) shall be conclusive and binding on all parties. All costs of an appraiser mutually selected by the Objecting Party and the Corporation or the two disinterested appraisers shall be shared equally by the Objecting Party and the Corporation. All costs of an individually selected appraiser shall be borne by the party selecting such appraiser.

7. Required and Prohibited Acts. Each Shareholder shall do or cause all the following to be done until such person is no longer a Shareholder of the Corporation:

(a) Cause the Corporation to operate as an "S corporation" under Section 1361 et seq. of the Code, unless all the Shareholders mutually agree otherwise in writing.

(b) Not consent to the revocation of the Corporation's "S corporation" status under the Code, without the prior written consent of all the Shareholders.

(c) Not transfer or agree to transfer any Shares owned by him by contract, will, or otherwise to any person or entity which shall cause the revocation of the Corporation's "S corporation" status under the Code, without the prior written consent of all the Shareholders.

(d) Not take or permit any other action which would result in the termination or revocation of the Corporation's "S corporation" status, including but not limited to causing the Corporation to issue or accepting from the Corporation any notes, stock options or other instruments that would constitute a second class of stock under Section 1361(b)(1)(D) of the Code or the regulations thereunder.

(e) If the Internal Revenue Service ("IRS") finds that the Corporation's "S corporation" status has been inadvertently terminated, consent to all adjustments required by the IRS as a condition to waiving the tax effect of the terminating event or events pursuant to Section 1362(f) of the Code.

(f) If (i) any Shares are transferred, (ii) such transfer results in the complete termination of a Shareholder's interest in the Corporation at a time during which the Corporation is an "S corporation", (iii) the effective date of such transfer occurs during the Corporation's taxable year, and (iv) any Shareholder so requests, then all the Shareholders shall take appropriate action to make an effective election under Section 1377(a)(2) of the Code to close the Corporation's books on the effective date of transfer.

(g) If (i) the Corporation's "S corporation" status terminates during the course of its taxable year for any reason, and (ii) any Shareholder so requests, then all the Shareholders shall take appropriate action to make an effective election under Section 1362(e)(3) of the Code to close the Corporation's books on the date immediately preceding the date on which the termination of "S corporation" status occurs.

8. Distributions. The Shareholders agree to cause the Corporation to make cash dividend distributions each year to each Shareholder in an amount determined by multiplying by a percentage (the "effective percentage") the amount of such Shareholder's taxable income resulting from the "S-corporation" pass-through allocations of the Corporation's income and gain to each Shareholder. The effective percentage shall equal the sum of the federal rate plus the adjusted state rate. The federal rate shall be the highest rate applicable to taxable income of individuals for such year under the Code. The adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside multiplied by the difference of one (1) minus the federal rate; provided, however, that if there is no deduction allowable under the Code for such year for state income taxes, the adjusted state rate shall be the highest rate applicable to taxable income of individuals under the income tax laws of the state which has the highest such rate among the states in which the Shareholders reside. By way of example, if a Shareholder's taxable income resulting from the "S-corporation" pass-through allocations is $20,000.00, and if the maximum federal rate is thirty-five percent (35%) and the highest rate among the states in which the Shareholders reside is six percent (6%), then the cash dividend distribution to the Shareholder shall be $7,780.00, determined as follows:

(a) The effective percentage is 38.9% (35% plus 3.9%), because (x) the federal rate is 35%, and (y) the adjusted state rate is 3.9%, which is equal to 6% multiplied by 65% being one (1) minus the federal rate.

(b) The amount of income from the "S-corporation," which is $20,000.00, is then multiplied by the effective percentage (38.9% or 0.389) to yield $7,780.00, which is the amount of the dividend distribution in this example.

(c) To prove that this is the correct figure, assume that the $20,000.00 income amount is subject to tax at the highest federal and state rates. The state tax would be equal to $1,200.00, which is 6% times $20,000.00. The amount of the state tax is currently deductible for federal income tax purposes, so that this amount would be deducted from the $20,000.00, leaving an amount of $18,800.00 subject to federal income tax. This amount multiplied by 35% equals $6,580.00, the federal income tax. The sum of the $1,200.00 state income tax amount and the $6,580.00 federal income tax amount equals $7,780.00.

9. Revaluation of Assets. If at a time when the Corporation is entitled to exercise an option to purchase Shares under this Agreement, it is prohibited from purchasing any or all such Shares under the Virginia Stock Corporation Act or any loan agreement or similar restrictive agreement, the Corporation and the Shareholders will, to the extent permitted by law, take appropriate action to adjust the value of its assets from book value to a fair market valuation based on accounting practices and principles that are reasonable in the circumstances, and if such action cannot be taken or does not create sufficient value to permit the Corporation to purchase all such Shares, then the Corporation shall be entitled to purchase only the number of Shares it is permitted to purchase.

10. Insurance Policies. In order to fund any of its obligations under this Agreement, the Corporation may obtain life insurance policies with respect to one or more of the Shareholders in such amounts and with such carriers as the Board of Directors of the Corporation from time to time determines to be desirable.

11. Stock Dividends, etc. In the event that after any determination of the purchase price per Share pursuant to Section 4 hereof, but before the settlement of a purchase of Shares to which such purchase price applies, the Corporation issues any Shares in addition to, in exchange or substitution for, in reduction of or otherwise on account of the Shares outstanding at the time such determination became effective (whether by stock dividend, stock split, recapitalization or otherwise), such purchase price shall be adjusted as necessary to take into account the issuance of such Shares, and such Shares as are issued to the Seller shall be included in the Shares purchased by the Corporation.

12. Shareholders' Agreement. This Agreement constitutes and is enforceable as an "agreement among the shareholders" of the Corporation within the meaning of Virginia Code § 13.1-671.1. To the extent the provisions of this Agreement are not in accordance with the Virginia Stock Corporation Act, as amended and in force from time to time, it is the intention of the parties hereto that the provisions contained herein shall govern. In particular but not by way of limitation, in those instances in which this Agreement permits the Corporation to take action upon the authorization of certain Shareholders, such authorization shall be necessary and sufficient for due and proper corporate approval of such action, without the need for further authorization by the Board of Directors, the other Shareholders or otherwise in order to be valid.

13. Legend. There shall be placed on all certificates for Shares the following legend:

> *Any disposition or encumbrance of this instrument and the rights evidenced hereby is restricted and subject to the terms of an Agreement dated as of __________________, 20___, a copy of which is on file at the principal office of the Corporation. Such Agreement complies with and is enforceable under Virginia Code § 13.1-671.1.*

14. Termination of Agreement. Unless sooner terminated by the written mutual agreement of the parties, this Agreement and the rights and obligations hereunder shall terminate as to each Shareholder at such time as he no longer owns any Shares in the Corporation.

15. Effect of Agreement. In the case of an incapacitated or deceased Shareholder, the term "Shareholder" shall be deemed to refer to his legal guardian or personal representative when appropriate. This Agreement shall be binding on and inure to the respective benefit of the parties, their successors, permitted assigns, estates and personal representatives.

16. Additional Shareholders. The Corporation shall not issue additional Shares from time to time hereafter unless and until (i) Shareholders holding at least two-thirds of the then outstanding voting Shares consent to such issue, and (ii) the issuee has become bound as a Shareholder hereunder. Any such issuee shall become bound as a Shareholder hereunder upon the execution by such issuee and the Corporation's President of Exhibit A attached hereto.

17. Amendments. This Agreement may be amended to bind any transferee or issuee of Shares as a Shareholder hereunder by the transferee or issuee and the Corporation's President executing Exhibit A attached hereto. No other change, modification or amendment of this Agreement shall be valid or binding unless in a writing signed by all the parties hereto.

18. Equitable Relief. The parties hereto agree that the obligations and performances of each party hereto set forth herein are of a special and unique character which, if breached, shall cause loss that is largely intangible but nonetheless real and irreparable. Accordingly, each party hereto agrees that the respective obligations and performances provided for herein may be enforced by an injunction or other equitable relief, in addition to any other rights or remedies that may be available under this Agreement or at law.

19. Attorneys' Fees. If any party brings any action to enforce any provisions of this Agreement, whether at law, in equity or otherwise, the party who substantially prevails in such action shall be entitled, in addition to any other rights or remedies available to him or it, to collect from the other party or parties the reasonable costs and expenses incurred in the investigation preceding such action and the prosecution of such action, including but not limited to reasonable attorneys' fees.

20. Governing Law. This Agreement shall be interpreted in accordance with and governed by the laws of the Commonwealth of Virginia applicable to agreements made and to be performed entirely within such Commonwealth.

21. Notices. All notices, consents and other communications to and between the respective parties hereto pursuant to the terms of this Agreement shall be in writing and shall be deemed to have been given, delivered or made, when mailed by registered or certified mail, postage pre-paid, and return receipt requested, to the Corporation at its principal office and to a Shareholder at his residence address as shown upon the records of the Corporation.

22. Entire Agreement. This Agreement, along with the attached exhibits, sets forth all of the promises, agreements, conditions and understandings between the parties respecting the subject matter hereof and supersedes all negotiations, conversations, discussions, correspondence, memoranda and agreements between the parties concerning such subject matter.

23. Headings. The underlined headings herein are for convenience only and shall not affect the interpretation of this Agreement. For simplicity of expression, pronouns herein may be expressed in a particular gender, but where and to the extent appropriate to the context, such pronouns shall be deemed to include the other genders.

IN WITNESS WHEREOF, the parties have executed this Agreement in more than one counterpart, each of which is an original.

SHAREHOLDERS

____
[name]

____
[name]

[NAME OF CORPORATION]

By:______________________________
[name], President

E. Optional Buy-Sell Provisions For LLC Operating Agreement

SECTION VIII: ASSIGNMENT; RESIGNATION

8.1 Assignment Generally. Except as provided in Sections 8.2, 8.3, and 8.4 of this Operating Agreement, each Member hereby covenants and agrees that he will not sell, assign, transfer, mortgage, pledge, encumber, hypothecate or otherwise dispose of all or any part of his interest in the Company to any person, firm, corporation, trust or other entity without first offering in writing to sell such interest to the Company. The Company shall have the right to accept the offer at any time during the 30 days following the date on which the written offer is delivered to the Company. The consent of all the non-assigning Managers, or if there are no non-assigning Managers, all of the non-assigning Members, shall be required to authorize the exercise of such option by the Company. If the Company shall fail to accept the offer within the 30-day period, such interest may during the following 60 days be disposed of free of the restrictions imposed by this Section 8.1 and the transferee shall become a Member upon the transferee's execution of this Operating Agreement; provided, however, that the purchase price for such interest shall not be less and the terms of purchase for such interest shall not be more favorable than the purchase price and terms of purchase that would have been applicable to the Company had the Company purchased the interest. Any interest not so disposed of within the 60-day period shall thereafter remain subject to the terms of this Section 8.1.

8.2 Gift to Family Member. Notwithstanding Sections 8.1 and 8.4, a Member shall not be required to offer to sell his Membership Interest to the Company prior to transferring his Membership Interest to his spouse or any of his descendants (or to a custodian for a minor descendant under the laws of the State of Virginia or any other state), or to a trust the sole beneficiaries of which are one or more of himself, his spouse and his descendants, provided that such transfer is by way of inter vivos gift or testamentary or intestate succession and the transferee executes this Operating Agreement.

8.3 Transfers from Custodianships or Trusts. Notwithstanding Sections 8.1 and 8.4, any Membership Interest that is held by a custodian for a minor under the laws of the State of Virginia or any other state shall be fully transferable and assignable to the minor, without an offer being made to the Company, when the minor reaches the age of termination of such custodianship under the applicable statute and executes this Operating Agreement, provided the transferee executes this Operating Agreement. In addition, any Membership Interest that is held by a trustee under the laws of the State of Virginia or any other state shall be fully transferable and assignable to a beneficiary of the trust, without an offer being made to the Company, provided the beneficiary is then entitled to a distribution of principal under the terms of the trust agreement or applicable state law and executes this Operating Agreement.

8.4 Purchase of Certain Membership Interests.

8.4.1 Notwithstanding Section 8.1, if an Option Event (as defined below) occurs with respect to any Member (an "Option Member"), the Company shall have the option to purchase the Option Member's Membership Interest upon the terms and conditions set forth in this Section 8.4. For purposes of the foregoing, an "Option Event" shall mean (i) the death of a Member, (ii) the inability of a Member to pay his debts generally as they become due, (iii) any assignment by a Member for the benefit of his creditors, (iv) the filing by a Member of a voluntary petition in bankruptcy or similar insolvency proceedings, or (v) the filing against a Member of an involuntary petition in bankruptcy or similar insolvency proceeding that is not dismissed within ninety (90) days thereafter. The term "Option Member" shall include an Option Member's personal representative or trustee in bankruptcy, to the extent applicable.

8.4.2 Upon any Option Event occurring to an Option Member, the Option Member shall deliver written notice of the occurrence of such Option Event to the Company, which notice shall include in the case of an Option Event resulting from the death of a Member a copy of the instrument governing the distribution of the Member's estate or, in the case of a Member dying intestate, a list of such Member's heirs. The Company shall have the option, but not the obligation, to purchase the Option Member's Membership Interest at any time during the sixty (60) day period immediately following the date on which it receives notice of the occurrence of the Option Event. Such option shall entitle the Company to purchase such Membership Interest for the fair market value of such Membership Interest. The fair market value of the interest shall be the amount that the Option Member would receive in exchange for his entire interest in the Company if the Company sold all of its assets, subject to their liabilities, at their fair market value as of the date on which the Option Event occurred and distributed the net proceeds from such sale in complete liquidation of the Company. The consent of all the Managers other than the Option Member, or if none, a majority of the Members other than the Option Member, shall be required to authorize the exercise of such option by the Company. Such option must be exercised by delivery of a written notice from the Company to the Option Member during the aforementioned period. Upon delivery of such notice the exercise of such option shall be final and binding on the Company and the Option Member.

8.4.3 If the foregoing option is not exercised, the business of the Company shall continue, and (i) the Option Member shall retain his Membership Interest, or (ii) in the case of an Option Event resulting from the death of a Member, the Option Member's personal representative shall distribute the Option Member's Membership Interest in accordance with the instrument provided with the written notice described in Section 8.4.2 above or the applicable intestate statute, as the case may be, but in no event shall such a distributee become a Member of the Company except upon the consent of a majority of the Managers.

8.4.4 The fair market value of the Option Member's Membership Interest shall be determined as expeditiously as possible by a disinterested appraiser mutually selected by the Option Member and the Company (the Company's selection being made by the Managers other than the Option Member, or if none, by a majority of the Members other than the Option Member). If the Option Member and the Company are unable to agree on a disinterested appraiser, then the Option Member and the Company shall each select a disinterested appraiser and if the disinterested appraisers selected are not able to agree as to the fair market value of the interest, then the two disinterested appraisers shall select a third disinterested appraiser who shall determine the fair market value. The determination of the fair market value of the Option Member's Membership Interest by the appraiser or appraisers shall be conclusive and binding on all parties. All costs of an appraiser mutually selected by the Option Member and the Company or the third disinterested appraiser selected by the two individually selected appraisers shall be shared equally by the Option Member and the Company. All costs of an individually selected appraiser shall be borne by the party selecting such appraiser.

8.4.5 If the option to purchase the Option Member's Membership Interest is exercised by the Company, then not later than thirty (30) days after the date on which the appraisal described above is complete (the "Appraisal Date"), the Company shall make a distribution of property (which may be cash or other assets of the Company) to the Option Member with a value equal in amount to the fair market value of the Option Member's Membership Interest; provided, however, that at the election of the Company such distribution to the Option Member may be made in five (5) equal annual installments, the first of which shall be made on the thirtieth (30th) day after the Appraisal Date and one of which shall be made on the same date in each of the four years thereafter, provided, further, however, that notwithstanding an election by the Company to make the distribution to the Option Member in five equal annual installments, the Company may accelerate without penalty all of such installments at any time or any part of such installment at any time. If the Company elects to make distributions to the Option Member in five equal annual installments as provided herein, the Company, in addition to such annual installments, shall pay the Option Member additional amounts computed as if the Option Member were entitled to interest on the undistributed amount of the total distribution to which the Option Member is entitled hereunder at an annual rate equal to the annual Federal Mid-Term Rate in effect under Section 1274(d) of the Code, as determined on the 30th day after the Appraisal Date, which additional amounts, computed like interest, shall be due and payable on the same dates as the annual installments of the distribution payable to the Option Member hereunder. Any unpaid capital contributions of the Option Member and any damages occurring to the Company as a result of the Option Event shall be taken into account in determining the net amount due the Option Member at the closing, and any excess of such unpaid capital contributions or damages over the amount due at closing shall be netted against subsequent installment payments as they become due.

8.4.6 If at a time when the Company has an option to purchase an Option Member's Membership Interest, it is prohibited from purchasing all or any portion of such Membership Interest pursuant to the Act or any loan agreement or similar restrictive agreement, the Option Member and the remaining Members shall, to the extent permitted by law, take appropriate action to adjust the value of the Company's assets from book value to a fair valuation based on accounting practices and principles that are reasonable under the circumstances in order to permit the Company to purchase such Membership Interest. If the Company becomes obligated to purchase an Option Member's Membership Interest under this Section and the above action cannot be taken or does not create sufficient value to permit the Company to do so, the Company shall be obligated to purchase the portion of the Membership Interest it is permitted to purchase.

8.4.7 In order to fund any obligations under this Operating Agreement, the Company or the Members may maintain such life insurance policies on the lives of one or more Members as the Members determine from time to time to be desirable.

8.5 Absolute Prohibition. Notwithstanding any other provision in this Article VIII, the Membership Interest of a Member, in whole or in part, or any rights to distributions therefrom, shall not be sold, exchanged, conveyed, assigned, pledged, hypothecated, subjected to a security interest or otherwise transferred or encumbered without the prior written consent of a majority of the non-transferring Managers, or if there is no non-transferring Manager, a majority of the non-transferring Members, if, as a result thereof, the Company would be terminated for federal income tax purposes in the opinion of counsel for the Company or such action would result in a violation of federal or state securities laws in the opinion of counsel for the Company.

8.6 Members Acquiring Membership Interest from Company. No Person, other than the initial Members, who acquires a Membership Interest from the Company, shall be admitted as a Member of the Company, except upon the unanimous consent of the Members.

8.7 Resignation. Any Member may elect to resign from the Company and to sell his entire interest in the Company to the Company at any time by serving written notice of such election upon the Company. Such notice shall set forth the date upon which such resignation shall become effective, which shall be not less than sixty (60) days and not more than ninety (90) days from the date of such notice. The purchase price for a resigning Member's interest in the Company shall be One Dollar ($1.00).

8.8 Effect of Prohibited Action. Any transfer or other action in violation of this Article shall be void ab initio and of no force or effect whatsoever.

8.9 Rights of an Assignee. If an assignee of a Membership Interest is not admitted as a Member because of the failure to satisfy the requirements of Section 8.4.3(ii) or 8.6 hereof, such assignee shall nevertheless be entitled to receive such distributions from the Company as the assigning Member would have been entitled to receive under Sections 6.7 and 9.4.3 of this Operating Agreement with respect to such Membership Interest had the assigning Member retained such Membership Interest.