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# TAX PLANNING IN BUSINESS PURCHASE AGREEMENTS, WITH SAMPLE CLAUSES

BY KENT D. KEHR\* AND GENE M. ZAFFT†

The success or failure of the small- or medium-sized business is dependent primarily upon the ability of its "key-men," who are generally the owners of the business. The death or retirement of one of these men, therefore, if not provided for, can cause havoc with the business to the detriment of the remaining shareholders or partners. This article will consider the tax problems raised by the death of a stockholder and the death or retirement of a partner and the most practical and beneficial methods of anticipating and meeting those problems.

## CORPORATION

What happens when a stockholder in a closely held corporation dies? It is obvious that some adjustment of the prior working relationship must be made. The surviving stockholders must either work with a new stockholder (*viz.*, the decedent's heir or heirs, or a purchaser of the deceased stockholder's interest), buy out the deceased's interest, or liquidate the business.

The alternatives which the surviving parties will have to face are fraught with problems, not the least of which is the uncertainty involved. The surviving stockholders will worry about harmonious relationships with new stockholders. Will new stockholders be a source of annoyance, and impede business management? Will there be a fiduciary stockholder, whose status would restrict business decisions? The heirs will worry about whether they will be able to get sufficient funds out of the business. If they keep the stock, will there be sufficient dividends; will they be forced to rely on dividends or will they be paid a salary, too? If they sell the stock, will there be a ready market for the stock or must they sell at forced prices?

The solution which many businessmen have found for these problems is a contract providing that the survivors in the business will buy out the interest of the decedent. Such contracts are usually called "buy-and-sell agreements." These contracts assure surviving stockholders that they will be able to continue business policies unhindered by outside interference. They assure a decedent's heirs of an "arm's length" sale price.

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Buy-and-sell agreements may take a variety of forms, but there are two basic types: One is a "stockholder cross-purchase agreement"; the other is a "corporate stock redemption agreement." Under a contract of the former type, the several stockholders agree that the stock of the first to die will be purchased by the survivors; under the latter type, the corporation agrees to redeem the stock of a deceased stockholder. The corporate stock redemption agreement seems to be favored in actual use over the cross-purchase agreement for two main reasons. In the first place, the cross-purchase agreement is cumbersome, especially if there are more than two stockholders.<sup>1</sup> Secondly, it may be more advantageous taxwise to use the corporate redemption agreement.

The funding of an agreement is as important to the objectives of the parties as the agreement itself. It is of no benefit to any of the stockholders to have an agreement unless they can be sure that ready cash will be available to carry it out. Insurance is the most common and probably the most feasible way of funding a buy-and-sell agreement; at the same time, it is the use of insurance which produces many of the income tax problems.

#### *The Tax Advantages of the Corporate Stock Redemption Type Agreement*

The primary tax advantage to be gained by the use of a corporate redemption type of agreement is that insurance to fund the agreement can usually be purchased by a corporation at a cheaper tax cost. Such premiums are paid with income that has only been taxed at the corporate level, while if the stockholders pay the premiums they probably would have to do so with dollars that have been taxed both to the corporation (as corporation income) and to the stockholders (as dividend income). Of course, if a corporation distributes money to the stockholders only in the form of salaries there is no double tax, but there is a limit to the amount a corporation can distribute as salaries. Also, there is the possibility that the corporation tax rate is lower than the stockholders' rates.

Another tax advantage which might occur under a corporate redemption agreement, whether funded with insurance or not, is that the corporation may be permitted to accumulate earnings without incurring the accumulated earnings tax. This would be so if such funding were considered to be a reasonable business use of corporate earnings. However, the possibility that the funding of a buy-and-sell agreement may constitute an unreasonable use of earnings which

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1. See text supported by note 13 *infra*, in connection with the problem of funding cross-purchase agreements.

would be subject to the accumulated earnings tax is the primary disadvantage in using this type of agreement. The problem of the accumulated earnings tax is discussed below.

### *Tax Treatment of Premium Payments by Corporation*

A. DEDUCTIBILITY OF PREMIUM PAYMENTS BY CORPORATION. How are insurance premiums paid by a corporation to fund the agreement treated for tax purposes? In the first place, it is specifically provided in the Internal Revenue Code that such payments are not deductible by the corporation when the corporation is directly or indirectly a beneficiary under such policy.<sup>2</sup> Of course, if such payments were considered to be salary, they would be deductible as such.

B. POSSIBILITY OF DIVIDEND TREATMENT TO STOCKHOLDERS. The tax effect upon the stockholders of premium payments by the corporation, until recently at least, has not been so clearly defined. Two recent cases, *Prunier v. Commissioner*<sup>3</sup> and *Sanders v. Fox*,<sup>4</sup> raised the possibility that such payments might be considered to be taxable to the stockholders as dividends. Though both cases have finally been reversed in favor of the taxpayers, the expensive lessons learned by these taxpayers should be observed in the future. Before discussing these cases, however, we should consider the state of the law prior to these two cases.

On the one hand, if the corporation paid premiums on insurance owned by the stockholders, and the stockholders had the right to name the beneficiaries, the premiums would constitute a distribution of a dividend or salary to the stockholders. This is merely an application of the principle that "the discharge by a third person of an obligation to him is equivalent to receipt by the person."<sup>5</sup> On the other hand, if the corporation owned the insurance on which it paid premiums and was the beneficiary, the payment of premiums would not constitute a distribution to the stockholders, because there would be no "receipt" by the stockholders—actual or constructive.

The Tax Court, in *Paul J. Bonwit*,<sup>6</sup> thought that these two principles were readily apparent and so held on issues involving both types of factual situations. In another case, *Lewis v. O'Malley*,<sup>7</sup> the Court of Appeals for the Eighth Circuit thought the corporation had retained enough of the rights of ownership, even though the stockholder was irrevocably granted the power to designate the beneficiaries, under the

2. Int. Rev. Code of 1954, § 264.

3. 248 F.2d 818 (1st Cir. 1958), reversing 28 T.C. 19 (1957).

4. 253 F.2d 855 (10th Cir. 1958), reversing 149 F. Supp. 942 (D. Utah 1957).

5. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929). See also *Louis Greenspon*, 23 T.C. 138 (1954).

6. 33 B.T.A. 507 (1935), aff'd, 87 F.2d 764 (2d Cir. 1937).

7. 140 F.2d 735 (8th Cir. 1944), reversing 49 F. Supp. 173 (D. Neb. 1943).

policy in question that the premiums were not dividends to the insured stockholder. In neither of these cases, however, was a buy-and-sell agreement involved. Both the *Prunier* and *Sanders* cases involved life insurance to fund buy-and-sell agreements, and the element that seemed to cause difficulty was that the facts (according to the trial opinions) did not fit exactly into either one of the two types of polar situations discussed above.

The trial courts in both cases held that the premium payments constituted a dividend to the stockholders, because the stockholders derived more benefit from the insurance than the corporation. What was meant by benefit, however, was not clearly defined. Also, the courts seemed to be confused in both cases as to who actually owned the policies. In the *Prunier* case, for example, the policies were issued to the stockholders, and the only evidence of corporate ownership during the year in question was an agreement between the parties that the proceeds were to go to the corporation to be used by it to buy out the interest of the first to die. The courts of appeal, in reversing these two cases, first determined that the corporations did own the policies and, therefore ruled, that the stockholders could not be said to be in receipt of income.

The courts of appeal did allude to the question of whether the corporation benefited from the purchase of the insurance or, in other words, whether there was some corporate purpose in connection with the purchase of the insurance. It is not clear why the courts saw fit to mention this aspect. It would not be pertinent to the principles discussed above. It might be pertinent, however, in determining whether premium payments constitute dividends, if the "sham transaction" doctrine could be applied in this situation. The sham transaction doctrine refers to the fact that transactions which have no substantive effect, but are merely legal devices to avoid taxation, will be disregarded. This rule has been applied to many types of situations,<sup>8</sup> but it has never been used in determining whether the payment of insurance premiums by a corporation on the lives of its stockholders constitute dividends to the stockholders.

The trial court in the case of *Casale v. Commissioner*<sup>9</sup> attempted to use the sham transaction doctrine to tax premium payments as dividends where the corporation had purchased insurance on the life of the sole stockholder to fund a non-qualified pension agreement. It was admitted that the corporation owned the policy and had all the rights appertaining thereto. The Tax Court thought that because the insured

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8. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Kocin v. United States*, 187 F.2d 707 (2d Cir. 1951).

9. 247 F.2d 440 (2d Cir. 1957), reversing 26 T.C. 1020 (1956).

owned all the stock in the corporation and therefore had complete control and dominion of the corporation, the stockholder was in reality only purchasing an annuity policy for himself. On this basis, the court concluded that the transaction "lacked bona fides and was merely a device whereby petitioner attempted to avail himself of corporation funds without incurring a tax on their use."<sup>10</sup>

The trial court's decision in *Casale* was reversed by the Court of Appeals for the Second Circuit. The court held that the arrangement did not lack substance and, in doing so went back, in effect, to the principles upon which *Prunier* and *Sanders* were later decided. The court pointed out that since the corporation did own the policy and could do with it as it saw fit, no economic benefit really vested in the stockholder. Nothing would be received by the stockholder until he started receiving payments pursuant to his pension agreement. Until the proceeds were thus paid out, the insurance would be subject to the claims of the corporation's creditors. It was also pointed out that the corporation was actively engaged in manufacturing and hence was not itself just a sham or shell corporation.

Suppose that the purpose of the insurance on which the corporation pays premiums is to fund a *cross-purchase* type buy-and-sell agreement, would the principle of *Prunier* and *Sanders* still apply in determining whether the stockholders were taxable on the premiums? The controlling principle should be the same. If the corporation owns the policy and has all the rights thereunder, the stockholders cannot be said to be in receipt of any benefit by the payment of the premium. The answer should be the same if some one other than the corporation is the named beneficiary, as long as the corporation has the right to change the beneficiary. The proper time to tax the stockholders is when an amount is paid out to the stockholders pursuant to the cross-purchase agreement, in which case the surviving stockholders would be in receipt of income to the extent that the proceeds are used to pay for their obligation to purchase the deceased's shares.

In *Doran v. Commissioner*,<sup>11</sup> the corporation paid for insurance on the lives of stockholders in order to fund a cross-purchase type buy-and-sell agreement. The policies were held by a trustee and upon the death of one of the stockholders the proceeds were paid to the trustee and used by him to carry out the purchase agreement. The commissioner tried to tax the proceeds to the surviving stockholders as dividends, because the proceeds were used to fulfill their personal obligations. The court of appeals held that the policies were not owned by the corporation, i.e., that the trustees were holding the insurance

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10. 26 T.C. at 1027.

11. 246 F.2d 934 (9th Cir. 1957), reversing 15 CCH Tax Ct. Mem. 629, P-H 1956 T.C. Mem. Dec. ¶ 56121 (1956).

for the stockholders and not for the corporation, and hence that there was no distribution from the corporation which could be taxed. The implication from this, although nothing was said in the opinion, is that each premium should have been taxed to the stockholder.

In *Paramount-Richards Theaters, Inc. v. Commissioner*,<sup>12</sup> the corporation apparently retained no interest in the policy and the premiums paid by the corporation were held to be dividends to the two sole stockholders. Since the payment of proceeds to the deceased stockholder's heirs was to reduce the cost of the stock to the survivor by one-half the amount of the proceeds, both stockholders were going to benefit equally by the insurance proceeds and both were taxed equally upon the payment of the premiums.

On the basis of the above cases, it appears that the primary principle to be used in determining whether premium payments will be taxed as dividends is "ownership." If the corporation owns the policies, and has all the rights thereunder, the premiums will not be dividends. On the other hand, if the stockholders own the policies, premium payments will constitute dividends. There could conceivably be a situation where the corporation owned the policies, but where the arrangement lacked substance, and the premiums would hence be taxable to the stockholders. In view of these principles the following points should be observed in purchasing insurance to fund a corporation redemption type buy-and-sell agreement:

- (1) The stockholders or their estates should not have any interest or right in the policy or proceeds under the terms of the policy itself or under any agreement.
- (2) The proceeds should be available for corporate purposes. (Perhaps it should be recited that the insurance is subject to the rights of corporate creditors.)
- (3) The price of the stock should be determined independently of the amount of insurance proceeds, and the amount of insurance proceeds should not be a minimum price which the deceased's estate will receive in all events.
- (4) Corporate objectives should be stressed in the minutes and in all agreements.

### *Do Insurance Proceeds Constitute Dividends to Stockholders?*

Generally speaking, insurance proceeds, as such, will not be taxable under either the cross-purchase or corporate redemption type of agreement. The Code provides that "gross income does not include amounts received . . . under a life insurance contract, if such amounts are paid by reason of the death of the insured."<sup>13</sup> There is one important

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12. 153 F.2d 602 (5th Cir. 1946), affirming 3 CCH Tax Ct. Mem. 806, P-H 1944 T.C. Mem. Dec. ¶ 44274 (1944).

13. Int. Rev. Code of 1954, § 101(a)(1).

exception, however.<sup>14</sup> This exception provides that the proceeds from a policy which was purchased for a valuable consideration will be taxable to the extent of the gain unless the policy is purchased by the insured, a partner of the insured, or a corporation in which the insured is a stockholder. Since the gain from an insurance policy purchased by one stockholder from the estate of another stockholder is recognized, it can readily be seen that the "transferee for value" rule might apply to a cross-purchase type of agreement where each stockholder has a policy on the life of the other stockholders. For example, when stockholder *C* dies, stockholders *A* and *B* collect the insurance proceeds on policies which they hold on *C*'s life, tax-free, and use this to buy *C*'s interest in the corporation. But then, *C*'s estate has insurance policies on the lives of *A* and *B*, in whose lives the estate has no insurable interest. If, upon the death of stockholder *C*, survivor *A* buys from *C*'s estate the policy on the life of survivor *B*, and survivor *B* buys from *C*'s estate the policy on the life of survivor *A*, the proceeds of both policies will constitute income to the extent that they exceed the costs of the policies.

It would, of course, be possible for surviving stockholders *A* and *B* to purchase the policies on their own lives, and receive the proceeds tax-free. Presumably, however, the buy-and-sell agreement would then be under-funded.

#### *Will Redemption of the Deceased Stockholder's Stock Constitute a Dividend?*

In considering whether the redemption of the stock of the deceased stockholder will constitute a dividend, there are two possibilities: In the first place, will it constitute a dividend to the deceased's estate? Secondly, will it constitute a dividend to the remaining stockholders?

The tax liability of the estate is determined under section 302<sup>15</sup> just the same as for any stockholder whose stock is being redeemed. If the estate meets any of the three tests of that section, i.e., if the redemp-

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14. Int. Rev. Code of 1954, § 101(a) (2) provides: "(2) Transfer for valuable consideration.—In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee. The preceding sentence shall not apply in the case of such a transfer—

"(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

"(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."

15. Int. Rev. Code of 1954, § 302.



tion completely terminates the estate's interest, or is substantially disproportionate, or is not essentially equivalent to a dividend, the redemption will be treated as a sale of stock and hence taxable only at capital gains rates. The amount of gain in such case will probably be small, because the estate has the date of death (or optional valuation date) value as its basis.<sup>16</sup> If the redemption does not meet one of these tests, the amount received by the estate will be dividend income to the extent of the corporation's earnings and profits. Ordinarily, if the stockholders are not related and the buy-and-sell agreement provides for a complete redemption, the transaction will qualify under section 302 and therefore the estate will not have dividend income.

Regarding the status of the surviving stockholders under a corporate redemption type buy-and-sell agreement, it is now possible to say that redemption of stock will not constitute a dividend to them.<sup>17</sup> The Tax Court opinion in *Joseph R. Holsey*<sup>18</sup> frightened some observers into thinking that redemption under a corporate redemption agreement might constitute a dividend to the surviving stockholders. In that case, one of two stockholders assigned his option to buy all the stock of the second stockholder to the corporation. The corporation exercised this option and the Tax Court held that the remaining stockholder had received a dividend of the purchase price at the time the option was exercised by the corporation, because the redemption had increased his interest in the corporation from fifty per cent to one hundred per cent.

The theory of the Tax Court was clearly wrong because the corporation's net worth was depleted by the purchase of stock, and stockholder thus owned one hundred per cent of a smaller asset after the redemption. If the redemption price is fair market value, the value of the remaining stockholder's interest should be exactly the same after the redemption as it was before. Thus, before the redemption the stockholder might have a fifty per cent interest in a corporation worth \$1,000,000 and after the redemption own one hundred per cent of a corporation worth only \$500,000; and theoretically the stockholder's economic position has not changed.

Suppose that the redemption price was determined by agreement at fair value two years prior to death, but at the time of death the

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16. Int. Rev. Code. of 1954, § 1014.

It is specifically provided in the regulations that payment under a buy-and-sell agreement does not constitute income in respect of a decedent to the estate. U.S. Treas. Reg. § 1.691(a)-2 (Example 4) (1957). The result would be the same to the estate if it sold the stock to the remaining stockholders pursuant to a cross-purchase agreement.

17. *Holsey v. Commissioner*, No. 12, 548, 3d Cir., Sept. 3, 1958, 2 Am. Fed. Tax R.2d 5660, reversing 28 T.C. 962 (1957); *Ray Edenfield*, 19 T.C. 13 (1952).

18. 28 T.C. 962 (1957), rev'd, *Holsey v. Commissioner*, supra note 17.

redemption price is less than fair market value. Will the surviving stockholder be in receipt of a dividend to the extent that the redemption price is less than fair market value because the survivor's economic interest will be increased to that extent? According to the *Holsey* case, the answer is no. The court considered it just an unrealized appreciation in the market value of an asset. In *Holsey*, the corporation redeemed fifty per cent of its stock for \$80,000 at a time when the earnings and profits of the company were over \$300,000, and the court held that the remaining stockholder had not received a dividend because the purchase price was fair (according to the court) at the time the option was granted.

By definition, under a corporate redemption agreement it is the corporation's obligation to buy the stock and not an obligation of the surviving stockholders. Naturally, if corporate funds are used to fulfill a surviving stockholder's obligation to buy a deceased stockholder's stock under a cross-purchase agreement, the survivor will be in receipt of income under the familiar doctrine of *Old Colony Trust Co. v. Commissioner*.<sup>19</sup>

#### *Will Premium Payments Be Subject to the Accumulated Earnings Tax?*

Section 531 of the 1954 Code imposes a tax, in addition to the regular income tax, upon earnings for the year which are accumulated in order to avoid paying a dividend. Section 533(a) provides that the fact that earnings and profits are accumulated beyond the reasonable needs of the business shall be determinative of the purpose to avoid paying a dividend. Case law indicates that one of the ways a corporation can prove that it did not accumulate earnings to avoid paying a dividend is to show that the funds were accumulated for the reasonable needs of the business. In view of the pivotal status of the question of "reasonable needs of the business" in connection with the accumulated earnings tax, it is necessary to inquire whether the purchase of insurance to fund a buy-and-sell agreement constitutes a reasonable need of the business.

The case of *Emeloid Co. v. Commissioner*<sup>20</sup> has been relied upon by many as authority that premium payments to fund a buy-and-sell agreement are a reasonable need of the business and will not, therefore, subject the corporation to an accumulated earnings tax. Actually, the issue in that case was whether money borrowed to pay for insurance on the lives of the two primary stockholders constituted "invested capital" for excess profits tax purposes. It could only constitute "in-

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19. 279 U.S. 716 (1929); *Zipp v. Commissioner*, 259 F.2d 119 (6th Cir. 1958), affirming 28 T.C. 314 (1957).

20. 189 F.2d 230 (3d Cir. 1951), reversing 14 T.C. 1295 (1950).

vested capital" if it were used for business purposes. Since the insurance was used, in later years at least, to fund a buy-and-sell agreement, the court had occasion to comment on whether such use was a reasonable need of the business in holding that such insurance did constitute invested capital:

Harmony is the essential catalyst for achieving good management; and good management is the *sine qua non* of long-term business success. Petitioner, deeming its management sound and harmonious, conceived of the trust to insure its continuation. Petitioner apparently anticipated that, should one of its key stockholder-officers die, those beneficially interested in his estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by contract to sell the stock to petitioner, might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals.<sup>21</sup>

There were other cases, too, which created a general atmosphere that led practitioners to think that insurance funding of a buy-and-sell agreement is a reasonable business need. In *Edgar M. Docherty*,<sup>22</sup> the corporation could not afford to buy all of the stock of any one of the majority stockholders upon his death, despite the fact that the corporation carried insurance on their lives. However, by converting some of the equity capital into debt, the corporation could put itself in a position where it could buy all the stock of a deceased stockholder and thus be assured of harmonious ownership and control. It was held that the corporation had a business purpose in exchanging bonds for stock and that, therefore, the exchange would be considered a tax-free reorganization.

In *Dill Mfg. Co.*,<sup>23</sup> and in *Gazette Publishing Co. v. Commissioner*,<sup>24</sup> the courts held that expenditures to purchase minority stock interests did not indicate that there had been an unreasonable accumulation of funds, nor was the purchase itself an unreasonable accumulation of funds. It appeared in both cases that the purchase of stock was unplanned and that funds used for the purchase had been accumulated for other reasons but were used to purchase stock when minority interests became disgruntled.

Although none of the cases actually involved the direct issue of whether the purchase of insurance to fund buy-and-sell agreements was a reasonable business use which will not subject the corporation to the accumulated earnings tax, the opinions looked very favorable until two recent pronouncements by the Tax Court. One of the cases

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21. *Id.* at 233.

22. 47 B.T.A. 462 (1942).

23. 39 B.T.A. 1023 (1939).

24. 103 F. Supp. 779 (E.D. Ark. 1952).

has been affirmed by the court of appeals. Again, neither case is exactly on point—but they are unfavorable precedents.

In the *Hedberg-Freidheim Contracting Co.* case<sup>25</sup> the commissioner had asserted that an accumulated earnings tax was due and the taxpayer argued that the accumulation of earnings was prompted, among other reasons, by the fact that all of the surplus would be needed by the corporation to buy up the stock of one of the two fifty per cent stockholders, if the dissension which existed between the two forced a split-up. The court thought that this was not a corporate business purpose, but rather a stockholder motivated purpose. *The Gazette* and *Dill* cases were distinguished on the grounds that those cases involved the buying out of minority stockholders.

In *Pelton Steel Casting Co.*,<sup>26</sup> two stockholders owning a combined eighty per cent interest in the corporation decided that they would sell their stock. The third stockholder had been largely responsible for the company's successful operating policies and believed that these policies might be jeopardized if the controlling stock got into the hands of some outside group. For this reason, the third stockholder decided to buy out the other two and the two majority owners agreed to this. The third stockholder did not have sufficient funds to buy all the outstanding stock, so it was arranged to have the corporation redeem \$500,000 in stock from the two controlling stockholders and the third stockholder buy \$300,000 in stock. In order for the corporation to have funds to redeem the stock, it did not declare a dividend for the year of the purchase and the commissioner asserted an accumulated earnings tax.

The issue, of course, was whether the redemption of stock by the corporation was a reasonable business use of its funds. The court held that such redemption was not a reasonable business use, and that the corporation was subject to the tax. The court pointed out that the retiring stockholders saved a considerable amount of taxes by handling the transaction in this manner and that the retirement of the stock fulfilled the personal needs of the stockholders and avoided only "theoretical harms" of the corporation. (In fact, the court thought that the transaction might have weakened the corporation financially because it had to borrow money to make the purchase.) The court recognized that there was an obvious conflict with the opinions in the *Dill* and *Gazette* cases, but those cases were again distinguished on the grounds that there the corporations were redeeming a *minority* interest. The significance of this distinction is not very clear, but apparently it has something to do with whether the transaction fulfilled a stockholder purpose or a corporate purpose.

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25. 15 CCH Tax Ct. Mem. 1433, P-H 1956 T.C. Mem. Dec. ¶ 56275 (1956).

26. 28 T.C. 153 (1957), aff'd, 251 F.2d 278 (7th Cir. 1958).

### *Estate Tax Treatment*

Estate tax consideration should play a major role in planning a buy-and-sell agreement, for two reasons: First, the planner will not wish both the proceeds of the insurance and the value of the stock to be included in the deceased's estate. Secondly, if the estate is to receive only a certain amount for the deceased's interest, the planner will probably want to make this amount the controlling value for estate tax purposes, so that he will not be paying an estate tax on a larger amount and, perhaps more important, so that there will not be protracted disputes with the government about the value of the interest.

Regarding the first consideration, the general rule is that insurance is not included in an estate if the estate does not receive the proceeds and the decedent did not have any of the incidents of ownership.<sup>27</sup> Thus, under a corporate redemption agreement, if one has been scrupulous about keeping the ownership of the insurance in the hands of the corporation in order to avoid having the premiums taxed as dividends, the decedent stockholder would not have any of the incidents of ownership and the proceeds would not be includible in his estate. Under a cross-purchase agreement, it is customary to cross the insurance, but this is not necessary to keep the insurance out of the estate when the insurance is to be credited against the purchase of stock.<sup>28</sup> However, whether the insurance is crossed may make a difference to the survivor. In the case of a partnership buy-and-sell agreement it has been held that the survivor does not add the value of the proceeds to his partnership basis when the proceeds are paid directly to the deceased's estate.<sup>29</sup> To make certain that, in a corporate cross-purchase plan, the surviving stockholders may add the value of the proceeds to the basis of their stock, it would be wise for the stockholders to cross the insurance rather than to own the insurance on their own lives, and have the survivors pay over the proceeds to the deceased's estate.

The proceeds of the insurance may indirectly slip into the decedent's estate, under a corporate redemption agreement, if the amount of insurance increases the value of the decedent's interest in the corporation. This may happen in two ways:

- (1) The parties may intentionally value the stock to include part or all of the proceeds of the insurance.
- (2) The commissioner may contend that the proceeds of the

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27. Int. Rev. Code of 1954, § 2042.

28. John T. H. Mitchell, 37 B.T.A. 1 (1938); Estate of Ealy, 10 CCH Tax Ct. Mem. 431, P-H 1951 T.C. Mem. Dec. ¶ 51137 (1951). See also Ray E. Tompkins, 13 T.C. 1054 (1949); M. W. Dobrzensky, 34 B.T.A. 305 (1936); Boston Safe Deposit & Trust Co., 30 B.T.A. 679 (1934) (all involving partnerships).

29. Paul Legallet, 41 B.T.A. 294 (1940).

insurance must be included in the value of the stock.<sup>30</sup> Presumably, the commissioner could make such a contention in any case except where the agreement is binding for estate tax purposes, under the rules discussed below.<sup>31</sup>

Whether the parties ought to draw the agreement to include the proceeds in the valuation of stock can only be answered in a partisan fashion. From the decedent stockholder's point of view, the proceeds should be included in the valuation, because a portion of his share of the corporation's earnings were used to purchase the insurance and his estate is, therefore, entitled to a pro-rata share of the proceeds. On the other hand, the surviving stockholders would not want the proceeds included in the value of the stock which the corporation must buy. The answer to the argument that the deceased helped pay the premiums and should therefore be entitled to share in the proceeds is that the idea of the insurance was to pay for the stock which must be bought and if the proceeds are included in the value of the stock, just that much more insurance must be purchased to pay for the stock. Such pyramiding could go on *ad infinitum*. On such reasoning many stockholders are willing to accept an agreement excluding the value of the proceeds from the value of the stock—especially since, at the time the agreement is drawn, each party probably believes he will be the survivor.

There is also, however, a compromise position. The cash surrender value of all the policies, including the policy on the deceased's life, could be included in the value of the stock as of the day prior to death. The only reason for this is that it gives the deceased the benefit of some of the premiums paid on his behalf, but yet gives the survivors the benefit of the proceeds in excess of the cash surrender value.

After it has been determined how the stock is going to be valued, the draftsman should attempt to make the valuation binding on the government. The regulations indicate the minimum requirements which are essential if an agreement is going to have any influence on valuation.

*Securities subject to an option or contract to purchase.* Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any,

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30. The *proposed* regulations provided that the proceeds must be considered in valuing the stock unless the agreement was binding on the commissioner and was for an adequate and full consideration in money or money's worth. U.S. Treas. Proposed Reg. § 20.2042-1(c)(b), 21 Fed. Reg. 7886 (1956). This provision was omitted in the final regulations.

31. In two cases where the corporation did own policies and receive the proceeds on the life of a shareholder, but where there was no buy and sell agreement, the proceeds were included as a corporate asset in valuing the stock. *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933); *W. A. Blair*, 4 B.T.A. 954 (1926).

that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.<sup>32</sup>

In short, the regulations set forth two requirements for an agreed value to be binding, namely, that the value be an arm's length or business arrangement, and that the decedent must not be able to sell the stock during his lifetime without restriction at other than the contract price. There are many court decisions on the subject, but all deal with interpretations of these two requirements.<sup>33</sup>

### *Conclusion*

Regarding the income tax treatment of corporate buy-and-sell agreements, the commissioner's attack has been systematic, but ineffectual to date. First, he contended insurance premium payments to fund an agreement were a dividend to the shareholders, and lost. Then, he contended that the actual redemption of stock was a dividend to the remaining shareholders, and lost again. In view of the *Pelton Steel* case, it seems likely he will next contend that the purchase of insurance constitutes an unreasonable accumulation of earnings.

Regarding the estate tax problems of buy-and-sell agreements, valuation of the stock can be a trap for the unwary. The two requirements for making an agreement binding upon the commissioner have never been adequately defined. Nevertheless, it seems possible, especially when the parties are unrelated, to draft an agreement which is subject to a minimum of risk that the valuation agreed upon by the parties will be upset.

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32. U.S. Treas. Reg. § 20.2031-2(h) (1958).

33. See Lowndes & Kramer, *Federal Estate & Gift Taxes* 533 (1956); Ness, *Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death*, 49 Colum. L. Rev. 796 (1949); *Valuation of Stock Subject to Restrictive Agreements for Federal Estate & Gift Taxation*, 60 Harv. L. Rev. 123 (1946).

## PARTNERSHIPS

This part of the article will make no attempt to encompass the entire area of partnership agreements, but will confine itself to a consideration of some of the tax aspects of "buy-and-sell" provisions contained within such agreements.

Prior to the 1954 Code, the tax consequences of the buy-and-sell provisions of a partnership agreement frequently were extremely difficult to predict. Since its adoption, however, taxpayers have gained rather greater certainty of tax treatment, although often at their own expense.

*Sale or Retirement Prior to Death*

A partnership, by its very nature, requires close personal contact between the partners; and, although every venture is undertaken with the expectation of cooperation and success, such is not always the case. Therefore, it is necessary to provide at the time of the formation of a partnership a procedure for the withdrawal of its members.

A logical starting point is to consider a provision that will permit a partner to sell his interest in the partnership either to the remaining partners or to a stranger. The tax treatment accorded such a sale is specifically set forth in section 741.<sup>34</sup> Thus, the problem of whether an interest in a partnership is an entity unto itself, or is a composite of the various assets owned by the partnership is resolved in favor of the former. Section 741 adopts the prior case law<sup>35</sup> with the exception that unrealized receivables and substantially appreciated inventory are treated separately.

Section 751, to which section 741 specifically refers, provides, in essence, that unrealized receivables and substantially appreciated inventory will not be subject to capital gain treatment. Its purpose is to prevent the conversion of what would normally be ordinary income into capital gain by means of the collapsible partnership, i.e.: a cash basis partnership sells goods or renders services on open account, and then the partners sell their interests, which have appreciated in value

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34. Int. Rev. Code of 1954, § 741: "In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value)."

35. *First Nat'l Bank v. Commissioner*, 183 F.2d 172 (5th Cir. 1950); *Commissioner v. Smith*, 173 F.2d 470 (5th Cir. 1949); *Long v. Commissioner*, 173 F.2d 471 (5th Cir. 1949); *Thornby v. Commissioner*, 147 F.2d 416 (3d Cir. 1944); *Stilgenbaur v. United States*, 115 F.2d 283 (9th Cir. 1940); *Hamilton A. Gray*, 11 CCH Tax Ct. Mem. 17 (1952), P-H 1952 T.C. Mem. Dec. ¶ 52002; *Anna Neuman*, 9 CCH Tax Ct. Mem. 877 (1950), P-H 1950 T.C. Mem. Dec. ¶ 50240.



because of the unrealized accounts receivable. Unrealized receivables and substantially appreciated inventory items are referred to as "section 751 property."<sup>36</sup>

The gain or loss attributable to a selling partner's interest in section 751 property shall be ordinary gain or loss.<sup>37</sup> This gain or loss is measured by the difference between (1) the portion of the total amount realized for the partnership interest allocated to section 751 property, and (2) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be accepted by the Commissioner.<sup>38</sup> Perhaps the following example will illustrate the operation of sections 741 and 751 to a sale of a partnership interest:

Assume the balance sheet of the personal service *AB* partnership (cash basis) is as follows:

<b>ASSETS</b>			
		<i>Basis per Books</i>	<i>Market Value</i>
Cash		\$ 6,000	\$ 6,000
Other Assets		10,000	12,000
Unrealized receivables (section 751 items)		0	10,000
		\$16,000	\$28,000
<b>LIABILITIES</b>			
Capital Account	<b>A</b>	\$ 8,000	\$14,000
	<b>B</b>	8,000	14,000
		\$16,000	\$28,000

If *A* sells his interest to *C* for the present market value, \$14,000, *A* will have realized \$5,000 ordinary income and \$1,000 capital gain. Since the partnership had no basis for the unrealized receivables, *A* has no basis for his one-half. Therefore, of the \$14,000 paid, \$5,000 is attributable to *A*'s one-half of the section 751 property, which has a zero basis; and the entire \$5,000 is realized and recognized as ordinary income. The balance of the purchase price, \$9,000 is attributable to the balance of the partnership interest which has an \$8,000 basis to *A*. Thus, he has \$1,000 of capital gain. Even if the "other assets" were not capital assets, the \$1,000 would be capital gain, provided, naturally, they were not section 751 property. Any amount realized by *A*

36. U.S. Treas. Reg. § 1.751-1(a) (1) (1956).

37. *Ibid.*

38. U.S. Treas. Reg. § 1.751-1(a) (2) (1956).

in excess of \$13,000 (\$5,000 section 751 property and \$8,000 basis) will be treated as capital gain.<sup>39</sup>

In addition to the gain recognized on the sale of his interest, a selling partner will have to recognize, as ordinary income, his distributable share of the partnership income to the date of sale.<sup>40</sup> This is so because for the partner selling his *entire* interest, the partnership's taxable year closes as of the date of sale.<sup>41</sup> Thus, poor timing as to the date of the sale of an interest in a partnership may result in a "bunching" of income to the selling partner. The following hypothetical situation will illustrate the danger:

*AB* partnership is on a fiscal year basis ending June 30. Partner *A* is on calendar year basis. For the fiscal year July 1, 1957, to June 30, 1958, *A*'s distributive share of partnership income is \$20,000. On October 1, 1958, *A* sells his partnership interest to *C*, and as of that date, *A*'s distributive share of partnership income for period July 1, 1958, to September 30, 1958, is \$5,000. *A* will have to recognize the entire \$25,000 in his personal return for the year 1958.<sup>42</sup>

Since this bunching will result only if *A* sells his entire interest between July 1, 1958, and December 31, 1958, it may be advisable for him to sell most of his interest on October 1, 1958, and sell the balance after January 1, 1959. Section 706(c)(2)(B) specifically provides that the partnership's taxable year shall not close with respect to a partner who sells less than his entire interest. If this "split-sale" procedure is adopted in order to avoid a bunching of income, it is suggested that more than a bare minimum interest be retained until the following calendar year so that the commissioner will have no ground to maintain the transaction was one of form rather than substance. However, it is felt that the bunching problem will be negligible for partnerships organized after 1954 because of the difficulty in placing the partnership on a taxable year different from that of its principal partners.<sup>43</sup>

If the bunching of income of a fiscal year partnership-calendar year partner may be a problem, provision may be made for the purchase price to be paid in two installments (one in each of two different calendar years) with the selling partner retaining an interest until the second installment is paid.

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39. 1957 Int. Rev. Bull. No. 27, at 13.

40. U.S. Treas. Reg. § 1.706-1(a)(1) (1956). Note that if the selling partner has a one-half or greater interest in capital and profits of the partnership, the partnership terminates and the taxable year closes as to all partners. Int. Rev. Code of 1954, § 708 (b)(1)(B).

41. Int. Rev. Code of 1954, § 706(c)(2)(A)(i); U.S. Treas. Reg. § 1.706-1(c)(1) (1956).

42. Int. Rev. Code of 1954, § 706(a).

43. Id. § 706(b).

It should be noted that the above buy-and-sell provision considers the sale of a partnership interest to the remaining partners *as individuals*, or to a stranger. It specifically avoids treating the transaction as a sale to the partnership. Although a sale to the individual remaining partners is desirable to the seller, it may not be so to the remaining partners. As a practical matter, they would probably prefer that the partnership, as an entity, purchase the seller's interest. If the partnership is the purchaser the transaction is treated as a "retirement" of a partner.

The case law prior to the 1954 Code raised considerable doubt concerning allocation of payments made by the partnership to a retiring partner for his capital interest in the partnership and his proportionate share of partnership profits. In *Bull v. United States*,<sup>44</sup> it was held that payments made to the executor of the estate of a deceased partner who elected, under the partnership agreement, to participate in the partnership profits for one year after the decedent's death received the payments as income and not in payment for the decedent's interest in the partnership. Although never overruled, the decision has had little or no following. Subsequent decisions held that if the deceased or retiring partner had a material capital interest in the partnership, payments made by the partnership after death or retirement were made in purchase of the partner's interest and not as distributions of partnership profits.<sup>45</sup> The *Bull* case was distinguished on the ground that the deceased partner there had no capital interest. If the partnership agreement, however, provided for an allocation of the payments between the capital interest and future profits, the Tax Court accepted such allocation.<sup>46</sup>

The draftsmen of the 1954 Code have made great headway in removing the uncertainty in this area by the provisions of section 736.<sup>47</sup>

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44. 295 U.S. 247 (1935).

45. *McClennen v. Commissioner*, 131 F.2d 165 (1st Cir. 1942); *Estate of Nutter*, 46 B.T.A. 35 (1942); *Estate of Miller*, 38 B.T.A. 487 (1938).

46. *Sidney Hess*, 12 T.C. 773 (1949); *Charles F. Coates*, 7 T.C. 125 (1946).

47. Int. Rev. Code of 1954, § 736:

**"PAYMENTS TO A RETIRING PARTNER OR A DECEASED PARTNER'S SUCCESSOR IN INTEREST.**

(a) **PAYMENTS CONSIDERED AS DISTRIBUTIVE SHARE OR GUARANTEED PAYMENT.**—Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) **PAYMENTS FOR INTEREST IN PARTNERSHIP.**—

(1) **GENERAL RULE.**—Payments made in liquidation of the interest of a

The section specifically spells out how payments to retiring partners are to be allocated between payments for interests in the partnership and payments in the nature of income. For the sake of brevity, payments for interests in the partnership will be designated 736(b) payments and other payments as 736(a) payments. Section 736(a) payments are taxed to the recipient as ordinary income, while 736(b) payments are treated as return of capital and capital gains. As a corollary to the tax treatment given the retiring partner, the partnership is permitted to deduct 736(a) payments, but not 736(b) payments. Section 736(b) (2) provides what items constitute partnership property under section 736(b) (1). Unrealized receivables are excluded,<sup>48</sup> and good will is excluded *unless* the partnership agreement provides for a payment with respect to good will.<sup>49</sup>

The fact that a payment for good will may be a section 736(b) or a section 736(a) payment depending on the inclusion or exclusion of a good will provision in the purchase agreement has created a special situation. One of the leading authorities in the area of partnership taxation has developed a "three tier" payment analysis of section 736.<sup>50</sup> The first tier payment is for the retiring partner's interest in the partnership, the second tier payment is for good will, and the third tier payments are those in excess of the first two tiers.

The first tier payment will be treated as a section 736(b) payment. However, it must be noted that if the assets of the partnership include unrealized receivables the retiring partner's interest in the unrealized receivables will be subject to section 736(a) treatment.<sup>51</sup> The second tier payment will be treated as a section 736(b) or a section 736(a) payment depending upon the inclusion or exclusion of a "good will" provision in the agreement. If the partnership agreement provides for a payment for the retiring partner's interest in good will, the

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retiring or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary or his delegate, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) SPECIAL RULES.—For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in Section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for payment with respect to good will."

48. Int. Rev. Code of 1954, § 736 (b) (2) (A).

49. Id. § 736 (b) (2) (B).

50. Willis, Handbook of Partnership Taxation, §§ 26.03-06 (1957).

51. See note 15 supra; U.S. Treas. Reg. § 1.736-1(b) (2) (1956).

retiring partner will have the benefit of capital gain, but the partnership will have no right to deduct the amount of the payment. If, however, the agreement contains no reference to good will, or if the agreement specifically states that no payment is being made for good will, all amounts paid in excess of the retiring partner's interest in the partnership will be ordinary income to him, but the partnership is entitled to deduct such payments.<sup>52</sup> Tier three payments are treated as section 736(a) payments, whether paid as a guaranteed amount or as a percentage of future profits.<sup>53</sup>

If a partnership is engaged in manufacturing or commerce, it is very likely to have developed valuable and vendible good will. If, however, the partnership is a professional one, there has been some question as to the sale of its good will—the recent decisions holding that there may be.<sup>54</sup> After having been unsuccessful in litigating the matter, the commissioner has recognized that vendible good will may attach to a particular firm name, if the right to the exclusive use of such name may be assigned. Thus, if a sale of a professional type business includes the right to the exclusive use of the firm name, the portion of the sales price attributable to such right shall be treated as derived from the sale of good will.<sup>55</sup> Therefore, if the retiring partner permits the use of his name by the firm after his retirement, and such firm has an established reputation, it is submitted that a section 736(b) payment could be made for good will if specified in the agreement. The valuation placed upon good will by an arm's length agreement of the partners is generally regarded as correct whether specific in amount or determined by a formula.<sup>56</sup>

If the partners believe the good will of the firm to have any substantial value, a problem may arise in the drafting of the agreement. A retiring partner will, naturally, desire that the agreement specifically provide that the partnership is paying for his interest in good will. The remaining partners will desire that no mention be made of good will. An often overlooked provision in the Code can go a long way towards solving the problem.<sup>57</sup>

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52. U.S. Treas. Reg. § 1.736-1(a)(4) (1956).

53. *Id.* §§ 1.736-1(a)(3)(i), 1.736-1(a)(3)(ii).

54. *Masquelette's Estate v. Commissioner*, 239 F.2d 322 (5th Cir. 1956); *Richard S. Wyler*, 14 T.C. 1251 (1950); *Rodney B. Horton*, 13 T.C. 143 (1949).

55. 1957 Int. Rev. Bull. No. 43, at 8.

56. U.S. Treas. Reg. § 1.736-1(b)(3) (1956).

57. Int. Rev. Code of 1954, § 761(c): "Partnership Agreement—For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement."

The agreement can be drafted with a provision that a retiring partner be paid  $X$  dollars for his interest in the firm's good will. However, when a partner indicates his desire to retire from the partnership, the partners can "sharpen their pencils" and make some computations. If the good will provision is applicable, the retiring partner will receive the  $X$  dollars as capital gain, but the partnership will not be able to deduct the payment. Thus, it may prove beneficial to amend the agreement by removing the reference to good will, pay the retiring partner an amount in excess of  $X$  dollars, but, thereby, entitle the partnership to a deduction for the payment. The excess amount paid the retiring partner may offset the difference between ordinary income and capital gain rates to him, and the remaining partners may save taxes by paying " $X$  plus" dollars that are deductible rather than by paying  $X$  dollars that are not deductible.

Although a *sale* by a partner of a fifty per cent or more interest in the capital and profits of a partnership within a twelve-month period will terminate the partnership,<sup>58</sup> a retirement of such an interest will not terminate the partnership.<sup>59</sup> The retiring partner is deemed to continue as a partner and the partnership's taxable year does not close with respect to him until his entire interest is liquidated.<sup>60</sup> This is true even in a two-man partnership.<sup>61</sup> Thus, it is relatively easy to avoid the "bunching" problem by providing that some material payments be made in each of two calendar years.

#### *Retirement of Partner's Interest by Reason of Death*

Just as a partner desiring to withdraw from the partnership may sell his interest in the partnership to the remaining partners as individuals, or may have his interest retired by the partnership as an entity, as the case may be, so may the payment for a deceased partner's interest be cast as a sale to the individual surviving partners, or as a retirement of the interest by the firm. Basically, the tax consequences surrounding the disposition of a deceased partner's interest will be the same as those involved in a sale or retirement of a withdrawing partner's interest, previously considered, depending upon the method chosen and the language of the agreement. The withdrawal of a partner can be timed, but no one can predict the date of death of a partner. Because of the frequent occasions of an untimely death, special provisions are desired by partners to protect their families.

A common provision is that the deceased partner's estate shall be entitled to receive a share of the firm's profits for a reasonable time

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58. Int. Rev. Code of 1954, § 708(b) (1) (B).

59. U.S. Treas. Reg. § 1.708-1(b) (1) (ii) (1956).

60. U.S. Treas. Reg. § 1.736-1(a) (6) (1956).

61. *Ibid.*

subsequent to his death. This is particularly true in service partnerships where the value of tangible assets is relatively little. Payments made under such a mutual insurance provision are taxed to the recipient as ordinary income if the payments are made in liquidation of the decedent's interest in the partnership.<sup>62</sup> However, if the decedent's estate, or successor in interest, continues as a partner in its own right, section 736 does not apply.<sup>63</sup>

Section 753 provides that the amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691. The value of a decedent's interest in the partnership at the time of death (or one year later if alternative valuation date is used)<sup>64</sup> will be the basis of the interest to decedent's estate.<sup>65</sup> However, section 1014(c) specifically excludes the applicability of section 1014 to items of income in respect of a decedent under section 691. Thus, the estate's basis for the interest of a deceased partner does not include the value of section 736(a) payments. A problem arises, however, of whether the commuted value of these payments is subject to inclusion in the decedent's gross estate.

The *Bull* case<sup>66</sup> held that the present value of the right of the estate of a deceased partner to receive section 736(a) payments was not includible in the decedent's gross estate for estate tax purposes. However, in the *McClennan* case<sup>67</sup> the first circuit court of appeals ruled that such a right is includible in the gross estate of the decedent. Congress, by enacting section 753, apparently intended to adopt the *McClennan* rule, rather than that of the *Bull* case. The senate finance committee report states, *inter alia*:

Section 753 thus covers payments in the nature of mutual insurance as well as payments attributable to the decedent's interest in the unrealized receivables of the partnership. Thus, while a successor in interest of a decedent partner will be required to include in gross income amounts received from the partnership which are attributable to the value of the decedent's interest in unrealized fees or mutual insurance, the recipient will at the same time receive a deduction for the estate tax paid with respect to the inclusion of such rights to income in the decedent's estate. (Emphasis added.)<sup>68</sup>

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62. Int. Rev. Code of 1954, § 736(a) (1).

63. U.S. Treas. Reg. § 1.736-1(a) (1) (i) (1956).

64. Int. Rev. Code of 1954, § 2039.

65. Id. § 1014(a).

66. 295 U.S. 247 (1935).

67. 131 F.2d 165 (1st Cir. 1942).

68. S. Rep. No. 1622, 83d Cong., 2d Sess. 405-06 (1954).

A recent decision by the second circuit court of appeals<sup>69</sup> followed the *McClennan* rule and distinguished the *Bull* case on the ground that the decedent's estate in the *Bull* case continued as a partner, whereas in the *McClennan* situation the section 736(a) payments were made in liquidation of the decedent's interest. A more important aspect of the *Riegelman* decision, however, is the opinion by the court that the *Bull* case no longer states the applicable law. This conclusion is premised on the fact that subsequent to the *Bull* decision, Congress adopted the concept of "income in respect of a decedent."<sup>70</sup> Section 691 of the 1954 Code is the present successor to section 134(e) of the 1942 act. The harsh result of including the present value of 736(a) payments in the decedent's gross estate and again including the payments, when received, in the gross income of the estate is softened by allowing as a deduction from the estate's gross income the amount attributable to the estate tax paid by virtue of the inclusion of the value of the section 736(a) payments in the gross estate.<sup>71</sup>

Although the taxable year of a partnership closes with respect to a partner whose interest is liquidated, such is not the case when a partner dies prior to the end of the partnership's taxable year.<sup>72</sup> This provision avoids an automatic bunching of income in the decedent's final return. However, if the decedent's estate, or other successor in interest, sells the entire interest, or if the entire interest is liquidated, the partnership's taxable year with respect to the estate, or other successor in interest, shall close on the date of the sale, or the date of the completion of the liquidation.<sup>73</sup> If under the terms of an agreement existing at the date of death of a partner, a sale of the deceased partner's interest in the partnership occurs upon that date, the taxable year of the partnership with respect to such deceased partner shall close upon the date of death.<sup>74</sup> Thus, the partners can prevent a bunching of income upon the death of one of their number by avoiding a provision that requires a sale of the interest of a deceased member as of the date of death.

One of the most perplexing problems in a buy-and-sell agreement is that of valuation of an interest in the partnership. In the situation of a sale or retirement by a living partner, it is usually a matter of contract between the parties. However, in the event of a partner's death, the commissioner becomes a party to the agreement because

69. *Estate of Riegelman v. Commissioner*, 253 F.2d 315 (2d Cir. 1958), affirming 27 T.C. 833 (1957).

70. Int. Rev. Code of 1942, § 134(e), 56 Stat. 831 (now Int. Rev. Code of 1954, § 691).

71. Int. Rev. Code of 1954, § 691(c).

72. Id. § 706(c) (2) (A) (ii).

73. U.S. Treas. Reg. § 1.706-1(c) (3) (i) (1956).

74. Id. § 1.706-1(c) (3) (iv) (1956).



the value of the decedent's interest must be included in his gross estate for estate tax purposes.<sup>75</sup>

The regulations<sup>76</sup> provide that the fair market value of any interest of a decedent in a partnership is the net amount which a willing purchaser, whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts. However, if a binding buy-and-sell agreement exists, both the buyer and the seller are compelled to act, and the theory of the "free market place" has no application. The cases hold that the commissioner will be bound by the valuation fixed in the agreement if it was arrived at in an arm's length transaction.<sup>77</sup>

A unique problem confronts the draftsman of a partnership buy-and-sell agreement in his treatment of good will. If the parties desire that payment made to the estate, or successor in interest, of a deceased partner for his share in the firm's good will is to be a 736(a) payment, the agreement can either specifically state that good will is given no value or can ignore the mention of good will.<sup>78</sup> If the first method is used, the agreement will not actually embody the intent of the parties. If the second method is elected (ignore the mention of good will), the regulations<sup>79</sup> hang like Damocles' sword. A suggested solution is to place a value on the firm's good will, but to provide that the payment for the decedent's interest therein is to be made from the future earnings of the partnership. Thus, the decedent's estate receives his share of the value of the good will, and the remaining partners receive the benefits of 736(a) payments.

Every contract is entered into with the expectation that all parties will abide by its provisions and perform according to its terms. If the selling or retiring partner is alive at the time of his withdrawal from the firm, he knows whether the buyer, or the partnership, is financially able to perform. However, no one can foresee the financial condition of the partnership at the time of a sudden and unexpected death of a partner. For this reason, the funding of partnership agree-

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75. Int. Rev. Code of 1954, § 2031(a).

76. U.S. Treas. Reg. § 20.2031-1(a) (1958).

77. *Mandel v. Sturr*, 57-1 U.S.T.C. § 11688, 52 Am. Fed. Tax R. 1585 (S.D.N.Y. 1957); *Estate of Weil*, 22 T.C. 612 (1954); *Estate of Maddock*, 16 T.C. 324 (1951); *Estate of Blodget*, 18 B.T.A. 1050 (1930).

78. Int. Rev. Code of 1954, § 736(b) (2) (B).

79. "Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners." U.S. Treas. Reg. § 20.2031-3 (1958).

ments with life insurance on the lives of the partners has gained considerable popularity.

Basically, there are two approaches to the situation: (a) the entity, and (b) the cross-purchase. Under the entity approach, the partnership owns the insurance and is the beneficiary. When a partner dies, the firm receives the death proceeds and uses the funds to retire the decedent's interest. The entity approach is simple, but the proposed regulations<sup>80</sup> raised a serious problem that caused considerable concern. There was language to the effect that if the buy-and-sell agreement was not supported by a full and adequate consideration, the decedent's gross estate would have to include not merely the value of his interest immediately prior to death, but the value as increased by the insurance proceeds payable on his own death. However, the regulations, as adopted, omitted this provision. It is the opinion of the writer that the decision of the Tax Court in *Estate of Tompkins*<sup>81</sup> properly states the law.

In that case the partnership agreement provided that the decedent's estate was bound to transfer to his surviving partner all of his interest in the partnership assets in exchange for the proceeds of certain life insurance policies which the partnership carried on his life. The court held that all of the insurance proceeds should be included in the decedent's gross estate, but the decedent's share of the partnership assets relinquished therefor need not be included. At the time of the decedent's death, his interest in the partnership assets was limited under the agreement to the amount of the insurance proceeds. In order to ensure the favorable result of the *Tompkins* case, the partnership agreement should provide that the value of a deceased partner's interest shall not include any part or share of the death proceeds received by the partnership under the life insurance policies.

Under the entity theory, each partner pays his pro-rata share of all premiums. At first blush this seems to be an equitable arrangement, but actually it may prove to be very unfair. The partner with the largest interest in the firm will have to pay the largest premium in order to ensure his co-partners that they will have the funds with which to "buy him out." This simple example may illustrate the point:

*A*, forty years old, owns sixty per cent of the business; *B* thirty-five years old, owns forty per cent of the business; *A* is paying sixty per cent of the premiums, but would need to acquire only forty per cent of the business if *B* died. *B*, however, pays only

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80. U.S. Treas. Proposed Reg. § 20.2042-1(c) (6), 21 Fed. Reg. 7886 (1956).

81. 13 T.C. 1054 (1949). See also *Estate of Ealy*, 10 CCH Tax Ct. Mem. 431 (1951), P-H 1951 T.C. Mem. Dec. ¶ 51137; *Estate of Mitchell*, 37 B.T.A. 1 (1938); *M. W. Dobrzensky*, 34 B.T.A. 305 (1936).

forty per cent of the premiums and, yet, will have the funds to acquire sixty per cent of the business.

As a matter of business "protection," the partners frequently desire a provision to the effect that even if the amounts to which their estates are entitled when they die are less than the death proceeds of the insurance policies, their estates shall still receive the full amounts of the proceeds. Such excess, under the entity theory, will be taxed to the estate as a 736(a) payment and will also be includible in the decedent's gross estate.

Under the cross-purchase approach, each partner owns a policy of life insurance on each of his co-partners. Thus, the death proceeds are payable directly to the surviving partners. This is a more complicated method than the entity approach. Upon the death of a partner, his estate would transfer the policies owned by him on the lives of his co-partners to those co-partners.<sup>82</sup> Under the 1939 Code,<sup>83</sup> if a person acquired a life insurance policy on another's life for a valuable consideration, the excess of the death proceeds received over the cost was taxable as ordinary income. However, section 101(a)(2)(B) of the 1954 Code exempts such excess from taxation if the purchase was from another partner, or from the partnership.

If the cross-purchase approach is adopted, then the payment by the surviving partners to the decedent's estate in exchange for his interest in the partnership will constitute a sale of the interest, and the provisions of section 741 rather than section 736 will apply. As previously discussed, this result will be favorable to the estate, but unfavorable to the surviving partners. In the cross-purchase situation, however, it is clear that the value of the decedent's interest in the partnership does not include any part of the death proceeds received on his death by the surviving partners.<sup>84</sup>

Possibly, a solution which offers the advantages of both the entity and cross-purchase methods is to have the partnership obligate itself to retire the interest of a deceased partner, but have the insurance policies owned by the individual partners. Upon the death of a partner, the survivors would collect the proceeds (which are non-taxable)<sup>85</sup> and would contribute the proceeds to the partnership. Thus the partnership would have the funds with which to fulfill its obligation; and, in addition, the surviving partners would increase the bases for their

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82. The terminable reserve value (roughly, the cash surrender value) of the policies owned by the decedent on the lives of the surviving partners is includible in the decedent's gross estate. *Estate of DuPont v. Commissioner*, 233 F.2d 210 (3d Cir.), cert. denied, 352 U.S. 878 (1956).

83. Int. Rev. Code of 1939, § 22(b)(2), 53 Stat. 9.

84. Rev. Rul. 56-397, 1956-2 Cum. Bull. 599.

85. Int. Rev. Code of 1954, § 101(a)(1).

interests in the partnership by the amount of the contributions.<sup>86</sup> This situation is distinguishable from the *Legallet* case<sup>87</sup> where the deceased partner's wife was the named beneficiary of the insurance policy on his life and the death proceeds were paid directly to her.

A consideration of the problems discussed herein, and the ramifications of these problems in particular situations, shows the obvious need of a partnership buy-and-sell agreement, particularly regarding the procedure to be followed in the event of a partner's death. It is believed that a logical close to this article is a sample provision for the retirement of a deceased partner's interest:

"A. Upon the death of a partner, the partnership shall be continued by the remaining partners without interruption. The estate of the deceased partner shall be entitled to receive the value of such deceased partner's interest pursuant to Paragraph B hereof, and no other amount. [If it is desired that deceased partner's estate share in future earnings for a limited period, such provision can be here inserted.] Such amount shall be paid by the partnership to such deceased partner's estate within \_\_\_\_\_ months following the month of his death. [If bunching may be a problem, spread out payments.] That part of the value as is determined pursuant to subparagraph 2 of Paragraph B, to the extent it exceeds the excess of the value of partnership property over the book value thereof, is deemed the value of the good will of the partnership. For income tax purposes it is the intention of the parties that the payments for the interest in good will of a deceased partner shall be treated as a part of the payment for such partner's interest in partnership property pursuant to section 736(b) of the Internal Revenue Code of 1954.

[In the event the parties desire to treat payments for good will as 736(a) payments, the agreement can provide that the amount determined pursuant to subparagraph 2 of paragraph B be paid in guaranteed installments, and that the parties intend such payment to be 736(a) payments.]

"B. (1) The value of the interest in the partnership property of a deceased partner shall be the sum of the following:

- (a) The credit balance in his Capital Account;
- (b) His proportionate share of accrued net income of the partnership to the date of his death, unless included in his Drawing Account;
- (c) Any debt owed to him by the partnership, less any debt owed by him to the partnership, and
- (d) One-third ( $\frac{1}{3}$ ) [if a three-man partnership; one-fourth if four-man, etc.] of the amount specified in subparagraph (2).

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86. *Id.* § 722.

87. Paul Legallet, 41 B.T.A. 294 (1940).

(2) (a) The partners hereby determine the amount of \$..... as representing the excess of the total value of the partnership property over its book value. This agreed amount represents the excess of the total fair market value of all partnership property, including good will, over the total book value of such property.

(b) The agreed value as above stated is subject to change by the partners upon their executing Schedule 'A' attached to the copy of this Agreement which is on file in the partnership office. The date and amount of each new valuation shall be indicated and shall be followed by the signatures of all of the partners. For the purpose of this Agreement, the last determination of valuation shall be binding upon the parties hereto and upon their successors, assigns, administrators and executors. The adjustment may be a minus amount if the partners agree that the total book value of the partnership property exceeds its total fair market value.

(c) In the event that no Agreement with respect to an amount has been made by the partners, in the manner provided in subparagraph (2) (b) above, within two years prior to the death of a partner, any continuing partner, or the representative of the estate of the deceased partner shall have the right to demand that the last agreement with respect to such amount shall be disregarded. In that event, there shall be submitted to arbitration, as hereinafter provided, the determination of the excess, if any, of the total value of the business, including good will, over its book value. The excess value thus determined shall be employed, as provided in subparagraph 1 above, in the determination of the value of the interest of the deceased partner. [Agreement should contain a standard arbitration provision.]

"C. At the present time the partnership owns a term life insurance policy insuring the life of each partner in the amount of \$..... The policies are set forth in Schedule B, attached hereto. In the event of the death of a partner, the value of his interest as computed in Paragraph B shall not include any part or share of the benefits received by the partnership under the aforesaid policies of life insurance.

[The following is an alternate paragraph C]:

"At the present time each of the partners owns term life insurance policies insuring the lives of his co-partners in the face amount of \$..... on each co-partner. The policies are set forth in Schedule B attached hereto. During the lifetime of the partners and the continuance in force of this Agreement, each party hereto shall pay the premiums on the policies owned by him, as they become due, and shall give proof of payment to the partnership within fifteen days after the due date of each premium. In the event a premium is not paid within fifteen days after it is due, the partnership shall pay such premium

and charge the payment against the Drawing Account of the partner responsible for the payment.

In the event of the death of a partner, the surviving partners shall receive the death proceeds under the policies owned by them on the decedent's life and shall contribute such proceeds to the capital of the partnership. The value of the deceased partner's interest as computed in Paragraph B shall not include any part or share of the benefits received by the surviving partners under the aforesaid policies of life insurance, and shall not include any part or share of the contributions to the partnership made by the surviving partners subsequent to his death. The estate of the deceased partner shall sell and assign to the surviving partners the policies of life insurance owned on their lives by the decedent at the same price that the estate can receive if such policies are surrendered and cancelled."

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