AN OVERVIEW
OF
BUSINESS AND TAX PLANNING ISSUES
THAT ARISE IN STRUCTURING
BUY-SELL AGREEMENTS
AND
PLANNING FOR BUSINESS BUY-OUTS

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Introduction

Any business venture among two or more owners is much like a marriage; it is easy and painless to get into, but when the honeymoon is over, it can be very disruptive (and expensive) to untangle the interests of the business partners unless there is a prior agreement or plan in place which contemplates this very possibility.

A Buy-Sell Agreement is a specific type of business agreement which sets forth the terms by which business interests will be bought and sold upon the happening or occurrence of certain future events. Buy-Sell Agreement provisions are commonly found within the terms of:

1. Partnership Agreements;

2. Limited Liability Company Operating Agreements; and

3. Corporate Shareholder Agreements (sometimes called Stock Purchase Agreements).

In simple terms, the Buy-Sell Agreement is a sort of **pre-marital agreement** for business owners. By executing a Buy-Sell Agreement today, the business owners can control, to some degree, the future disposition of the business. Therefore, like a pre-marital agreement, the Buy-Sell Agreement provides closely-held business owners with a certain level of security and predictability to an otherwise unstable and unpredictable relationship.

Careful planning, however, is required in negotiating and structuring the terms of a Buy-Sell Agreement. Because the Buy-Sell Agreement is structured with a view toward the future, many unintended income and estate tax results may occur without proper consideration.

For example, the structure of a Buy-Sell Agreement may have drastic **income tax** consequences to the outgoing and continuing partners upon the happening of a specified buy-out event under the Buy-Sell Agreement.

Moreover, in the case of closely held family businesses, the existence of a Buy-Sell Agreement may provide other very valuable **estate and gift tax benefits** in addition to assuring family ownership continuation. Specifically, as we will discuss later, the existence of a Buy-Sell Agreement may serve to establish or "fix" the transfer value of business ownership interests for estate planning purposes. Moreover, as we'll also discuss later, the existence of the Buy-Sell Agreement may also affect whether gifts and bequests of business interests will qualify for the marital deduction or the $13,000 annual gift tax exclusion for federal estate and gift tax purposes.

This outline will focus on the structuring of Buy-Sell Agreements among business owners. The discussion will be divided into two (2) parts.

Business Planning Issues.

In Part One of our discussion, we will review the role of Buy-Sell Agreements in business planning for closely-held business clients and the important role the client's tax advisors will play in this **Business Planning** process.

Tax Planning Issues.

In Parts Two through Four of this presentation, we will review selected **income and estate tax issues** that often arise in structuring buy-outs in closely-held businesses.

Many of the concepts discussed in this outline will apply equally regardless of whether the business enterprise takes the form of a partnership, corporation or limited liability company. Furthermore, many of the considerations in drafting Buy-Sell Agreements for unrelated business owners will likewise apply in the context of the family business. To the extent practical, we will try to highlight the differences which arise in Buy-Sell Agreements for family businesses versus businesses owned by unrelated parties.

PART ONE:
BUSINESS ISSUES IN STRUCTURING BUY-SELL AGREEMENTS

I. Why Are Buy-Sell Agreements So Important In Business Planning?

To understand the importance of Buy-Sell Agreements for business and tax planning, often it is helpful to review some of the disastrous consequences that may result where no Buy-Sell Agreement is in place. Regardless of whether the business operates as a corporation, partnership or limited liability company, in the absence of a formal written agreement among the owners, North Carolina State law will determine the parties' relative rights to share in the future success of the business venture.

A. The Buy-Sell Agreement will balance the competing objectives of the business entity itself and the objectives of the individual owners. In most cases, business owners will have two very significant, but competing, concerns with respect to their investment in the business enterprise.

1. Assuring Continuity of Ownership in the Business Enterprise. First of all, from the perspective of the business venture itself, the owners as a group will be very concerned about insuring continuity of ownership of the underlying business. Not surprisingly, therefore, the business entity itself will wish to restrict the individual owners' ability to transfer or encumber their interests in the business enterprise in favor of third parties.

2. Providing Co-Owners with the Ability to Realize on Their Investment. On the other hand, from the perspective of each individual owner of the business venture, the individual owners themselves will wish to have some mechanism in place that will allow them to cash-in or realize upon their investment in the business venture. Since it is always possible that a co-owner may die, become disabled, or wish to withdraw, each business owner will want to provide themselves with the ability to realize on what perhaps may be their most valuable investment asset.

B. In the Absence of a Buy-Sell Agreement, North Carolina State Statutory Law May Defeat The Parties' Objectives and Goals. However, in many cases, North Carolina law may act to severely inhibit the business entity or the individual owners from accomplishing their desires. Therefore, the purpose of the Buy-Sell Agreement is to address these competing concerns, and achieve some balance between the interests of the individual owners and the interest of the business entity itself.

1. North Carolina Corporations. For example, under North Carolina corporate law, corporate shareholders are free to transfer or devise their corporate stock in the absence of a contrary agreement among the parties. Therefore, without a restrictive Shareholder Agreement in place, the corporation has no way to insure continuity of corporate stock ownership.

On the other side of the coin, however, North Carolina law provides no ability to the shareholders to force a buy-out of their corporate stock. Therefore, the individual shareholders of a North Carolina corporation, in the absence of a contrary agreement, may have no practical ability to realize on their investment in the event of their death, disability or desire to withdraw.

2. **<u>North Carolina Limited Liability Companies</u>**. Under N.C.G.S. Section 57C-5-02, members of an LLC are free to assign their membership interests to third parties. In addition, LLC membership interests may be subject to a charging order in favor of the judgment creditors of the individual LLC members. N.C.G.S. Section 57C-5-03.

Under N.C.G.S. 57C-5-02, a Membership Interest is assignable, but the assignment only gives the transferee the right to receive distributions from the LLC. Thus, the transferee does not become a voting members unless and until the transferee is admitted as a member. N.C.G.S. 57C-5-04(a) provides that an assignee becomes a member (with voting rights) only if the assignee meets the requirements set out in the LLC Operating Agreement. And, if there is no LLC Operating Agreement in place that addresses transfers of membership interests, then the transferee becomes a voting member only if all of the other members unanimously consent to the transferee becoming a voting member. N.C.G.S. 57C-5-04(a)(2).

Also, under N.C.G.S. 57C-5-03, if a judgment is issued against an LLC member, then a court may grant the judgment creditor a "charging order" against that Member's LLC interest which entitles the judgment creditor to receive the debtor/member's share of cash distributions from the LLC, but no voting rights.

Thus, assignees and judgment creditors of a member are not entitled to become a member, or to exercise the voting rights of any member. Nevertheless, the possibility of assignment of a membership interest can create a great deal of uncertainty for the continuing owners.

On the other hand, Members of an LLC are not permitted to voluntarily withdraw from the LLC, unless withdrawal is specifically allowed pursuant to the terms of an Operating Agreement among the LLC members. N.C.G.S. Section 57C-5-06. Furthermore, the withdrawal of an LLC member will not cause the dissolution of the LLC, unless, once again, there is a prior agreement among the parties which would require the LLC to dissolve. N.C.G.S. Section 57C-6-01.

As a result of these provisions, in those cases where there is an LLC Operating Agreement which prohibits assignments of membership interests, or which does not allow an LLC member to voluntarily withdraw from the LLC, the individual LLC member will be unable to liquidate and recognize upon their investment.

Accordingly, for a North Carolina LLC, Buy-Sell Agreements are critically important to assure continuity of ownership and to ensure that the members will have some type of exit strategy for withdrawing from the business.

3. **North Carolina General Partnerships**. In general, assignees of a general partnership interest do not become general partners in the partnership. N.C.G.S. Section 59-57. Thus, the assignee is not permitted to participate in management or even require any information or accountings regarding partnership transactions. Instead, the assignee is entitled to receive only his share of partnership profits that the transferor was entitled to receive. N.C.G.S. Section 59-57. Likewise, judgment creditors of a general partner only acquire the rights to receive partnership profits from the debtor-partner. N.C.G.S. Section 59-58. Therefore, in most cases, the general partnership itself is protected from voluntary or involuntary transfers of general partnership interests.

Nevertheless, under North Carolina law in the absence of a contrary agreement among the partners, a general partnership will be dissolved and liquidated:

(i) At the will of any general partner; or
(ii) Upon the death or bankruptcy of a general partner.

N.C.G.S. Section 59-61.

Therefore, although general partnership interests are not freely transferable as such, a North Carolina general partnership will not be protected from dissolution.

4. **North Carolina Limited Partnerships.** The North Carolina Uniform Limited Partnership Act provides a great deal of protection to the limited partnership entity in the event of the death of a limited partner or an assignment of a limited partnership interest. In general, general and limited partnership interests are transferable and may be subject to judgment creditors. N.C.G.S. Section 59-702 and 59-703. If there is an assignment of a general or limited partnership interest, then the assignee may only become a limited partner if the other partners agree or if the partnership agreement permits the assignee to become a limited partner. N.C.G.S. Section 59-704(a).

Once again, however, the effect of these provisions is that limited partners are virtually powerless to realize on their investment in a limited partnership. Thus, it may be impossible to attract limited partnership investors without some partnership agreement provisions which would allow limited partners to cash in on their investments in the event of their death, disability or their desire to withdraw.

C. **Summary.** As indicated above, the application of North Carolina statutory law will have varying effects on the business venture and its owners in the absence of specific buy-sell provisions in a formal written agreement. This is specifically the reason that Buy-Sell Agreements are so important in business planning.

II. Structuring the Buy-Sell Agreement.

In structuring the terms of the Buy-Sell Agreement, at least six (6) important issues must be addressed. Regardless of whether the business is owned by related or unrelated parties, and regardless of the form of the business enterprise, the following questions must be answered:

1. What events will trigger a buy-sell option or obligation?

2. Under what circumstances will the sale/purchase obligation be voluntary or mandatory?

3. How will the purchase price be determined?

4. What will the payment terms be under the buy-out?

5. Who will be designated as the purchaser under the buy-out: the continuing owners or the business enterprise itself?

6. What other management or operational provisions, if any, will be present in the Buy-Sell Agreement?

Throughout the rest of this paper, we will examine the various alternatives for structuring the Buy-Sell Agreement and the different considerations which must be addressed in determining the proper structure of the Buy-Sell Agreement.

III. Events Triggering the Buy-Sell Option/Obligation.

A. In General. In the context of any closely-held business (whether among related or unrelated owners), it is essential that the business owners provide for the orderly continuation, or, if appropriate, the buy-out of a disassociated equity owner or the dissolution of the business, upon the occurrence of one of the following four "Big D's":

1. Death;
2. Disability;
3. Default; or
4. "Divorce".

The existence of a Buy-Sell Agreement will benefit both the individual owners as well as the business itself in the event of the occurrence of one of the four "Big D's". In the case of the first two "Big D's" referred to above, death and disability, it is easy to see why a Buy-Sell Agreement is important.

In the case of the latter two "Big D's", additional clarification is necessary. As will be discussed later, in the context of closely-held businesses, the business owners may set forth and enumerate various types of events which will constitute a "default" by one of the business owners.

Moreover, when we refer to "divorce" in the context of a Buy-Sell Agreement, we are not speaking only of the termination of the marital relationship of one of the business partners and his/her spouse. We are also specifically addressing the possibility that a business owner may become "divorced" from the business enterprise. A properly drafted Buy-Sell Agreement will contemplate both types of "divorces".

B. "Mandatory" Versus "Optional" Buyout Provisions. In structuring a Buy-Sell Agreement, there are basically **three (3) buy-sell options** available to the business enterprise and the business partners:

1. Mandatory buy-sell obligations between the parties;

2. Non-mandatory options to purchase provided to the business enterprise or to the other business partners;

3. A "put" option which will require a purchase by the business enterprise or the other business partners - thus allowing a withdrawing owner or his estate to force a buy-out.

As we will see, the selection of one of the three buy-sell options will vary depending upon which of the four "Big D's" are at issue.

C. Death. Most Buy-Sell Agreements will provide for a **mandatory** buy-sell obligation/option with respect to the business interest owned by a deceased business partner.

1. Advantages to the Deceased Owner's Estate. A mandatory buy-out "obligation" at death will benefit the deceased owner's estate in several ways:

a. Provides a Ready Market. First, since the Buy-Sell Agreement will identify a specific purchaser of the ownership interest of a deceased owner, a ready market will be created for the deceased owner's interest.

b. Providing Liquidity. Where the Buy-Sell Agreement mandates the purchase of a deceased owner's interest, the Buy-Sell Agreement will provide the estate with liquidity to pay estate expenses (death taxes, debts and administration expenses) and to support surviving heirs.

c. Guaranteeing a Fair Price. The existence of a Buy-Sell Agreement obligation at death also will enable the estate to obtain a fair price for the business owner's interest. Since the Buy-Sell Agreement usually will provide a specific mechanism for determining the buy-out price, the estate will not be forced to negotiate price and payment terms from an unfavorable bargaining position.

2. Advantages to the Continuing Business Owners. From the perspective of the business enterprise and the continuing owners, a mandatory buy-out "option" also will benefit the continuing owners:

a. A mandatory buy-out will allow the surviving business owners to avoid interference by the deceased business partner's estate (or attorney) in the affairs of the business;

b. A mandatory buy-out may eliminate potential friction between the business (or surviving owners) and the deceased owner's estate since the purchase price and payment terms will be predetermined; and

c. It usually is relatively easy to plan for a buy-out obligation at death through adequate life insurance.

D. Disability. In the event of the disability of a business owner, the business enterprise, as well as the disabled owner, may benefit from the existence of a Buy-Sell Agreement providing for a buy-out in the event of disability.

1. Advantages to the Disabled Owner.

a. Disability Funding. From the disabled owner's perspective, a buy-out will generate liquidity to support the disabled owner (since the disabled owner would no longer be able to draw a salary or earnings from the business entity).

b. Ensuring a Ready Market and a Fair Price. Because closely-held business interests are usually unmarketable, the existence of a Buy-Sell Agreement will provide a ready market for the business interest of a disabled owner, and presumably at a fair price.

2. Advantages to the Continuing Business Owners. From the perspective of the business enterprise and the continuing owners, a buy-out will be appropriate since the disabled owner, arguably, will no longer be able to contribute to the success of the business.

So, the only question, therefore, usually is whether the buy-sell opportunity should be mandatory or optional.

3. Mandatory vs. Optional Buyouts at Disability. In most cases, the buy-out in the event of disability would be structured as follows:

a. Partial or Temporary Disability. In the case of a partial or temporary disability, the business enterprise and continuing owners usually will have an option, but will not be obligated, to purchase the disabled owner's interest. In many cases, the option to purchase will be exercisable only at the end of a specified waiting period. This provides the disabled owner with an opportunity to return to work.

b. Total or Long Term Disability. In the case of total or long term disability, the disabled owner will likely face significant financial hardship. So, the Buy-Sell Agreement often will grant a "put option" to the disabled owner in the event of "long-term" partial disability or total disability. This "put option", which often is exercisable only after some specified waiting period (for instance two to five years), gives the disabled partner a way to fund his disability but, at the same time, will provide the business with an opportunity to plan for any proposed purchase.

E. Default. Depending upon the nature of the relationship between the business and its owners, the Buy-Sell Agreement may set forth certain "events of default" which will give rise to a buy-sell option in favor of the business enterprise. For example, the following is a list of such default events:

1. bankruptcy, insolvency or an assignment for the benefit of creditors;

2. attempted voluntary transfers to outside third parties;

3. transfers to divorced spouses; and

4. an event of fraud, misappropriation or embezzlement of the business funds or assets by the business partner.

In the event of any of these events of default, the business enterprise should be given the option, but not the obligation, to acquire the “defaulting” partner’s interest in the business. This purchase option will allow the remaining owners to avoid involvement of creditors or the bankruptcy trustee in the day-to-day affairs of the business. Therefore, the business enterprise or nondefaulting partners should never be required to purchase the interests of a defaulting partner in the event of a default.

1. Bankruptcy or Insolvency of an Owner. In most cases, the bankruptcy or insolvency of an owner will trigger an **automatic purchase option** by the business or the continuing business owners. Hopefully, this provision will allow the remaining owners to avoid involvement of the bankruptcy trustee in the day-to-day affairs of the business.

2. Attempted Transfers of Business Interests to Third Parties. In order to assure that business interests are not transferred to any outside parties, the Buy-Sell Agreement typically will provide for a **purchase option** in the event that there is an attempted **sale or gift** to a third party. These "transfer restrictions" typically will offer a "right of first refusal" to the business and other owners.

3. Transfers to Spouses at Divorce. The business owners usually will want to take some action to assure that a divorced spouse of a business owner will not acquire an ownership interest in the business. Such a spousal transfer may occur voluntarily, or it may occur involuntarily such as where there is a transfer pursuant to a court-ordered equitable distribution or separation agreement. Typically, the Buy-Sell Agreement will grant the divorced business owner a first option to purchase the business interest back from his or her ex-spouse. If the divorced owner does not exercise this purchase option, then the remaining owners or the business enterprise itself will have an option (but not a mandatory obligation) to purchase the ownership interests from the divorced spouse.

F. Events of "Divorce". As discussed above, the fourth big D, "divorce," does not refer to the divorce of a business owner from his or her spouse. Instead, in the context of Buy-Sell Agreements, a "divorce" among the business owners must also be contemplated.

A "divorce" among the business owners may be "voluntary" such as where the business owners amicably decide to "part ways." Or, the "divorce" may be "involuntary" such as where the employment of an owner is involuntarily terminated. The structure of the buy-sell provisions will vary significantly depending upon the nature of the "divorce."

1. Retirement or Voluntary Termination of Employment. In the case of the unexpected retirement or voluntary termination of a business owner, the business enterprise usually will not be obligated to immediately purchase the interest of the withdrawing partner. This protects the business from having to fund an unexpected buy-out created by the sudden "walk-out" of a partner. Instead, the business enterprise usually is given the option to purchase the interest of the withdrawing partner.

On the other hand, to protect the interests of the withdrawing partner (and to allow an opportunity for funding retirement), the withdrawing partner may be given a "put right" to require a purchase after a suitable waiting period (once again, two to five years). This should allow the withdrawing business owner to realize on the value of his investment in the business but should not cause any undue economic strain on the business.

2. Involuntary Termination of Employment. Where there is an involuntary termination of employment, the business enterprise usually is given an option to purchase the terminated owner's interest. If the termination is "without cause", then the terminated owner may be given a "put right" to require a buy-out of his interest; but often, this "put right" will not be exercisable until some future time. However, if the termination is "for cause", then the terminated employee-owner will have no "put right" option.

3. Deadlock. If the business enterprise has equal partners, then it is essential to make provision for what should happen if the partners can no longer get along or are in a deadlock as to the direction of the business. The Buy-Sell Agreement should therefore contain a provision that gives any business partner the right to announce to the other partners his election to either (i) buy the interests of the other partners or (ii) require the other partners to purchase his interest. The other partners can elect either (i) to sell their interests to the announcing partner or (ii) to purchase the announcing partner's interest.

Often times, the Buy-Sell Agreement will provide that the price and payment terms for a purchase or sale will be set forth in the announcement notice. In order to "even up" any difference in economic resources among the partners, the Buy-Sell Agreement will usually allow the other partners a period of time in which to make their election. This will allow the "weaker partner" to either put together a financial package or to find a new partner to take the place of the unhappy partner.

This type of arrangement sometimes is called the "Texas shoot out." Carolyn T. Geer, "Prenuptial for Business Partners," Forbes (December 5, 1994).

IV. Establishing the Purchase Price.

A. In General. One of the most difficult decisions to reach in structuring a Buy-Sell Agreement is the method or formula for determining the **purchase price** of the interest to be bought or sold.

Without the existence of a Buy-Sell Agreement, the establishment of a purchase price would likely be the most fiercely debated aspect of a buy out. However, because the Buy-Sell Agreement usually will specifically set forth the method for determining the purchase price, the existence of a Buy-Sell Agreement may serve to avoid future disputes since the owners will have agreed upon a valuation method prior to the specific identification of the purchasers and sellers.

In the context of a family owned business, the purchase price component of a Buy-Sell Agreement may have very significant income and estate tax ramifications. As will be discussed later in this paper, in the context of S corporations, the purchase price component of a buy sell agreement may affect the preservation of the company's S Election where the Buy-Sell Agreement is used to ensure a ready market for the S corporation's stock held by an investor.

Likewise, as we'll also discuss, for estate planning purposes, a Buy-Sell Agreement may "fix" the estate tax value of a business owner's interest in the business. Unfortunately, in many cases estate tax consequences are not considered when Buy-Sell Agreements are executed. As a result, there may be missed opportunities to "freeze" the values of business interests for transfer tax purposes. Likewise, the existence of the Buy-Sell Agreement may actually result in an inflated business interest valuation.

And finally, the existence of the Buy-Sell Agreement may affect whether bequests of stock to the deceased shareholder's spouse will qualify for the marital deduction for estate and gift tax purposes. And, the terms of the Buy-Sell agreement could also prevent gifts of business interests from qualifying for the $13,000 annual gift tax exclusion.

These income and estate and gift tax issues will be discussed further below.

B. Alternative Valuation Methods. There are several alternative valuation methods that may be used in a Buy-Sell Agreement. The following is a brief discussion of several possible valuation methods.

1. Fixed Price Specified In the Agreement. The simplest valuation method is to simply to provide for a buy-out price under the terms of the agreement. The problem with this method, of course, is that the fixed price should be adjusted to reflect increases or decreases in the value of the business.

Therefore, most agreements incorporating a fixed price valuation method will provide that the partners shall periodically review and redetermine the purchase price. The new agreed upon purchase price will be incorporated into the Buy-Sell Agreement and a "Certificate of Agreed Value" will be attached to the Buy-Sell Agreement each year to be kept with the other records of the business.

Of course, an agreement among the business partners to redetermine the purchase price each year is merely an "agreement to agree". As a result, the partners may fail to redetermine the purchase price on a periodic basis. Thus, the Buy-Sell Agreement should provide that, if the partners fail to execute a Certificate of Agreed Value at least annually, then the most recent agreed value will be adjusted based upon increases or decreases in book value, fair market value or earnings of the business.

2. Book Value Method. Because most businesses prepare financial statements based upon historical cost information, a book value method for valuing business interests is another simple valuation method. Of course, because book values are based upon historical costs less depreciation, the book value of the business may not adequately reflect the true going concern value of the business. Thus, most agreements which incorporate a book value methodology will really use a "modified" book value method which will mandate that some business assets be valued at their fair market value.

3. Valuation Based Upon Fair Market Values of Assets. The principal advantage of the fair market value valuation method is that it avoids the problems with historical cost valuation. On the other hand, the use of the fair market value methodology will almost certainly necessitate the use of appraisers. The agreement should specifically set forth the method for selecting the appraisers as well as how their fees will be allocated among the partners.

4. Appraised Value of Business Interests. The Buy-Sell Agreement may simply provide that a purchase price will be determined by an independent appraiser. The agreement may specifically identify the appraiser or the method in which the appraiser will be selected. Attention should be given to the necessary qualifications of the selected appraisers and how the appraisal fee will be allocated among the parties. The Buy-Sell Agreement also should specifically address whether “minority interest” or “lack of marketability” discounts should be taken to value the interests of the seller.

5. Capitalization of Earnings Method. Under this valuation method, the value of the business is determined by multiplying the earnings of the business by a capitalization factor. The value may be determined using the business' most recent earnings or by using a weighted average of several years' earnings. The problem with using the capitalization of earnings method is that capitalization rates generally will vary among industries; thus, industry data should be examined to determine the appropriate capitalization factor. Moreover, a capitalization of earnings method may yield an unreasonably high value for the interests of a minority business owner unless minority interest and marketability discounts are taken into consideration.

C. **<u>Selecting a Valuation Method - Summary</u>.** To select an appropriate valuation method, the business owners should keep several points in mind. First of all, every business is different and there is no one correct method for valuing the business.

For example, the value of fast food franchises typically are determined based upon a multiple of gross income, while real estate businesses typically are sold based on the value of its fixed assets. Manufacturing and retail businesses are typically sold on the basis of a multiple of net earnings.

Whatever formula or method is adopted, several factors should always be considered:

(i) First, in setting the purchase price terms, the business owners should assume that they will be purchasing rather than selling the business interest so as not to overinflate the estimate of value.

(ii) Second, the business owners should consider the ability of the business to pay the price established. It is not unusual for a buy-sell price to be significantly less than the value the business would be offered to a third party purchaser. The lower value reflects the enhanced risk to the remaining partners, the increased cost of the deal to the remaining partners and the loss to the business by the withdrawal or death of the partner.

(iii) A different or higher value may be used in the case of death (covered by insurance) than would be used in the case of a default or voluntary withdrawal by a partner (at a discounted or "penalty price").

(iv) The selection of the purchase price may have unexpected tax consequences.

V. <u>Establishing Payment Terms</u>.

A. **<u>In General</u>.** The Buy-Sell Agreement should also specify how the purchase price will be paid. In some cases, the Buy-Sell Agreement will provide for the payment of the entire purchase price in cash. In most circumstances, however, the Buy-Sell Agreement will provide that the purchase price will be payable partly in cash and partly by the issuance of an installment promissory note. This will allow the purchasing entity to avoid having to go out and borrow substantial amounts of money to fund the buy-out. This is very important in cases where it has not been possible to fund the buy-out with other means either because of uninsurability or because of insufficient opportunity to save sufficient assets for a buy-out.

B. Typical Payment Terms. As discussed above, the payment terms should be structured so as not to jeopardize the continuation of the business enterprise operation, yet, remain fair to the selling business partner. The following are some considerations for structuring the payment of the purchase price:

1. arguably, all insurance proceeds received by the business (or the other owners) should be applied to the purchase price and paid lump sum to the seller;

2. the balance of the purchase price, if any, should bear interest - but the interest rate may be below or above the prime rate;

3. the balance, plus any interest, will be payable monthly or annually over a term established by the business - but how long should the term be?

4. there may be a minimum monthly or annual installment amount to provide a minimum level of income to the selling owner; and

5. the agreement may "cap" the required installment amount if corporate earnings or cash flow fail to reach a certain level.

Note that the Buy-Sell Agreement could provide for a longer payout of the purchase price if there is a "default" by the selling owner, if a "divorce" event has occurred or if the former business partner has elected to compete with the business enterprise. A low interest rate or a no interest rate deal can be imposed as a "penalty" for competition with the business or a default by the withdrawing partner.

VI. Methods of Funding the Buy-Out.

A. In General. As soon as the Buy-Sell Agreement has been drafted, the parties should also give due consideration as to how a buy-out would be funded in the event of a buy-out event.

From the perspective of a **selling owner**, the Buy-Sell Agreement will have very little intrinsic value unless the purchasing parties have the ability to fulfill their buy-out obligations. From the perspective of the **potential buyers**, an unexpected buy-out event could place significant financial hardships upon the remaining buying partners.

Moreover, after the occurrence of a buy-out event, there becomes an increased need to fund additional buy-outs. This is because once there has been a buy-out event, each business owner will then own a greater proportional interest in the business enterprise. Therefore, more funds will be necessary in future years to fund each subsequent buy-out.

B. Funding Mechanisms. In most cases, there are only three possible options for funding a buy-out:

1. Financing the Purchase. If the business or the continuing owners do not have sufficient cash to fund a buy-out, the purchasing parties may look for financing. As discussed, the Buy-Sell Agreement will often provide for the payment of the purchase price over a number of years in certain events (such as a default or divorce event). In these cases, where the purchase is seller-financed, the corporate stock will often be pledged as collateral.

Outside financing is usually much more difficult to locate. The problem with third party financing is that the business may have very little collateral to use as security for the debt. Furthermore, a third party lender may have deep reservations about the credit worthiness of the business after the occurrence of the death or withdrawal of one of the business owners. In light of these concerns, the personal guarantees of the continuing business owners may not even be sufficient security for third party lenders.

2. Use of a Sinking Fund.

a. Advantages. If the business owners plan far enough ahead into the future, they may be able to establish a sinking fund for an eventual buy-out. Indeed, when compared to an investment in life or disability insurance, an investment in a sinking fund may yield a greater return on the investment. In addition, where one or more business owners are uninsurable, the use of a sinking fund may be the only available method to fund a buy-out.

b. Disadvantages.

(i) Premature Death or Disability. The principal disadvantage of the sinking fund method is that there is always the risk of a premature death or disability. Thus, the potential seller, as well as the potential buyer, may be disadvantaged by the use of a sinking fund.

(ii) Cash Flow Consideration. Moreover, the establishment of a sinking fund may be quite a drain on the cash flow of the business enterprise or its owners.

(iii) Accumulated Earnings Tax Problems. As discussed in Section VII (B)(2)(e) below, the use of a sinking fund may also trigger the accumulated earnings tax for C corporations.

(iv) Corporate State Law Insolvency Limitations. Finally, the corporate law of some states may prohibit a corporate redemption if certain solvency tests are not met. See for example N.C.G.S. Section 55-6-40(c).

3. <u>Use of Disability and Life Insurance</u>. The use of disability and life insurance is the most popular funding mechanisms, except in those cases where the owners are uninsurable. Although an investment in life and disability insurance may produce a lower investment yield than would the sinking fund alternative, the use of insurance insures against the greatest disadvantage of the sinking fund method: that is, the possibility of a premature death or disability. Also, if a life insurance policy product is utilized that accumulates cash value, the cash surrender value may be used to fund the retirement of a retiring owner.

VII. <u>Identifying the Purchaser Under a Buy-Sell Agreement</u>.

A. <u>In General.</u> In structuring a Buy-Sell Agreement, appropriate consideration must be given to the identification of a purchaser in the event of a buy-out of an interest in the business. In this regard, there are only two possible purchasers: the remaining owners and the business enterprise. Thus, most Buy-Sell Agreements fall into one of the following three categories:

1. <u>Entity Redemption Arrangement</u>. In an entity redemption arrangement, the business enterprise redeems the sold interest.

2. <u>Cross-Purchase Arrangement.</u> In a pure cross-purchase arrangement, the remaining business owners will purchase the interest of a withdrawing business partner.

3. <u>Hybrid Arrangement</u>. With the hybrid arrangement, the business enterprise <u>and</u> the remaining owners will be potential purchasers of a sold interest. In most cases, the remaining owners are given the first option to purchase an outgoing partner's interest. If the remaining owners fail to exercise their purchase options, then the business enterprise will then have the option (or obligation) to purchase the business interest.

In deciding between the entity redemption method, cross-purchase method or a hybrid method, many tax and non-tax considerations must be addressed.

B. <u>Entity Redemption Arrangement</u>.

1. <u>Advantages</u>.

a. <u>Use of Business Funds</u>. Under the entity redemption method, the funds of the business enterprise are used to purchase the outgoing partner's interest or to pay premiums on the disability or life insurance policies. From the perspective of the business owners, the primary advantage of the entity redemption method is that the individual owners do not have to rely on each other's ability to fund a buy-out. In addition, the individual owners will not be primarily liable for the purchase obligation.

b. <u>Simplification of Insurance Plan</u>. Where the proposed buy-outs will be funded with insurance, the primary advantage of the entity redemption arrangement is that only one life insurance and disability policy must be taken out for each individual partner. As will be discussed later, with the cross-purchase arrangement, each individual partner must take out disability and life insurance policies on each other. This greatly increases the number of total policies which must be taken out in order to properly fund the buy-out.

c. Entity Redemption May Provide A Current Tax Deduction For LLC Members or Partnership Partners. In the event of a redemption of a partner or LLC member, the redemption proceeds may be treated as either

(1) a "guaranteed payment";

(2) a distribution of partnership profits; or

(3) a liquidating distribution.

If part or all of the redemption proceeds are treated as a "guaranteed payment", the continuing owners may be entitled to take a current income tax deduction for the guaranteed payment amount. Examples of guaranteed payments include payments to the partners or LLC members for services (salary) or for the use of capital (interest).

However, if the redemption is treated as a distribution of profits or as a liquidating distribution, or if a cross purchase is used, the continuing partners or LLC members will not be entitled to any current income tax deduction.

d. Payment of Life Insurance Premiums On Entity Owned Policies. Amounts paid for life insurance premiums to fund a buy-out are not deductible to the business entity or to the individual owners. In the case of a cross-purchase agreement, the business entity may have to make distributions of income to allow the individual owners to pay premiums on the life and disability insurance policies.

Therefore, under the Entity Redemption Arrangement, if a C corporation is in a lower tax bracket than the individual owners, it would be less expensive to have the corporation pay non-deductible premiums (since corporate distributions to the shareholders to enable them to pay the life insurance premiums would be taxed at their higher individual rates). Of course, in the case of S corporations, partnerships and limited liability companies, there is no tax rate differential problem.

2. Disadvantages.

a. Corporate-Owned Investment Assets and Life Insurance Policies are Subject to Claims of Creditors.

b. Possible Dividend Treatment. If the enterprise is a family owned C corporation, the redemption arrangement may result in a corporate redemption being characterized as a taxable dividend as opposed to a sale or exchange of a capital asset. This issue will be discussed further below.

c. Income Tax Basis Considerations. Also, as we'll discuss later, the distinction between the Cross Purchase Arrangement and the entity redemption arrangement will affect whether the continuing shareholders will be able to secure an increase in their tax basis of the closely-held business interests. Generally, the main advantage of the Cross Purchase Arrangement over the Entity Redemption Arrangement is that the purchasing shareholder under the cross purchase arrangement always gets a basis step up. The same is not true in the case of the Entity Redemption Arrangement.

d. Alternative Minimum Tax Consequences. When life insurance is owned by a C corporation to fund a buy-out, the life insurance proceeds may be subject to tax as a result of the alternative minimum tax provisions of the Internal Revenue Code. In the case of S corporations, partnerships or limited liabilities companies, there is no alternative minimum tax issues since life insurance proceeds do not generate alternative minimum tax for individuals.

e. Accumulated Earnings Tax. In cases where a C corporation funds a buy-out through a sinking fund method, there may be accumulated earnings tax consequences. Under IRC §531, an accumulated earnings tax of 15% is assessed on the accumulated earnings and profits of a C corporation in excess of the amount required for the normal operating expenses of the business. Depending upon the circumstances, the accumulation of funds for the buy-out of a business owner may or may not be considered a reasonable need of the corporation. Thus, the possibility of the accumulated earnings tax is somewhat of a disadvantage of the entity purchase arrangement.

f. Inequality of Premium Payments. In cases where business owners are of different ages or different insurability levels, there may be some inequities among the owners depending upon whether a cross-purchase or entity redemption method is chosen. In the case of a redemption agreement, the majority owner essentially will be funding his own buy-out through the payment of premiums at the entity level. On the other hand, if a cross-purchase method is selected, a younger (more insurable) or minority owner will have to pay a greater premium on the policies insuring an older or majority owner.

g. Shift in Ownership Percentages. The Entity Redemption Arrangement may also cause a shift in proportional ownership interests of the remaining business owners. For example, assume that Father and Son each own 30% of the outstanding stock of XYZ Company. Shareholder A owns the remaining 40%. If all of Father's share of stock in XYZ Company are redeemed, then, after the redemption, Shareholder A will end up owning 57% of the outstanding stock in XYZ Company (40%/70%). Son will own the remaining 43%. As a result of the entity redemption in this case, control of XYZ Company has shifted from Father and Son to Shareholder A.

This is another major disadvantage of the Entity Redemption Arrangement.

h. Increase In Entity Value. If a redemption is funded by life insurance proceeds, the insurance proceeds will constitute an asset of the entity. In the case of a deceased owner, the life insurance proceeds may increase the value of a deceased owner's interest in the business absent a provision in the Buy-Sell Agreement specifically stating that life insurance proceeds are not taken into consideration in valuing the deceased owner's interest. Once again, without careful planning, this is another disadvantage of the entity repurchase arrangement.

i. **Application of State Law.** The corporate law of some states may prohibit the business entity from purchasing ownership interests of its members if the redemption would render the business entity insolvent as a result of the redemption. See N.C.G.S. §55-6-40(c).

j. **Possible Application of FASB 150**. In May 2003, the Financial Accounting Standards Board issued FASB 150 which requires that certain "mandatorily redeemable financial instruments" be classified as liabilities for GAAP purposes under FASB 150. "Mandatorily redeemable financial instruments" include shareholder stock redemption agreements. Taken literally, FASB 150 would require that any corporation, with a shareholder stock redemption agreement, would have to book a liability, under its GAAP financial statements, for the amount of contingent liabilities which might arise in the future, if the corporation is required to purchase the stock of a shareholder.

The issuance of FASB 150 created a great deal of concern for closely-held businesses that issue GAAP prepared financial statements. Clearly, FASB 150 would produce disastrous financial reporting obligations for any closely-held business which would be required to convert a portion of its shareholder equity into a balance sheet liability for contingent liabilities under its stock redemption agreements.

Fortunately, in November 2003, FASB issued FASB Staff Position 150-3 which indefinitely delays the application of FASB 150 to stock redemption agreements which provide for mandatory redemptions of stock upon cessation of employment due to termination, death or retirement. Thus, for our closely-held business clients, FASB 150 will not now apply to redemption agreements. However, when we structure buy-sell agreements, we must be concerned about whether (or when) FASB 150 would become applicable to mandatory redemption agreements for non-SEC registered businesses.

> **Note:** In light of potential application of FASB 150, some closely-held businesses are converting their traditional entity redemption agreement to a primary cross purchase arrangement which provides for an entity redemption only if cross purchase options are not exercised.

k. **Other Considerations.** In some cases, the terms of loan agreements may restrict the entity's ability to redeem an owner's ownership interest. Moreover, if the entity incurs a debt in order to acquire an ownership interest, this debt on the books of the business entity may inhibit its future ability to borrow money. These are major disadvantages to the entity repurchase arrangement.

C. **Advantages and Disadvantages of the Cross-Purchase Arrangement.**

1. **Advantages.** The primary advantage of the Cross Purchase Arrangement is that it avoids many of the tax disadvantages of the entity purchase arrangement. For instance, with the cross-purchase arrangement, there are no alternative minimum tax or accumulated earnings tax concerns. Furthermore, with a cross-purchase arrangement, capital gains recognition on the sale of a business interest will always be assured. In addition, there are other tax advantages with the cross-purchase arrangement.

a. **Tax Basis Increases.** The primary advantage of the cross-purchase arrangement is that each purchasing shareholder will receive an increase in their tax bases as a result of the purchase of a withdrawing partner's interest. In the case of C corporations, this is a primary disadvantage of the entity purchase arrangement. In the context of S corporations, however, this difference is not as significant where the entity buy-out is funded by life insurance.

b. **Capital Gain Recognition to the Selling Shareholder.** The sale of a selling owner's interest in a corporation to a continuing business owner will always produce capital gain treatment to the selling owner. This is because the dividend equivalency test of IRC §302 will not come into play in the context of a cross-purchase arrangement.

2. **Disadvantages.**

a. **Issuance of Multiple Policies.** The primary disadvantage with the cross-purchase arrangement is the administrative difficulty where a buy-out will be funded by insurance. In the case of a cross-purchase arrangement, each shareholder will be required to own insurance policies on each other shareholder. Thus, the total number of policies required for a cross-purchase arrangement can be calculated using the following formula:

$$N \times (N-1)$$

where N equals the number of owners of the business.

Thus, where there are five business owners, 20 insurance policies would be necessary to fund a cross-purchase arrangement [5 x (5-1)].

b. **Individual Responsibility For Funding Buy-Outs.** Another disadvantage of the cross-purchase arrangement is that each individual business owner must rely on the other business owners' abilities to fund a buy-out. Also, each purchasing owner will face individual liability for the buy-out obligation.

D. **The Use of the Hybrid Arrangement.** As discussed above, with the hybrid arrangement, the tax advantages of a cross-purchase arrangement are combined with the non-tax advantages of an entity purchase arrangement. The hybrid arrangement is essentially a "wait and see" approach in which the business entity and the remaining owners are all designated as possible purchasers of a business interest. Thus, the business owners can allocate the responsibilities for maintaining insurance policies among the business owners and the business entity. In the event of a buy-out, the business owners can decide whether a purchase by the business entity or the individual owners would be most advantageous from a tax planning standpoint.

VIII. Other Buy-Sell Provisions.

A. Introduction. In addition to containing transfer restrictions and provisions for the buy-out of ownership interests, the Buy-Sell Agreement may also address other management and operational issues of the business. Some of these additional provisions will be designed to benefit both majority and minority business owners. However, in many cases, these buy-sell provisions will address certain issues of great significance to the minority owner. In fact, in many cases the specific provisions will be necessary in order to attract minority interest investors. The following is a discussion of some of these issues that may be addressed in a Buy-Sell Agreement.

B. Compensation and Dividend Payment Policies. In order to protect the interests of minority business owners, the Buy-Sell Agreement may contain provisions which limit the payment of compensation to majority owner-employees. This would prevent the majority owners from syphoning out business profits through excessive compensation.

Likewise, in the case of corporate Buy-Sell Agreements, the minority shareholders may require a formal agreement setting forth the dividend policy of the company. In the case of an S corporation, the shareholder agreement may mandate the payment of annual dividends to allow shareholders to pay income tax on their share of S corporation income. Or, in the case of C corporations, a minority shareholder may negotiate a dividend policy which insures that he or she will receive dividend distributions in proportion to the dividend amounts paid to the majority shareholders.

C. Minority Participation in Management. In order to assure that a minority owner is guaranteed a management position within the business, the Buy-Sell Agreement may contain a provision requiring that all owners vote their interests so as to insure representation of the minority owners on the management team.

D. Put Options For Minority Owners. To provide minority owners with a ready market for their business interests and a way to cash out their investment, prospective investors will often require that they be granted some sort of put option to insure that they will always be able to cash out their investment.

E. Arbitration Provisions. The Buy-Sell Agreement should always contemplate the possibility that the business owners may become deadlocked in a disagreement over the management of the business. Because civil litigation can be an extremely expensive (and unfulfilling) experience, the Buy-Sell Agreement may provide for mandatory arbitration in the event that a dispute should arise among the owners. Any such provision should specifically address the method of selecting an arbitrator and how the arbitration fees will be allocated among the parties.

F. <u>"Tag-along" Provisions</u>. A Buy-Sell Agreement may also prevent a majority owner from selling his interest to an outside purchaser unless the remaining owners are also given the opportunity to sell their interests at the same price and on the same terms as are applicable to the majority owner. This type of provision is called a "tag-along" provision which is essentially designed to prevent a "squeeze-out" of minority owners.

G. <u>Capital Calls and Contribution Obligations</u>. If additional capital is needed in order to fund business operations, a key question is where will the funds come from. Often, the buy-sell agreement will obligate the owners to contribute additional operating capital. If any owner fails to contribute additional capital, the buy-sell agreement may authorize a reallocation of equity interest percentages, or the agreement may treat unfulfilled capital calls as a loan to the defaulting partner.

H. <u>Guaranty Provisions and Rights of Contribution</u>. Frequently, one or more of the equity owners will be required to personally guarantee some obligation of the business enterprise. In the absence of a contribution provision in the buy-sell agreement, controversies may arise where less than all of the owners are required to pay off a guaranteed obligation.

PART TWO:
A REVIEW OF SELECTED TAX ISSUES
APPLICABLE TO S CORPORATIONS

I. Preserving S Corporation Status

A. S Corporation Status Provisions. The Buy-Sell Agreement of an S corporation should always prohibit the transfer of S corporation stock to ineligible S corporation shareholders in order to preserve the company's S corporation status. Such a provision would typically include language to the effect that any such transfer to an ineligible S corporation shareholder would be void and of no effect.

B. The Effect of Shareholder Agreements on the Application of the "One Class of Stock" Rules for S Corporations Under I.R.C. Section 1361(b)(1)(D), an S corporation may have only one class of stock. Although an S corporation may have classes of stock which offer differing voting rights, all classes of stock must confer identical rights to distribution and liquidation proceeds. Reg. 1.1361-1(l)(1).

If an S corporation's Shareholder Agreement is not carefully drafted, the existence of the Shareholder Agreement may violate the one class of stock rules. Under Section 1.1361-1(l)(2), a Shareholder Agreement is a binding corporate agreement which must be reviewed to determine whether all S corporation shares of stock confer identical rights to distribution and liquidation proceeds.

For purposes of applying the "one class of stock" rules in the context of Shareholder Agreements, the tax code regulations distinguish between Shareholder Agreement provisions that contain buy-out provisions upon death, disability, termination of employment and divorce, and those Shareholder Agreements which provide for buy-out opportunities upon any other event.

1. Agreements Which Provide for Buyout in the Event of Death, Disability and Termination of Employment or Divorce. As discussed above, many shareholder agreements provide for varying buy-out prices, depending upon whether the buyout occurs because of the death, disability, withdrawal or divorce of the "outgoing shareholder." In some cases, a Buy-Sell Agreement will provide for an increased purchase price in the event of the death or disability of the Selling Shareholder. Generally, the increased purchase price is designed to alleviate the cash-flow pressures which will befall the family of a deceased or disabled shareholder. On the other hand, in some cases, a Buy-Sell Agreement will contain "penalty provisions" which are designed to depress the purchase price where a buy-out is triggered upon divorce or termination of employment.

Under the one class of stock rules, a Shareholder Agreement will be disregarded in determining whether the S corporation has more than one class of stock unless:

(i) a principal purpose of the agreement is to avoid the one class of stock rules: <u>and</u>

(ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess or below fair market value.

Reg. 1.1361-1(l)(2)(iii).

Therefore, in most cases, a Shareholder Agreement will be disregarded in determining whether an S corporation has more than one class of stock, to the extent that the buyout provisions relate only to death, disability, termination of employment or divorce. Reg. 1.1361-1(l)(2)(iii).

For example, assume an S corporation has a Shareholder Agreement in place which provides for a depressed purchase price upon **termination of employment**. Under Reg. 1.1361-1(l)(2)(iii)(B), these provisions will be disregarded in determining whether an employee's stock is subordinate to other shares held by other shareholders.

Likewise, a shareholder agreement that provides for a buyout price upon **death** which is substantially greater than the price offered to other shareholders would not be deemed to confer preferred shareholder rights.

2. <u>Other Buy-Out Events</u>. On the other hand, in those cases where the Buy-Sell Agreement addresses other buyout events (other than death, disability, termination of employment or divorce), then these Buy-Sell Agreements will not be disregarded in determining the one class of stock issue if:

(1) a principal purpose of the agreement is to circumvent the one class of stock requirements; and

(2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

Please note that the Shareholder Agreement will fail to satisfy these rules only if it is determined that the purpose of the buy sell agreement is to circumvent the one class of stock rules, even if it is clear that the buyout price under the Shareholder Agreement differs substantially from fair market value.

For example, assume that an S corporation enters into a Shareholder Agreement which grants the other shareholders a purchase option in the event a shareholder should become insolvent or make an assignment for the benefit of creditors. Also assume that the option price is substantially <u>below</u> the fair market value of the stock at the time the agreement is entered into. In this case, even though the buyout price differs substantially from fair market value, the Shareholder Agreement in this case **does not** violate the one class of stock requirements, unless it can be shown that the purpose of the agreement itself was to avoid the one class of stock rules.

But don't let these rules allow you to become too comfortable in structuring Buy-Sell Agreements, because many traps await around the corner.

For example, in many cases, an investor-shareholder will wish to enter into a Shareholder Agreement, prior to investing, to assure the investor that he or she will be able to realize on his investment at some point in the future. In these cases, the structure of the Buy-Sell Agreement may jeopardize the S corporation status.

> **EXAMPLE**: In 2007, S Corporation offers to issue stock to an investor at an issue price of $10.00 per share which is roughly equal to the fair market of the stock at the date of issuance. Upon investment, S Corporation enters into a Shareholder Agreement with the investor which will give the investor a "put" option to require the corporation to buy back the investor's shares at the expiration of an initial five year period, at a put price of $100.00 per share.
>
> Five years later, the IRS asks to review the company's Shareholder Agreement to determine whether the Agreement violates the "one class of stock" rules. At the time of the audit, the fair market value of the stock is $100.00 per share, which is equal to the buy-out price under the Shareholder Agreement.
>
> In this case, the put price under the Shareholder Agreement substantially exceeds the fair market value of the stock **at the date the agreement was entered into**. In addition, since the purpose of the Shareholder Agreement was to provide the investor with a ready market for his stock, the IRS may succeed in concluding that a principal purpose of the Shareholder Agreement was to avoid the one class stock rules.

II. Income Tax Allocations for S Corporation Buy-Outs.

In structuring the terms of Buy-Sell Agreements for S corporations, the parties should specifically provide for allocation of income and loss items in the event of a future stock buy-out. The S corporation shareholders should remember that, in the event of a buyout of S corporation stock, the allocation of S corporation income and loss items during the year of the buy-out will affect:

- The income tax liabilities of the selling and continuing shareholders.
- Whether S corporation distributions during the tax year will be treated as taxable dividends to the shareholders.
- The determination of the selling shareholder's tax basis in the sold S corporation stock.
- The calculation of tax basis for the continuing shareholders .

EXAMPLE: ABC, Inc. is an S corporation with 2 shareholders, X and Y. On June 30, 2012, X purchases all of Y's stock in ABC, Inc. pursuant to the terms of the company's shareholder agreement. As of June 30, ABC, Inc. has incurred net operating losses of $100,000. Prior to the buy-out, ABC, Inc. made S corporation distributions to X and Y. During the remainder of 2012, ABC, Inc. recognized $300,000 in profits and made additional S corporation distributions to X.

Consider what effect the buy-out will have on the tax liability of X and Y during 2012 under the general S corporation income allocation rules.

Under the general S corporation income allocation rules, X and Y will be allocated income and losses on a per-share per-day basis, which means that Y will be allocated $50,000 in S corporation taxable income for the year (taxed at ordinary income tax rates), and X will be allocated $150,000 in taxable income.

These general income allocation rules will **also** affect:

- The calculation of Y's tax basis in his ABC, Inc. stock, and thus the amount of taxable gain he is required to recognize on the sale to X;

- X's end of the year tax basis in his ABC, Inc. stock; and

- If ABC, Inc. has accumulated E&P from previous C corporation tax years, whether X or Y (or both of them) will be taxed on the ABC, Inc. distributions they received during the year.

Therefore, in this case, it may be "fairer" for the parties to make an election to terminate the tax-year of ABC, Inc. and treat ABC, Inc. as having 2 separate tax years. (See Section 1377). If such an election were made, Y would be allocated $50,000 in losses, and X would be allocated $50,000 in losses and all of the $300,000 income.

Therefore, whenever an S corporation is involved, the parties to the Buy-Sell Agreement should address if and when these such elections will be made.

III. Mandatory S Distributions to Cover S Corporation Tax Liabilities.

Since S corporation shareholders are required to pay income tax on their distributive share of S corporation income, most S corporation Buy-Sell Agreements will mandate annual, or perhaps quarterly, distributions to cover end-of-the-year and estimated tax payments. This provision will protect minority shareholders from having to pay income tax on "phantom" S corporation income.

Warning! Beware of the "One Class of Stock" Rules! Any such mandatory distributions should not be made with specific reference to each shareholder's specific marginal tax rates, because this arrangement could result in disproportionate distributions which could result in the termination of the S election, if the shareholders are subject to differing marginal tax rates. Instead, the Buy-Sell Agreement should mandate distributions to all shareholders at the highest combined federal and state marginal tax rate present among the shareholders.

PART THREE
STRUCTURING BUY-OUTS USING REDEMPTIONS
VS. CROSS PURCHASE BUY-OUTS

I. In General.

Perhaps the most complicated (and often least understood) tax consideration in structuring a buy-out is whether to structure a buy-out through a redemption versus a cross purchase transaction. As discussed above, the Entity Redemption form of a Buy-Sell Agreement is often easier to structure and administer than is the Cross Purchase arrangement.

The advantages of the Entity Redemption arrangement over the Cross Purchase Arrangement are as follows:

1. Entity Buy-Out Obligation. The entity (rather than other owners) are primarily responsible for fulfilling the buy-out obligation.

2. Simplification of Insurance Plan. The entity needs to maintain only one insurance policy per owner.

The potential disadvantages of the Entity Redemption Arrangement, and hence the advantages of the Cross Purchase Arrangement, are

1. **Continuing owners usually receive no tax basis increase** where entity funds are used to fund a buy-out of the selling owner.

2. **Possible dividend (rather than capital gain) treatment to the selling shareholder** where the redeeming corporation has accumulated earnings and profits from C corporation tax years.

II. Income Tax Basis Considerations for the Continuing Owners. The distinction between the Cross Purchase Arrangement and the Entity Redemption Arrangement will affect whether the continuing owners will be able to increase their tax basis of their closely-held business interests upon the buy-out of another owner.

A. C Corporations. If a C corporation redeems stock of a withdrawing owner, the remaining shareholders do not receive a "step up" in their tax bases as a result of the redemption. At the same time, however, each remaining shareholder's proportional ownership interest in the value of the business will increase. If the remaining shareholders anticipate selling their stock before their death, this income tax basis issue will be a major disadvantage of the Entity Repurchase Arrangement.

B. S Corporations. In the context of S corporations, however, this difference is not as significant where the entity buy-out is funded by life insurance upon the death of the redeemed shareholder. The reason for this is that, in the case of S corporations, the receipt of life insurance proceeds will result in a basis increase for each person who is a shareholder of the S corporation at the time the S corporation accrues the right to receive the insurance proceeds.

Thus, if the S corporation is an accrual basis taxpayer, then part of the basis step-up will inure to the benefit of the deceased shareholder. Nevertheless, the remaining S corporation shareholders will receive some benefit from the basis increase from the life insurance proceeds.

In the case of a cash basis S corporation which purchases the S corporation stock of a deceased shareholder, the life insurance proceeds will result in a basis step-up only for the surviving shareholders, as long as the buy-out occurs before the S corporation receives the life insurance proceeds.

For example, in PLR 200409010, the IRS ruled that the redemption of a deceased shareholder’s stock prior to the accrual basis corporation’s receipt of life insurance proceeds and the corporation’s election to terminate the tax tear of death will not serve to prevent the allocation of tax basis to deceased-selling shareholder. This PLR presents a clever attempt to resolve problems presented by life insurance payable to an accrual basis S Corporation. Under the facts of this ruling, an accrual basis S Corporation held a life insurance policy on the life of a deceased shareholder.

In the PLR, the Corporation stated that it was planning to redeem the stock held by the deceased shareholder by issuing to his estate a promissory note - prior to receipt of the proceeds of life insurance or even prior to submission of a claim for payment of the death benefit proceeds. In addition, after the redemption, the remaining stockholders intended to make an election under IRS Section 1377 to terminate the corporation’s taxable year to insure that, after termination of the corporation’s taxable year after the redemption but prior to the submission of a claim on the life insurance policy, the remaining stockholders could seek to have all of the insurance proceeds allocated to their share of stock in the S Corporation.

The S Corporation, requesting the PLR, stated that the purpose of this PLR request was to insure that the stock of the deceased shareholder would not be increased by the amount of insurance proceeds that would have been allocable to his estate in the absence of the closing of the S Corporation’s taxable year.

However, the IRS ruled in this case that, notwithstanding the S Corporation’s intention to terminate the tax year prior to receipt of the death benefit proceeds or submission of a death benefit claim, the full amount of the life insurance proceeds received by the accrual method S Corporation would have to be allocated to all the shareholders (including the decedent) based upon their stockholder interests as of the date of death. This PLR makes it clear that, in cases where an entity redemption arrangement is in place for an accrual basis S Corporation, a potential train wreck lies ahead.

C. **Partnerships and LLCs.** In the case of partnerships and LLCs, an entity redemption does not automatically allow the continuing owners to increase their individual tax bases in their interests in the partnership or LLC. In the case of cross purchase of partnership or LLC interests, there is an automatic increase in tax basis without any affirmative action on the part of the partners or LLC members.

Where the LLC or partnership holds life insurance to fund a buy-out, the receipt of life insurance proceeds will result in a tax basis increase for all persons who are members of the LLC or partnership when the LLC or partnership accrues the right to receive the insurance proceeds. Thus, in the case of an accrual basis LLC, part of the tax basis increase will inure to the benefit of the deceased-selling LLC member. Likewise, in the case of a cash basis LLC which receives life insurance upon the death of a member, part of the basis will inure to the benefit of the deceased member, unless the buyout is completed before the LLC receives the life insurance proceeds.

Also note that, regardless of whether there is an entity redemption arrangement or cross purchase agreement, the continuing owners of an LLC or partnership should consider the potential benefits of making a Section 754 election after a buy-out. If the partnership or LLC makes a "Section 754 election", the partnership or LLC may be allowed to increase the entity's tax basis in its assets if the outgoing partner or member recognizes gain on the redemption. This will have the effect of reducing future recognition of taxable gain to the continuing owners. The potential problem, however, is that the entity must not fail to affirmatively and timely elect to make a Section 754 election to increase the entity's tax basis in its assets.

III. Dividend v. Capital Gains Treatment to the Redeemed Shareholder.

A. **S Corporations with No C Corporation E and P.** If a buy-out is structured using the Entity Redemption Arrangement, and the redeeming corporation is an S corporation with no accumulated C corporation E & P, the redeemed shareholder will recognize **capital gains** to the extent the redemption proceeds exceed the selling shareholder's tax basis in the S corporation stock.

B. **C Corporations and S Corporations with C corporation E & P**. However, if the redeeming corporation is a C corporation or an S corporation with C corporation E & P, then the provisions of IRC Section 302 will apply to determine whether the redemption will be treated as a **dividend** or as a **capital gains transaction**.

Under IRC §302(b), the redemption will qualify as a capital sale or exchange of a capital asset if the redemption:

- effects a complete termination of the selling shareholder's stock ownership;

- is "not essentially equivalent to a dividend". (A redemption will not be essentially equivalent to a dividend if the redeemed shareholder's proportionate interest in the corporation is less than 80% of his ownership interest before the redemption); or

- constitutes a "substantial disproportionate redemption."

However, if the redemption fails to qualify as a capital gains transaction under any of the above referenced tests, then the redemption will be treated as a **dividend** which may produce disastrous tax consequences to the redeeming shareholder.

C. <u>The Family Attribution Problem For C Corporations and S Corporations With Accumulated C Corporation E & P.</u>

The problem here is that, in the family business context, the family attribution rules of IRC §318 may apply whenever a family member's stock is redeemed. As a result of the attribution rules, the redemption of a family member's stock may not constitute an adequate reduction in the family member's interest in the business. This could cause a redemption to be recharacterized as a dividend distribution.

As a result of the family attribution rules, an Entity Redemption Arrangement may be inappropriate in the family business context for C Corporations and S Corporations with accumulated C Corporation E & P, since any redemption could be recharacterized as a dividend.

D. A Case Study Example.

1. <u>Fact Background.</u>

- Smith Co. is a family-owned S corporation which is owned by three individuals, Father (60%), Son (20%) and Daughter (20%).

- Son and Daughter acquired their stock ownership in Smith Co. from Father as part of Father's annual gifting program for estate tax avoidance purposes.

- In 1997, Father decides to retire from Smith Co. At the time of Father's retirement, Father's income tax basis in his stock is $100,000.

- When Father announces his retirement, Son and Daughter agree to purchase Father's stock for $550,000 with $50,000 being paid to Father now and $500,000 paid over the next 10 years.

- At that time, Smith Co. has $550,000 in cash on hand (enough to purchase Father's stock). Smith Co. also has an accumulated adjustments account (AAA) of $50,000 and has $300,000 of undistributed C corporation Earnings and Profits from pre-S election years.

2. How should this purchase be structured: through a Cross Purchase Arrangement or by having Smith Co. redeem Father's stock?

3. Father's Tax Concerns.

Regardless of how the sale-purchase is structured, Father wants to ensure that his sale of stock will qualify for capital gains treatment. This will allow Father to:

1. deduct his tax basis from the sales proceeds;
2. recognize postponed gain under the installment method; and
3. recognize capital gains at capital gains tax rates.

4. Tax Concerns of Son and Daughter.

Son and Daughter are concerned about how they will fund the 10 year purchase obligation, and whether they will be able to increase their tax basis in their stock as payments are made to Father.

Son and Daughter realize that if, an Entity Redemption Arrangement is used and corporate funds are used to purchase Father's stock, Son and Daughter may not be able to increase their tax basis for the annual note payments, unless the note payments are made from annual S corporation earnings which increase their stock basis from year to year.

On the other hand, Son and Daughter also realize that they may not have adequate means, on their own, to purchase Father's Stock under a Cross Purchase Arrangement. Therefore, if the parties use a Cross Purchase Arrangement, Son and Daughter may have to use corporate distributions to meet their annual purchase obligations. These annual distributions to Son and Daughter will either be:

1. "Bonus" distributions which may be subject to payroll taxes;

2. S corporation distributions which may be treated as dividends if the AAA account ($50,000 now) is not sufficient to cover future annual distributions.

5. What options are available to Father, Son and Daughter?

6. Alternative One: Structure the Purchase as a Redemption.

If Smith, Co. redeems Father's stock for $50,000 cash and a $500,000 note, this redemption presumably would qualify for capital gains treatment under Section 302, since the redemption would completely terminate Father's stock ownership.

However, the family CPA advises them that the "family attribution" rules of Section 318 must be reviewed to determine whether a complete redemption of Father's stock has occurred. Under the general Section 318 parent-child attribution rules, Father will be deemed to own all of the stock then owned by Son and Daughter even after the redemption, and thus Father will not be able to meet the "complete termination" requirement.

This means that, unless the family attribution rules can be avoided, Father's redemption will be treated as a dividend and not as a capital gain.

Fortunately, however, Father may be able to avoid the family attribution rules (and accomplish a complete termination of his stock) if three requirements are met:

1. After the redemption, Father will have no interest in Smith, Co. other than as a creditor.

2. Father will not acquire any interest in Smith Co. over the next ten years.

3. Father files an agreement with the IRS to notify the IRS if he acquires any interest in Smith, Co. over the next 10 years.

I.R.C. 302(c)(2)(A).

But we are not out of the woods yet.

Even if Father meets all three of the above-mentioned family attribution rules, the parties will not be able to "waive" family attribution if Son and Daughter have acquired their stock from Father during the past 10 years in a "tax avoidance" transaction. I.R.C. 302(c)(2)(B)(ii).

Fortunately, however, the IRS in the past has ruled that prior gifts to children do not violate the "waiver of family attribution" rules if the gifts were part of a plan to transition the business to succeeding generations. Rev. Rul. 77-455; LTR 8637090.

Therefore, it appears that Father can achieve capital gains treatment through an Entity Redemption Arrangement.

But will this address the tax concerns of Son and Daughter?

The answer to this question may be "no" since an Entity Redemption Arrangement may not allow Son and Daughter to get any tax basis increase as future note payments are made to Father unless these future note payments are made from annual corporation profits.

Therefore, in light of their concerns, Son and Daughter may have to structure the purchase as a Cross Purchase Arrangement to ensure Son and Daughter that they will get to increase their stock basis as payments are made to Father.

7. <u>Structure the Purchase as a Cross Purchase</u>

Under the Cross Purchase Arrangement, since Son and Daughter will be purchasing Father's stock directly, they will be able to increase their tax basis in their corporate stock as note payments are made to Father. Also, since Father will not receive any payments directly from Smith Co., there is no danger that Father's buy-out will be structured as a dividend, rather than as a capital gains transaction.

However, whenever a Cross Purchase Arrangement is used, the issue arises as to how the purchasers will be able to fund their purchase obligation.

In this example, if Son and Daughter do not have sufficient resources of their own to fund the buy-out, they will have to withdraw funds from Smith Co. each year in order to meet their annual payment obligations. These annual withdrawals will be treated:

- as non taxable dividends (if AAA is sufficient to cover their note payments to Father); or

- as a bonus or loan (if AAA is not sufficient to cover their note payments to Father).

The foregoing example is an adaptation of Case Study 12B found on page 12-31 of PPC Tax Planning Guide - S Corporations (Practitioners Publishing Company).

IV. An Alternative Buy-Sell Arrangement For Corporations: The Life Insurance Partnership.

A. In general. As discussed above, the primary disadvantage with a Cross Purchase Arrangement is the administrative difficulty in maintaining multiple insurance policies on the lives of each business owner. On the other hand, because of its tax disadvantages, the Entity Redemption Arrangement may not be a suitable alternative to the Cross Purchase Arrangement. This is especially true where C corporations are involved since most of the tax disadvantages of the Entity Redemption Arrangement are uniquely applicable to C corporations (such as alternative minimum tax, dividend/capital gain recognition and income tax basis considerations). In fact, in light of these tax disadvantages, the hybrid arrangement may not be entirely satisfactory either.

Therefore, in recent years a great deal of interest has arisen in the use of life insurance partnerships.

B. The Life Insurance Partnership. A life insurance partnership is a partnership among the business owners. The partnership would own the life insurance policies on each partner-shareholder. At the death of the partner-shareholder, the partnership would use the life insurance proceeds to purchase the deceased partner-shareholder's stock. The surviving partners-shareholders would then acquire the deceased partner-shareholder's beneficial interest in the policies insuring their lives.

C. The Advantages of the Life Insurance Partnership. The advantages of the Life Insurance Partnership over the Cross Purchase and Entity Redemption Arrangements are obvious:

1. only one policy per owner is necessary;

2. a buy-out at death will always be treated as capital gain;

3. the surviving business owners get a "step-up" increase in tax basis.

4. potential “transfer for value” rules would be avoided since the deemed transfer of life insurance policies would be deemed a transfer to the partners. Internal Revenue Code Section 101(a)(2)(B).

Although there have been a few private letter rulings in this area, there is little authority with respect to this technique, and each particular situation should be addressed carefully before implementing a life insurance partnership.

PART FOUR
ESTATE AND GIFT TAX CONSEQUENCES OF BUY-SELL AGREEMENTS

I. "Fixing" Estate and Gift Tax Values

A. In General. As discussed above, in the event of the death of a business owner, the terms of the Buy-Sell Agreement may "fix" the estate tax value of a deceased owner's interest in the business. Thus, in the context of a family business, the Buy-Sell Agreement may be properly structured so as to "freeze" the value of the business interests for estate tax purposes. On the other hand, if a Buy-Sell Agreement is prepared for a family business without appropriate consideration to estate tax consequences, the deceased owner's estate may be burdened by an inflated valuation.

The following is a discussion of the rules for "fixing" the estate tax value of business interests through the use of a Buy-Sell Agreement.

As a result of IRC Section 2703, which was added to the Internal Revenue Code as part of the Revenue Reconciliation Act of 1990, the rules for fixing estate tax values under Buy-Sell Agreements will vary depending upon whether the agreement was executed before or after October 9, 1990.

B. Pre-October 1990 Agreements. Reg. 20.2031-2(h) indicates that the existence of a Buy-Sell Agreement may have an effect on the value of the business interests for estate tax purposes. Under the relevant case law, a buy-sell arrangement will "fix" the estate tax value of a business interest if the following four requirements are met:

1. Price. The buy-sell price must be fixed or determinable under the terms of the agreement.

2. The Estate Must be Obligated to Sell. The estate must have been obligated to sell at the fixed price under the terms of the Buy-Sell Agreement. Thus, if the business or surviving owners are given **options** to acquire the interests of a deceased owner, this usually will fix the estate tax value since the estate would be obligated to sell in the event of the exercise of those options. See Estate of Carpenter, T.C. Memo 1992-653.

On the other hand, if the Buy-Sell Agreement merely gives the surviving owners a right of first refusal, then this will not establish the estate tax value since the estate in that case is not obligated to sell its interest in the business. Estate of Pearl Gibbons Reynolds, 55 T.C. 172 (1970). Of course, if the surviving owners have a right of first refusal, this may lower the value of the business interest for estate tax purposes. See Reynolds, 55 T.C. 172 (1970); Worchester County Trust Co. v. Comm'r., 134 F.2d 578 (1943).

3. Binding Obligation During Lifetime. The deceased owner's obligation to sell at the buy-sell agreement price must be binding during his lifetime. Revenue Ruling 59-60, 1959-1 C.B. 237. For instance, if a corporate shareholder, during his lifetime, was subject to a right of first refusal to the corporation and the other shareholders who could elect to buy-out the selling shareholder's stock at the **lower of** the price offered by the third party or the price set out in the buy-sell agreement, then this would constitute a lifetime obligation which would "fix" estate tax values. However, if the agreement does not restrict lifetime transfers but simply provides for a buy out at death, then there will be no lifetime obligation to sell and thus the agreement will not fix the estate tax values. See Harwood, 82 T.C. 239 (1984). Likewise, where a shareholder, during his lifetime or at death, could transfer his stock to any person at any price without first offering to sell his stock to the remaining shareholders, the buy-sell agreement did not "peg" the estate tax values. Matthews v. Comm'r, 3 T. C. 525 (1944). In the case of Obering v. Comm'r, since the buy-sell agreement did not prevent a transfer to another shareholder during lifetime, the existence of the buy-sell agreement was one factor, but not a determinating factor, to be considered in determining estate tax values. Obering, 48 T. C. M. 733 (1984).

4. The Buy-Sell Agreement Must be a Bona Fide Business Arrangement And Not Merely a Device to Pass Interests to Family Members For Less Than Adequate Consideration. In order to establish that the Buy-Sell Agreement is a bona fide business arrangement, and not simply designed to pass assets to the next generation tax free, the terms of the Buy-Sell Agreement should be established by negotiation among the parties, and the buy-out price must be fair when the agreement is made. In addition, there should be substantial evidence that the buy-out price was established based upon some reasonable means (through an appraisal, based upon industry information, etc).

C. Buy-Sell Agreements Executed after October 1990 and Buy-Sell Agreements Substantially Modified after October 1990. When IRC Section 2703 was added to the Internal Revenue Code, a new set of rules became applicable to Buy-Sell Agreements executed after October 1990, and to Buy-Sell Agreements executed before 1990 if there is a substantial modification in the Buy-Sell Agreement after October 1990.

If a Buy-Sell Agreement was executed or substantially modified after October 1990, then Section 2703 states that a Buy-Sell Agreement will not be determinative of the value of a business interest for estate tax purposes unless all of the following three (3) requirements are met:

1. The Buy-Sell Agreement must be a bona fide business arrangement;

2. The Buy-Sell Agreement must not be a device to transfer the business interests to the decedent's heirs for less than full consideration; and

3. The terms of the Buy-Sell Agreement must be comparable to similar arrangements entered into by persons in arms length transactions.

D. Final Points to note about Section 2703:

1. Section 2703 Exception for Unrelated Parties. Reg. 25.2703-1(b)(3) provides that a Buy-Sell Agreement will be deemed to have met the three statutory exceptions to Section 2703 if more than fifty percent (50%) of the value of the business is owned by unrelated individuals. Thus, if the business enterprise is not exclusively a family owned business, then Section 2703 may not operate to prevent the terms of the Buy-Sell Agreement from fixing the estate tax value.

2. Section 2703 Does Not Automatically Assure an Estate Freeze. Please note that Section 2703 does not replace prior case law regarding the effects of the existence of the Buy-Sell Agreement on the estate tax value. Thus, even if the agreement satisfies the three requirements of Section 2703, the agreement still will not fix the estate tax value of the business interest unless the other prior case law requirements (Section I (B) above) are met. See S. Budget Comm., 101st Cong., 2d Sess., Informal Report on S. 3209, 136 Cong. Rec., S15,629, S15,683 (Oct. 18, 1990) (indicating that the new Section 2703 would not otherwise alter requirements for a buy-sell agreement, such as the requirement that it have lifetime restrictions in order to be binding at death): See also Treas. Reg. 20.2031-2(h).

E. Gift Tax Consequences. The IRS generally takes the position that a Buy-Sell Agreement will not "freeze" the value of corporate stock for gift tax purposes unless the requirements of Section 2703 are met. Nevertheless, in prior cases, courts have held that the existence of a Buy-Sell Agreement may have a depressing effect on the value of corporate stock for gift tax purposes, especially where the transferred stock was subject to a Buy-Sell Agreement which grants rights of first refusals in the event of an attempted subsequent sale of the gifted stock. See for example Chamberlain v. Commissioner, 2 T.C.M. 469 (1943) and McDonald v. Commissioner, 3 T.C.M. 274 (1944). In both of these cases, the Tax Court held that, although the buy-sell provisions did not establish the gift tax value of the gifted shares, the existence of the rights of first refusal nevertheless had a depressing effect on the gift tax value of the shares.

II. The Effect of Buy-Sell Agreements on the Estate Tax Marital Deduction for Estate Planning Purposes.

Another potential trap for the unwary in dealing with Buy-Sell Agreements is the possible consequences that the existence of a Buy-Sell Agreement may have upon whether a gift or bequest will qualify for the marital deduction for estate tax purposes. Frequently, under an estate plan, a substantial portion of a decedent's estate will pass to the surviving spouse either outright or through a type of trust (such as a qualified terminal interest property trust) which qualifies for the marital deduction for estate tax purposes.

Under Section 2056, an estate may claim the marital deduction for the value of property passing to a surviving spouse at the decedent's death. No marital deduction will be available, however, where the surviving spouse's interest may terminate or fail on the happening of certain events.

Under Sections 2056(b), no marital deduction is allowed if an interest transferred to a spouse is a "terminable interest." Under Reg. 25.2056(b)-1(b), a terminable interest is an interest which will terminate or fail on the lapse of time or upon the occurrence or failure to occur of some contingency. Likewise, under 2056(b)(5), a marital trust will qualify as a qualified terminable interest property trust only if the trust insures that no person other than the surviving spouse will ever be entitled to any distributions from the trust.

Therefore, for example, where stock is transferred or bequeathed to a spouse of the transferor, or to a trust for the spouse's benefit, subject to a buy sell agreement, the issue arises as to whether the purchase options in favor of other third parties could be deemed to cause the termination of the spouse's interest. If this is the case, then the gift to the spouse will be a "terminable interest" which will not qualify for the marital deduction.

In TAM 9147065, the decedent bequeathed all of his stock in a closely held corporation to a QTIP trust for the benefit of the surviving spouse. Under the decedent's will, however, the decedent's two children had the option to purchase his stock in the closely held corporation at any time within the next two years at an option price of $1,000 per share. At the time of the decedent's death, the fair market value of each share of stock in the decedent's estate was $11,000 per share.

In that case, the estate sought to claim the marital deduction for the value of the stock passing to the QTIP trust. However, the Internal Revenue Service disallowed the marital deduction to the extent of the stock transferred to the QTIP trust. In light of the fact that the option price was so far substantially below current fair market value, the IRS concluded that the existence of the option constituted a power of appointment in favor of the decedent's children. In essence, over 90% of the value of the stock placed in the trust would pass to the sons upon their exercise of the purchase options. Thus, the sons had a power of appointment over the marital trust property in favor of themselves which caused the trust to be disqualified from the marital deduction. See also TAM 9139001 (April 30, 1991).

Likewise, in Renaldi v U. S., 97-2 USTC ¶ 60,281 (Fed. Cl. 1997), aff'd, 178 F. 3d 1308 (Fed. Cir. 1998), the court held that a bequest of stock to a QTIP trust did not qualify for the marital deduction, because the decedent's son was given the right, under the decedent's Will, to purchase stock at less than fair value - even though the stock was actually redeemed at fair market value before the estate made the QTIP election.

III. Provisions in the Buy-Sell Agreement May Prevent Gifts of Business Interests From Qualifying for the $13,000 Annual Gift Tax Exclusion.

In Hackl v. Commissioner, 335 F.3d 664 (7th Cir. July 7, 2003), aff'g, 118 T.C. 279 (2002), Albert and Christine created Treeco LLC, to own and operate a tree farm. They anticipated that the farm would produce no current income, but would eventually produce significant capital gains. The taxpayers formed the LLC, transferred assets to it, and then assigned LLC membership interests to their children, their grandchildren, and to trusts for their grandchildren.

The LLC Operating Agreement named Albert as the manager of the LLC for life, and gave him the right to determine when and if distributions would be made, but any distributions had to be made to all members of the LLC, in proportion to their membership interests. No member could withdraw any of his or her capital account or compel the LLC to make any distributions without the approval of the manager.

In addition, under the LLC Operating Agreement, Members could not withdraw from the LLC without the prior consent of the manager. A member could, however, offer to sell his or her units of LLC interest to the LLC, if the manager chose to buy them. A member could sell or otherwise transfer his or her interest to an outside third party only with the manager's consent. Each member could vote to remove the manager and elect a successor, though an 80-percent vote was required to do so.

The Hackl's gift tax returns were audited, and the IRS asserted a gift tax deficiency of $400,000 on the basis that gifts made by Mr. and Mrs. Hackl during the tax years did not qualify for the $10,000 annual gift tax exclusion.

The Tax Court agreed with the IRS that the taxpayers' gifts of membership interest did not qualify for the gift tax annual exclusion, because the restrictive provisions of the LLC agreement did not give the donees a "present interest" with respect to gifted LLC membership interests. The Court stressed that the present interest rule requires that the donee receive a "substantial present economic benefit" from the possession, use, or enjoyment of the gift property or the income generated by the gift property, which benefit the court found lacking in this case. Citing *Fondren v. Commissioner* 324 U.S. 18, 20-21 (1945)*; Ryerson v. United States,* 312 U.S. 405, 408 (1941)*; United States v. Pelzer,* 312 U.S. 399, 403-404 (1941). The court stated that transfers of interests in a family LLC were taxed under the same rules applicable to transfers of interests in trust, because to do otherwise would be to allow the taxpayers' choice of the form of transfer to dictate the tax results.

The court also rejected the taxpayers' contentions that the annual exclusion should be available because the donees' interests were fully vested, and were identical to the interests retained by the donors. The court stressed that neither of these facts established the existence of a substantial economic benefit. The court rejected the argument that the future gains from the property created a present interest, because those gains were postponed and were not, therefore, a present substantial benefit. The court also denied that there was a present interest in the income from the LLC, because the LLC held non-income producing assets and anticipated retaining those assets indefinitely.

The Seventh Circuit affirmed, in a relatively brief opinion. The court noted that the burden is upon the donor to show that the gift was of a present interest qualifying for the annual exclusion. The court viewed the essence of the taxpayer's contention as that the annual exclusion applies if the donor transfers full ownership of an interest, retaining no rights in the transferred assets. The court stated that the regulations' definition of a present interest as "[a]n unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)" does not automatically cause an outright transfer to constitute a present interest gift. Regs. § 25.2503-3.

The court also relied on its prior decision in *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000), in which the forgiveness of a corporation's debt was deemed to be a future interest, because shareholders could not individually realize the gift without liquidating the corporation or declaring a dividend, and no one individual, under the corporation's bylaws, could compel these events. In other words, the court stated, a "present interest" requires the right to substantial present economic benefit, which did not occur in *Hackl*, because the operating agreement so restricted the transferred voting shares so as to render them "essentially without immediate value to die donees."

The operating agreement in *Hackl* gave the donee members very little control over the economic activities and benefits of the LLC, but these terms are only slightly more severe than those of most FLPs and LLC's.

> **Note:** One approach adopted to create a present interest is to permit the donee members freely to sell their membership interests. This caries no significant risk that the donees actually will sell their interests, because virtually no one will buy a minority or nonvoting interest in an FLP or LLC. In *Hackl*, however, the members could sell their assignee interests, but not their membership interests. It is not clear that a right to sell one's membership interest would provoke a different response than the rights held in *Hackl*.
>
> Another approach to assuring the availability of the gift tax annual exclusion for a gift of an FLP or LLC interest is to give the donees a *Crummey* withdrawal power with respect to gifts of their interests. Such a right would enable the donee to withdraw their share of the partnership capital for a limited period after each gift. Such a right would, however, reduce or eliminate any discount for lack of marketability or control with respect to that portion of each gift that qualified for the annual exclusion, but that is a modest penalty to pay for the entire elimination of the gift tax on the first $11,000 of gifts to each donee each year.
>
> The best approach may be to give each donee the temporary right to "put" his or her interest to the partnership for an amount equal to its fair market value, taking into account all applicable discounts. This is functionally equivalent to a *Crummey* power, and so should obtain the gift tax annual exclusion. It also should preserve the appropriate discounts. The lapse of the put right could be an event described in Section 2704(a), but this would cause a taxable transfer by the donee of the difference between the value of the partnership interest with the put right and the value of the interest without it. Code § 2704(a)(2). This figure should be zero.

CONCLUSION

By implementing a buy-sell agreement, business owners can gain some sense of security and predictability in an otherwise insecure and unpredictable relationship. A buy-sell agreement can address a number of issues in the business relationship, including potential voluntary and involuntary transfers, death, deadlock and disability. Proper structuring of the agreement, including establishing a method to determine the purchase price, who will be the purchaser and how to fund the purchase of stock, is imperative to meet the intentions of the parties.