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Drafting an Effective Buy-Sell Agreement with Emphasis on Estate Tax Valuation of Close Corporate Stock

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DRAFTING AN EFFECTIVE BUY-SELL AGREEMENT WITH EMPHASIS ON ESTATE TAX VALUATION OF CLOSE CORPORATE STOCK

The value of shares in a close corporation can be fixed for estate tax purposes by use of a "buy and sell" agreement prior to death. While this is undoubtedly true, this over-simplifies a complex matter.

At the outset it should be noted that the amount of writing on the subject of the so-called "buy-sell" agreement and its relationship with our taxing structure is quite extensive.[1] The cases, however, litigating the precise question of their binding effect on the commissioner in his evaluation for estate taxes are considerably less numerous, particularly at the appellate level. There is practically nothing which has reached the Supreme Court that is helpful on the question of standards or guidelines.

While the primary concern of this paper is the close corporation, usually a family operation whose stock has no ready market, the points taken herein will almost uniformly be applicable in theory to similar business interests with no established market value, *e.g.*, partnerships.

For the most part this paper will encompass an attempt to survey and categorize, as narrowly as possible, the requirements for drafting effective (taxwise) "buy-sell" agreements based on the latest promulgations of the Internal Revenue Service (hereinafter designated IRS) and the Treasury, together with the latest pronouncements of the courts and some writers.

Inherently, the problem of valuation of stock in a closely held corporation is subject to confusion and disagreement. The standard measure of value for all property for estate taxes is the fair market value[2] "at the time of . . . death,"[3] and since there is no established market value for stock in a close corporation, it becomes a matter of computation *ad hoc*. On the point of time of measurement and whether it is the value to the deceased just prior to death or to his estate, much confusion has existed. The latest pronouncement in this area comes from the Fifth Circuit Court of Appeals in *United States v. Land*,[4] where the court held that the point of measurement is to be the instant of death no matter how fleeting; reasoning, that since the tax is an excise tax on the transfer, valuation should be at the time of transfer, and that is the time of death. On the measure of

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[1] Lowndes & Kramer, Federal Estate and Gift Taxes 485 n. 40 (2d ed. 1962).
[2] Treas. Reg. § 20-2031-2 (1958).
[3] Int. Rev. Code of 1954, § 2031(a).
[4] 303 F.2d 170 (5th Cir. 1962).

value the court said ". . . (V)alue looks ahead. To find fair market value of a property interest at decedent's death we put ourselves in position of a potential purchaser of the interest at that time."[5] In this decision we have, in effect, a reiteration of one fairly well accepted standard of value: the maximum price realizable by the estate.[6]

In valuation of closely held stock, the Internal Revenue Code itself is helpful only to the extent of specifically providing that in the case of an unlisted stock a comparison with listed securities of a similar business shall be considered.[7] The Commissioner, however, does suggest a list of factors to use in determining the proper value, while recognizing that there can be no general formula applicable to the many varied situations which arise. See the following:[8]

a) The nature of the business and its history;
b) The economic outlook in general and in specific;
c) The book value and financial condition of the corporation;
d) Earning capacity;
e) Dividend paying capacity;
f) The existence of goodwill and like intangibles;
g) Past sales of stock and size of the block; and of course,
h) The market price of stock in like corporations whose stock is "freely traded."

It should seem fairly obvious that an estate owning stock in a close corporation is likely to be taxed on a much higher basis than in case of listed securities which have a definite value. Experience has shown the market price on listed securities ordinarily to be much lower than the theoretical fair market value determined as in case of closely held stock by an examination of financial data and the usual methods of valuation.

According to one writer, business interests of no established market value are particularly vulnerable to overvaluation by "attribution of a fictitious good will to the business based upon a capitalization of probable future earnings which reflect the wildest optimism on the part of the treasury."[9]

One widely used and reasonably successful method of protection from such over-evaluation is our "buy-sell" agreement. These agreements in general provide for a sale at death at a fixed figure—specifically or by formula—and thus hopefully establish a specific

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[5] *Id.* at 173.
[6] United States v. Land, *supra* note 4; Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932).
[7] Int. Rev. Code of 1954, § 2031(b).
[8] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.
[9] Lowndes & Kramer, *op. cit. supra* note 1, § 18.45.

value to the estate for tax valuation. Additional obvious advantages of having such a fixation include: permitting more intelligent estate planning and the preclusion of costly involvements with the IRS over the proper valuation. Probably the biggest inducement for contracting such "buy-sell" agreements is the protection of the interests of the surviving members for the uninterrupted continuance of the business.

Since the actual influence of "buy-sell" contracts on valuation is not entirely clear, by reason of the fact that the Supreme Court has not yet ruled on their effect, drafting one should entail considerable consideration. In reality, it is fairly certain that with proper planning, the price fixed under a restrictive agreement can be made conclusive of value for federal estate tax purposes, and for that matter, for state inheritance tax purposes.[10]

In drafting an effective "buy-sell" agreement attention must be given to form as well as substance, guided by the fact that, whatever the result, it must be such as will convince the IRS that it was not intended primarily as a tax dodge.

The various type of possibilities are innumerable; however, for purposes of discussion may be broken down into three main headings: I, "cross purchase," which is an agreement among the shareholders exclusively; and II, "entity," which provides for the corporation itself as the redeeming party; and III, that type which is funded by insurance.[11] Under each of the first *two* main groupings there are four sub-groupings: (a) that agreement which binds the parties affirmatively to buy and to sell under certain conditions; (b) that which binds a party to the option of the redeeming party or parties; (c) the "first refusal" agreement which binds a party, desiring to sell, to offer first to the redeeming party or parties; (d) that which binds the redeeming party or parties to buy at the option of the decedent or his estate.[12]

Types I(a) and II(a), being the most restrictive, are the ones most likely to succeed in fixing the estate value, all other requirements being met.[13] Types I(d) and II(d), being the least restrictive, are fairly certain not to control value, although they may be of some weight.[14] Types I(b) and II(b), though somewhat less restrictive

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10 Page, *Setting the Price in a Close Corporation by Buy-Sell Agreements*, 57 Mich. L. Rev. 655, 679-84.

11 *Ibid.*

12 Lowndes & Kramer, *op. cit. supra* note 1, § 18.45.

13 Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Estate of Orville D. Littick, 31 T.C. 181 (1958), Acq., 1959-2 Cum. Bull. 5; Lowndes & Kramer, *op. cit. supra* note 1, at 488.

14 Lowndes & Kramer, *op. cit. supra* note 1 at 488.

than the "a" types, are generally held binding on the commissioner where other general requiremetns are met.[15] The "first refusal" type agreements, I(c) and II(c), are said to give the most trouble because the estate may keep the *full* benefits by refusing to sell.[16]

Once the type of instrument has been selected, careful consideration must be given to several other areas; the price must be carefully fixed; the whole instrument together with all surrounding circumstances must be made to manifest itself as a bona fide business arrangement;[17] alienation of the stock must be sufficiently restrained; also, the contract must be the result of a voluntary act of his shareholder;[18] and a provision *should* be made for goodwill.[20]

How should the *price* be fixed? How much differential will be permitted between the fixed price and the unrestricted fair market value?

The issue of price has not been precisely litigated and a formula can no more be given for its determination than for valuing the stock without such an agreement. But, although the law as it now stands is rather indefinite and without limits at either end, the problem of fixing a price should be studied very carefully, for this sole factor can determine the whole matter. Certainly the price arrived at must be accurate, reasonable, fair and probably should approximate the "fair market value" (although this terminology seems somewhat inappropriate for in a sense this price properly restricted is the *only* market value or price). More specifically, the contract should not provide a higher price for inter vivos transfers than the estate can realize at death;[21] and the amount should apparently be the absolute maximum that the estate could realize from a transfer at the time of death.[22] Virtually all of the recent cases surveyed by this writer wherein the taxpayer has prevailed, consistently follow these general guides except that of approximating the "fair market value," *if* we take that value to coincide with the commissioner's appraisal. Some of the agreed prices accepted by the courts recently as conclusive of value, as compared with the commissioner's appraisal, were: $200,000

[15] May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Davis v. United States, 5 Am. Fed. Tax R.2d 1902 (D.C. Utah 1960); Angela Fiorito, 33 T.C. 440 (1959), *Acq.*, 1960-1 Cum. Bull. 4; cf. United States v. Land, 303 F.2d 170 (5th Cir. 1962).

[16] *See* Mathews v. United States, 226 F. Supp. 1003 (E.D. N.Y. 1964); *But see* Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Lowndes & Kramer, *op. cit. supra* note 1, at 489 n. 50.

[17] Treas. Reg. § 20-2031-2(h) (1958).

[18] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237.

[19] Lowndes & Kramer, *op. cit. supra* note 1, § 18.45.

[20] *Ibid.*

[21] *Page, supra* note 10.

[22] United States v. Land, 303 F.2d 170 (5th Cir. 1962).

compared with $257,910;[23] twenty-five per cent of the net value of the assets or $80,540 compared to $322,163;[24] a book value of $345,000 compared to $516,000;[25] a book value of $182,782 compared to $301,037;[26] zero compared to $100 per share.[27] From a study of these cases and others, it can only be concluded that whatever differential exists between the contract price and the commissioner's appraisal of what would at least otherwise be the fair market value, should be capable of substantiation in terms of the aforementioned general guides—reasonableness, accuracy and fairness.

A second area of concern, which is undoubtedly the overriding control and in which price is an influencing factor, centers around the requirement that the agreement must at least appear to be a *bona fide business arrangement.* The IRS must be convinced that it was made in good faith to accomplish a legitimate business purpose and not to escape taxes. Some points to watch, about which the courts at least comment, are: (1) whether the agreement was at arms length;[28] (2) whether there was equivalent consideration—and this is usually satisfied by a mutual exchange of like promises with all parties; (3) whether the relationship of the parties is such as to negate good faith, *i.e.*, where the redeeming party is the natural object of deceased bounty, in which case more proof of good faith may be required.[29] The net result is that *all* available circumstances may, in a close case, be surveyed to determine whether the agreement is bona fide or not.

The third category of concern is the *extent of restraint* upon the alienability of the stock, how the parties are bound and to what extent. This area, to a considerable degree, overlaps the selection of the type of agreement. In general, as has already been suggested, the more restrictive the terms and the more binding their extent, the more likely the agreement is to control the value. In any event at least one thing is fairly certain—the agreement must bind the parties during life as well as at death, although there need be no affirmative obligation to sell during life.[30] The agreements accepted by the courts fre-

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23 Estate of Orville B. Littick, 31 T.C. 181 (1958).

24 Davis v. United States, 5 Am. Fed. Tax R.2d 1902 (D.C. Utah 1960).

25 Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955).

26 Angela Fiorito, 33 T.C. 440 (1959).

27 May v. McGowen, 194 F.2d 396 (2d Cir. 1952). The contract price for transfer of the corporation stock in this case was to be determined by deducting from the fair market value the proportionate amount of a certain outstanding debt of the deceased. That proportion exceeded the fair market value.

28 Estate of Orville B. Littick, 31 T.C. 181 (1958).

29 See Davis v. United States, 5 Am. Fed. Tax R.2d 1902 (D.C. Utah 1960).

30 Treas. Reg. § 20-2031-2(h) (1958); Lowndes & Kramer, *op. cit. supra* note 1, at 487; United States v. Land, 303 F.2d 170 (5th Cir. 1962).

quently merely prohibit inter vivos transfers rather than specify an inter vivos buy-out procedure.[31] The foundation for this rule which is specifically set out in Rev. Rul. 59-60, seems best explained by the court in the *Land* case:

> When a decedent retains complete freedom . . . his inaction constitutes a passive transfer of an interest in the property to the person who stands to benefit by the limitation on the value of the property passing to the decedent's heir or legatee.[32]

It also appears that an affirmative duty to sell must be imposed upon the estate at the option of the corporation or surviving parties. This, if absolutely necessary, would effectively eliminate the "first refusal" types, I(b) and II(b), from the category of "buy-sell" agreements which control valuation.[33] The precise reasoning for such rule is not clear, although recent cases have uniformly followed the rule. This rule probably stems from the "requirement", as discussed by some writers and courts,[34] that the agreement be specifically enforceable.

To date the determination of whether a "buy-sell" agreement price is binding on the commissioner for estate taxes or not has been on an *ad hoc* basis with reference to the aforementioned general principles. As a result, the state of the law (taxwise) on this subject, leaves the estate planner somewhat unsure in many instances. However, the valuation of stock in close corporations has always been difficult with or without these agreements. It follows, then, that in the interest of better estate planning some such agreement should be worked out wherever possible.

When skillfully done, the chances are better than even that the value fixed by the agreement will be conclusive and controlling. If not, consolation can be had in the fact that, at least by virtue of its very existence, the agreement will tend to influence value. It is a factor which will be considered in the overall valuation in any event.[35]

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[31] Angela Fiorito, 33 T.C. 440 (1959); Estate of Orville B. Littick, 31 T.C. 181 (1958).

[32] United States v. Land, 303 F.2d 170, 173 (5th Cir. 1962).

[33] Mathews v. United States, 226 F. Supp. 1003 (E.D. N.Y. 1964).

[34] Lowdes & Kramer, *op. cit. supra* note 1, at 490.

[35] Rev. Rul. 59-60, 1959-1 Cum. Bull. 237; Mathews v. United States, 226 F. Supp. 1003 (E.D. N.Y. 1964).