

Louisiana Law Review

Volume 54 | Number 1
September 1993

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Repository Citation

Mark R. Siegel, *The Internal Revenue Code's Assault on Buy-Sell Agreements*, 54 La. L. Rev. (1993)
Available at: <https://digitalcommons.law.lsu.edu/lalrev/vol54/iss1/9>

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The Internal Revenue Code's Assault on Buy-Sell Agreements

Mark R. Siegel^{*}

Corporate shareholders often enter into restrictive arrangements regarding their stock. These agreements, known as shareholders' agreements or buy-sell agreements, serve a multitude of business concerns that the shareholders harbor.¹ They may be entered into at the inception of the corporation or at a later time when the shareholders perceive the need.

The two basic forms of buy-sell agreements are redemption agreements and cross-purchase agreements. A redemption agreement is between the corporation and its shareholders, whereas a cross-purchase agreement is between or among shareholders. Under a redemption agreement, the corporation is obligated, or has the option, to acquire the stock upon the occurrence of certain triggering events, i.e., a shareholder's death, disability, retirement, or termination of employment. In contrast, a cross-purchase agreement obligates, or gives an option to, the remaining shareholders to purchase the stock.

A third form of buy-sell agreement is known as a combination agreement. It generally provides that the corporation has the primary obligation or option to purchase upon a triggering event with the remaining shareholders having a secondary obligation or option to purchase.

I. BUSINESS OBJECTIVES

Shareholders of a closely held corporation typically have a number of business objectives when contemplating entering into an agreement restricting the transferability of their shares of stock. Continued successful operations may be jeopardized through a loss of the consensual efforts among the historic shareholders. As a group, the shareholders charged with management responsibilities may wish to provide certainty of corporate ownership, which can be accomplished through restrictions against stock transfers to unrelated transferees outside of the ownership group. Further, the shareholders may seek to retain control to prevent family members with little or no background or training from having an ownership stake in the business enterprise.

Unlike shareholders of publicly traded companies, shareholders of closely held corporations do not have the ability to call their broker and convert their stock to cash. The lack of marketability attendant to closely held stock and the shareholders' need for liquidity can be resolved through buy-sell arrangements.

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1. Not all restrictive stock provisions are contained in these agreements. For instance, restrictive provisions may be found in the articles of incorporation or corporate bylaws.

The agreement may provide a ready market for a selling shareholder or needed liquidity for the estate of a deceased shareholder.

Concerns of minority interest shareholders may be focused on issues of valuation. A buy-sell agreement may establish certainty as to stock value by fixing a price for the shares of stock through an agreed value, a valuation formula, or an appraisal.

Even with a buy-sell agreement in place, the ability to convert a shareholder's stock investment into cash will be thwarted if the putative buyer lacks the cash at the requisite time. To secure adequate funding, many restrictive agreements are funded with life insurance.

A restrictive agreement may also limit stock transfers that would result in the termination of S corporation status. To protect favorable S corporation status for the continuing owners, the agreement should prevent stock transfers to ineligible shareholders.

Business justifications alone seldom dictate the form, funding, and valuation formula shareholders incorporate into their buy-sell arrangements. This article examines and analyzes the income, corporate, estate, and gift tax rules business owners encounter in making their choices. Recent tax legislation has added to the complexities that owners and their advisors face when entering and structuring buy-sell agreements.

II. REDEMPTION AGREEMENTS

A. *Impact on Seller*

In general, a repurchase by a corporation of its own stock is a distribution of property subject to the rules of sections 301 and 316 of the Internal Revenue Code.² As a result, the distribution is treated as a dividend to the extent of the acquiring corporation's current or accumulated earnings and profits. Amounts in excess of earnings and profits are treated as tax free returns of capital to the extent of the redeeming shareholder's stock basis. Any amounts received that are in excess of the stock basis are treated as the proceeds from the sale of stock, which would ordinarily result in capital gains treatment.

Fortunately, not all corporate distributions are dividends. For example, a complete redemption qualifies as a sale or exchange.³ The rules are more complex for redemptions of less than all of a shareholder's stock. Redemptions otherwise subject to distribution treatment under section 301 may be treated as stock sales if the exceptions contained in either sections 302 or 303 apply.⁴

Due to changes enacted by the Tax Reform Act of 1986 (the 86 Act), it is appropriate to question whether the distinction between capital gains and

2. I.R.C. §§ 301, 316 (1988 & Supp. 1991).

3. I.R.C. § 302(b)(3) (1988). See *infra* text accompanying notes 8-14.

4. I.R.C. §§ 302, 303 (1988).

dividends has meaning. Although the 86 Act eliminated the tax rate differential between capital gains and ordinary income, the Revenue Reconciliation Act of 1990⁵ restored a preferential rate for capital gains by providing that net capital gain will be taxed at a top rate of twenty-eight percent, while ordinary income will be subject to a maximum rate of thirty-one percent.⁶ The tax consequences of treating a corporate distribution as a redemption instead of a dividend have significance beyond the presence or absence of rate differentials between capital gains and ordinary income. The full amount of the dividend, while nondeductible by the corporation, is includible in the shareholder's income. On the other hand, for redemptions that qualify as sales or exchanges, the shareholder may offset his stock basis against the amount received in the distribution. Moreover, given the fair market value at death basis rules under section 1014,⁷ little, if any, gain will usually be recognized for qualifying redemptions made shortly following the shareholder's death.

Section 302(a) affords capital gains treatment to redemption proceeds if one of the four exceptions contained in section 302(b) is satisfied. First, a redemption will be treated as a sale if it is not essentially equivalent to a dividend.⁸ To avoid dividend treatment under this exception, there must be a meaningful reduction in the shareholder's interest in the corporation.⁹ Because precise guidelines of what constitutes a meaningful reduction do not exist, shareholders cannot rely on this exception as a sure means to avoid dividend treatment.

Under section 302(b)(2), redemptions that are substantially disproportionate are accorded sales treatment. To be substantially disproportionate, a redemption must meet a two-part test. First, the redeeming shareholder must own less than fifty percent of the voting power of all classes of voting stock following the redemption; second, the redeeming shareholder after the redemption must own less than eighty percent of the common and voting stock owned before the redemption. For family owned corporations, the family attribution rules contained in section 318¹⁰ may prevent the redeeming shareholder from meeting the twenty percent reduction in interest test.

A redemption of all of the shareholder's stock in the corporation, a complete redemption, is treated as a sale of stock.¹¹ Redemptions of the shareholder's entire stock interest do not necessarily guarantee dividend avoidance.

5. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-490 (codified in scattered sections of 26 U.S.C.).

6. The preferential rate applies to tax years beginning January 1, 1991.

7. In general, section 1014 provides that the basis of property acquired from a decedent is equal to the fair market value of the property as of the date of the decedent's death.

8. I.R.C. § 302(b)(1) (1988).

9. *United States v. Davis*, 397 U.S. 301, 313, 90 S. Ct. 1041, 1048 (1970).

10. I.R.C. § 318 (1988).

11. I.R.C. § 302(b)(3) (1988).

The attribution rules found in section 318 may prevent a redemption from otherwise qualifying as a complete redemption. For income tax purposes, the selling shareholder is deemed to own the stock of certain family members. Through this constructive ownership, the selling shareholder continues to have an interest in the corporation. Under section 302(c)(2), however, the family attribution rules under section 318(a)(1) can be waived when, among other things, the shareholder, immediately after the distribution, has no interest in the corporation other than an interest as a creditor.¹²

Lastly, a redemption which is in partial liquidation of the distributing corporation is treated as a sale.¹³ The redeeming shareholder cannot be a corporation.¹⁴

Section 303 permits the withdrawal of large amounts of cash from the corporation without dividend treatment. The proceeds are eligible for capital gain treatment to the extent of the sum of federal and state estate taxes, interest, and funeral and administration expenses. To qualify under section 303, the value of the stock included in the deceased shareholder's estate must exceed thirty-five percent of the gross estate reduced by the sum of claims, expenses, and losses deductible for estate tax purposes pursuant to sections 2053 and 2054.¹⁵ While the redeeming shareholder must be obligated to pay the death taxes and expenses, there is no statutory requirement that the proceeds actually be applied in payment of such expenses. Thus, the redemption can qualify under section 303 even though the redeeming shareholder has ample cash and does not need the proceeds to pay taxes and expenses.

Where the liquidity needs of the selling shareholder are not paramount, the purchaser under the redemption agreement may be given the right to pay all or a portion of the purchase price in installments. In this situation, the rate of interest charged on the installment payments is critical. If the installment payments do not provide for an adequate rate of interest, the amount of interest for income and deduction purposes will be recomputed under a complex set of rules contained in section 1274.¹⁶ The tax effect is to convert a portion of the stated principal amount into interest for tax purposes. Generally, to avoid interest being imputed under section 1274, it is wise to provide for an interest

12. Under section 302(c)(2)(A)(i), the distributee may not have an interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor. In *Lynch v. Commissioner*, 801 F.2d 1176 (9th Cir. 1986), the Ninth Circuit held the waiver of the family attribution rules inapplicable since the distributee remained a consultant to the corporation after the redemption. *Id.* at 1182. Therefore, the redemption proceeds were dividends and not a complete redemption under section 302(b)(3). *Id.*

13. I.R.C. § 302(b)(4) (1988). A distribution can qualify for the partial liquidation exception if it is attributable to the corporation's ceasing to conduct a qualified trade or business (or consists of assets of the qualified trade or business), and, immediately after the distribution, the distributing corporation is actively engaged in conducting a qualified trade or business. I.R.C. § 302(e)(2) (1988).

14. I.R.C. § 302(b)(4)(A) (1988).

15. I.R.C. §§ 2053-2054 (1988).

16. I.R.C. § 1274 (1988 & Supp. 1991).

rate to be paid over the life of the payment obligation that is equal to the applicable federal rate.¹⁷

B. Impact on Buyer and Continuing Shareholders

When the redemption proceeds are paid in cash, the corporation will not recognize gain or loss, irrespective of whether the proceeds are treated as dividends under section 301 or as a sale under either sections 302 or 303. However, if the corporation uses appreciated property to effect the stock redemption, it must recognize gain measured by the excess of the fair market value of the property distributed over its adjusted basis.¹⁸ Corporate gain is recognized no matter if the distribution to the shareholder is treated as a dividend or as a sale of stock.

In most redemptions pursuant to buy-sell agreements, the continuing shareholders are not directly affected by the purchase. However, if the corporation acquires stock from the redeeming shareholder that the continuing shareholders had a primary and unconditional obligation to purchase, the purchase will be treated as a constructive dividend to the continuing shareholders.¹⁹ To avoid constructive dividend problems, the buy-sell agreement should be structured to give the shareholders an option to purchase rather than an unconditional purchase obligation. The corporation's purchase rights should arise only if the shareholders fail to exercise their option.

Stock redemptions under buy-sell agreements are often funded through the purchase of life insurance on the lives of the shareholders. Where death is the event that triggers the redemption, the corporation then has the funds necessary to purchase the stock from the decedent's estate or heirs. The 86 Act created a corporate alternative minimum tax (AMT) applicable to buy-sell arrangements funded through life insurance proceeds.

The 86 Act also created a new tax preference item commonly known as the book-tax preference item, under which one-half of the difference between a corporation's financial accounting or book income and its alternative minimum taxable income is treated as a preference item. Life insurance proceeds collected by corporations are included in book income but not in regular taxable income.²⁰ As a result of this new preference item, corporations may become subject to a twenty percent tax on one-half of the collected insurance proceeds.

For taxable years beginning after 1989, an even larger amount may constitute a preference item. Commencing in 1990, the fifty percent book-tax

17. I.R.C. § 1274(d) (1988).

18. I.R.C. § 311 (1988).

19. Rev. Rul. 69-608, 1969-2 C.B. 42; *Pulliam v. Commissioner*, 48 T.C.M. (CCH) 1019 (1984); *Jacobs v. Commissioner*, 41 T.C.M. (CCH) 951 (1981), *aff'd*, 698 F.2d 850 (6th Cir. 1983).

20. A corporation, as recipient of the insurance proceeds, is entitled to exclude from gross income insurance proceeds paid by reason of the insured's death. I.R.C. § 101(a)(1) (1988).

preference is replaced with an adjustment based on adjusted current earnings (ACE). ACE applies only to C corporations.²¹ Under ACE, the twenty percent AMT rate will apply to seventy-five percent of the excess of the corporation's ACE amount over its alternative minimum taxable income (AMTI).

The ACE amount, though not the same as earnings and profits, is determined by reference to earnings and profits and utilizes some of the same calculations. As life insurance proceeds increase earnings and profits,²² and the ACE amount,²³ seventy-five percent of the proceeds may be subjected to tax at the twenty percent AMT rate.²⁴ Thus, the insurance proceeds may be taxed at an effective rate of fifteen percent (twenty percent AMT rate multiplied by seventy-five percent).

Redemptions under sections 302 and 303 reduce the amount of corporate earnings and profits.²⁵ However, for purposes of calculating the ACE amount, the law in effect prior to the Revenue Reconciliation Act of 1989 (the 89 Act) provided that the section 312(n)(7) adjustment to earnings and profits did not apply.²⁶ Consequently, timing the redemption to occur in the same tax year that the corporation collected the insurance proceeds would not reduce the ACE amount. For tax years beginning after December 31, 1989, the 89 Act amended section 56(g)(4)(D) to delete any reference to section 312(n)(7). Thus, at first blush, it appears that a corporation may be able to avoid the AMT by having the redemption occur in the same tax year as the insurance proceeds are collected; however, this is not in fact the case. The ACE adjustment is basically AMTI computed with certain additional adjustments. The law in effect prior to the 89 Act did not permit AMTI to be reduced through a redemption timed to occur in the same year as the corporation collected its insurance proceeds. Likewise, ACE is not reduced. Moreover, there is no statutory authority which specifically permits such an ACE reduction.

III. LIMITING OR AVOIDING AMT LIABILITY

Because the AMT can apply to C corporations that receive life insurance proceeds, one AMT avoidance method is to elect S corporation status. Another solution to minimize the ACE adjustment relating to insurance proceeds is the use of a split-dollar life insurance arrangement. With this arrangement, insurance premiums are financed by having the corporation and insured shareholders share

21. Section 56(g)(6) makes ACE inapplicable to S corporations.

22. Rev. Rul. 54-230, 1954-1 C.B. 114.

23. I.R.C. § 56(g)(4)(B) (1988 & Supp. 1991).

24. ACE is increased for the annual cash surrender value buildup in excess of the premiums allocable to pure insurance. I.R.C. § 56(g)(4)(B)(ii) (1988).

25. I.R.C. § 312(n)(7) (1988 & Supp. 1989).

26. I.R.C. § 56(g)(4)(D)(iv) (Supp. 1991).

the cost of the insurance policy, as well as split the proceeds.²⁷ Under the typical split of the proceeds, the corporation receives the cash value or investment portion of the proceeds and the insured shareholder receives the pure insurance or at-risk portion. The ACE adjustment will be reduced because only a portion of the proceeds are paid to the corporation.

To avoid the harsh consequences of the corporate AMT, corporations with existing redemption agreements funded by life insurance may wish to convert their agreements to cross-purchase arrangements. One method to accomplish the conversion involves the transfer of existing policies to the shareholders; however, policy transfers are fraught with tax difficulties because a corporate transfer may cause the proceeds to be taxable to the recipient. As a general rule, life insurance proceeds paid upon the named insured's death are non-taxable to the beneficiary.²⁸ However, when the policy (or an interest in it) is transferred for a valuable consideration, the proceeds may become taxable.²⁹ Valuable consideration is not limited strictly to cash purchases. For instance, a policy transfer to a co-stockholder in exchange for his contractual obligation under a cross-purchase arrangement is deemed to be for a valuable consideration.³⁰

There is an exception in section 101 to the foregoing transfer-for-value rule covering transfers to the insured.³¹ Nevertheless, conversions from redemption agreements to cross-purchase agreements involve transfers to the insured's co-stockholders rather than the insured.³² Another exception exists in section 101 for policies transferred to a partner of the insured or to a partnership in which the insured is a partner.³³ As a result, if the shareholders are also partners in an existing operating partnership, the transfer-for-value rule will not apply to a corporate transfer of the policies to the insured's partnership or to the partner-

27. A common cost sharing method is for the corporation to pay the portion of the premium attributable to the increase in cash surrender value and for the insured shareholder to pay the remainder. Because the cash surrender value portion of the policy increases each year while the pure insurance portion decreases, the annual premiums paid by the insured shareholder are reduced in subsequent years.

Under another variation, the corporation pays the entire premium and charges the shareholder with income equal to the annual value of the benefit received. The value of the economic benefit equals the lower of the P.S. 58 rate established by the government or the yearly renewable term rates actually charged by an insurer for comparable coverage. See Rev. Rul. 66-110, 1966-1 C.B. 12.

28. Section 101(a)(1) allows the recipient to exclude the proceeds from gross income.

29. I.R.C. § 101(a)(2) (1988). Taxability results through a limitation imposed on the general rule of exclusion. The proceeds are includable in the transferee's gross income to the extent they exceed the actual value of the consideration plus any premiums paid by the transferee. *Id.*

30. *Monroe v. Patterson*, 197 F. Supp. 146 (N.D. Ala. 1961).

31. I.R.C. § 101(a)(2)(B) (1988).

32. Transfers from a corporation to one of its shareholders have long been held to be transfers for value. *Lambeth v. Commissioner*, 38 B.T.A. 351 (1938). Section 101(a)(2)(B) does not contain a transfer-for-value exception for transfers to a shareholder.

33. I.R.C. § 101(a)(2)(B) (1988).

stockholder.³⁴ To take advantage of this exception, one must be careful to observe all formalities in the formation and operation of the partnership.³⁵

Provided the shareholders are insurable, a better conversion method may be achieved through a corporate cancellation of existing policies followed by each shareholder's purchases of policies on the lives of the other shareholders. A distribution of the cash surrender value realized on the cancellation could be structured as reasonable compensation to provide for a corporate level deduction. Although the shareholders would have taxable income as a result, they would have cash to defray the cost of purchasing the new policies.

Cross-purchase agreements, unlike redemption agreements which require one policy per shareholder, require the purchase of multiple policies because each shareholder must own a policy on the life of every other shareholder. As the number of shareholders increases, the number of policies required under the cross-purchase arrangement increases exponentially. Two policies are needed for two shareholders, six policies are needed for three shareholders, and twelve policies are needed for four shareholders.³⁶

A solution to the multiplicity-of-policy problem and transfer-for-value problem encountered in cross-purchase arrangements is the establishment of a shareholders' insurance trust together with the cross-purchase agreement. The shareholders would contribute funds to the trust to enable the trust to acquire and maintain a single policy on each shareholder. Upon a shareholder's death, the trustee would collect the insurance proceeds and distribute them to the continuing shareholders to use in acquiring the shares from the deceased shareholder's estate.

Concerns over the applicability of the AMT to insurance funded redemption agreements should not result in the hasty conclusion that conversion to a cross-

34. In Private Letter Ruling 90-12-063 (March 23, 1990), two individuals equally owned stock in a corporation. The two shareholders were also partners in a real estate partnership that owned and leased property and equipment to the corporation. To avoid exposure to alternative minimum tax liability, the corporation proposed to transfer the life insurance policies it owned on the two shareholders to the partnership in partial payment of its rental obligation. The proposal also provided that the partnership would change the beneficiary designations so that each shareholder would be the beneficiary of the policy insuring the life of the other shareholder. The government ruled that there were two transfers for valuable consideration—the first from the corporation to partnership and the second arising out of the beneficiary designation changes made with consideration. Both transfers were found to be excepted from the transfer-for-value rule: the first transfer because it was a transfer to a partnership in which the insured was a partner and the second transfer because it was a transfer to a partner of the insured.

It should be noted that not every beneficiary designation change raises a transfer-for-value issue. In Private Letter Ruling 92-39-033 (June 30, 1992), there was no transfer for value where the beneficiary change was made without any additional consideration.

35. *Swanson v. Commissioner*, 38 T.C.M. (CCH) 296 (1974), *aff'd*, 518 F.2d 59 (8th Cir. 1975).

36. The number of policies needed can be expressed by the following mathematical equation where N equals the number of shareholders: $N \times (N-1) = \text{Number of policies needed}$.

purchase agreement is appropriate. Any conversion should only be made after considering the estate tax implications discussed in Section VI.

Life insurance obtained on the lives of shareholders is not the sole method of funding redemption agreements. In lieu of insurance, corporations frequently accumulate funds to satisfy future redemption obligations. These accumulations may subject the corporation to the accumulated earnings tax levied against unreasonable accumulations.³⁷ Amounts that a corporation accumulates to meet its reasonable business needs (including reasonably anticipated needs), however, are not subject to the tax.³⁸ Thus, because a corporation's section 303 redemption needs are considered "reasonable business needs," these accumulations are generally exempt from the accumulated earnings tax.³⁹ But, the exemption granted to accumulations for a section 303 redemption will not necessarily protect all of these accumulations. Rather, it only covers earnings accumulated in the year of the shareholder's death to fund the section 303 redemption.⁴⁰

The section 303 exemption will be of no avail for accumulations made to effectuate redemptions triggered by events other than death. In those cases, the corporation must establish that the accumulation meets its reasonable business needs. However, corporate funds accumulated to acquire stock from a majority shareholder are less likely to be for business purposes than accumulations for redemptions from minority shareholders.⁴¹

IV. CROSS-PURCHASE AGREEMENTS

A. Impact on Seller

In general, because a shareholder's stock in a corporation is a capital asset, the selling shareholder will have a capital gain or loss upon sale of his stock under a cross-purchase agreement. The shareholder's holding period will determine if the gain (or loss) is long term or short term. Nonetheless, if the sale is triggered by a shareholder's death, the "fair market value at death" basis

37. I.R.C. § 531 (1988). The accumulated earnings tax equals 28% of the accumulated taxable income as defined in I.R.C. § 535 (1988 & Supp. 1991).

38. I.R.C. § 537 (1988 & Supp. 1991).

39. I.R.C. § 537(a)(2) (1988).

40. I.R.C. § 537(b)(1) (1988).

41. *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960), *rev'g* 18 T.C.M. (CCH) 306 (1959) (accumulated earnings tax inapplicable to accumulations made to redeem a minority stock interest); *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir. 1958) (accumulated earnings tax applied to accumulations made to redeem an 80% interest). Because a minority stockholder cannot exercise control over the corporate dividend policy, there is a greater likelihood that accumulations made to accomplish redemptions of minority interests will be found to serve a corporate or business purpose.

rules under section 1014⁴² will most likely produce little or no gain upon sales made shortly after death.

B. Impact on the Buyer

The purchasing shareholders receive a cost basis in the shares acquired under the cross-purchase agreement.⁴³ Additionally, the purchase commences a new holding period for the newly acquired shares. Cross-purchase arrangements that permit the purchaser to acquire shares from the selling shareholder through installment payments may give rise to substantial interest payments. Although interest on indebtedness is generally deductible under section 163(a),⁴⁴ section 163(d)⁴⁵ limits the amount of investment interest deductible by non-corporate taxpayers to the amount of the taxpayer's net investment income. Investment interest is defined as interest paid or accrued on indebtedness allocable to property held for investment. Excluded from this definition is any interest taken into account in determining a taxpayer's income or loss from a passive activity under section 469.⁴⁶

Prior to the 86 Act, interest paid in connection with the purchase of stock in a C corporation was generally treated as investment interest and, thus, subject to the investment interest limitation found in section 163(d).⁴⁷ With the 1986 enactment of the passive loss rules, the IRS may contend that such interest is trade or business interest if the passive loss rules of section 469 would limit or otherwise defer a current deduction.

With respect to interest paid to acquire an interest in a pass-through entity such as an S corporation, the IRS has issued Notice 89-35.⁴⁸ The Notice provides that such interest is to be allocated among the assets of the S corporation and characterized by the activities in which the assets are used. As a result, if the S corporation uses the assets in its trade or business, the interest will be characterized as trade or business interest and may be subject to the passive loss limitations so long as the purchaser does not materially participate in the activities of the S corporation.

Cross-purchase arrangements (including those that were never redemption agreements) involving more than two shareholders create transfer-for-value problems under section 101(a)(2). Upon the first shareholder's death, the

42. I.R.C. § 1014 (1988 & Supp. 1991).

43. I.R.C. § 1012 (1988 & Supp. 1991).

44. I.R.C. § 163(a) (1988). Section 163(h) denies a deduction for personal interest. Personal interest is interest other than trade or business interest, passive loss interest, investment interest, and qualified residence interest. I.R.C. § 163(h)(2) (1988).

45. I.R.C. § 136(d) (1988).

46. I.R.C. § 469 (1988 & Supp. 1991).

47. *Recklitis v. Commissioner*, 91 T.C. 874, 907 (1988); *Miller v. Commissioner*, 70 T.C. 448, 455 (1978). For individual taxpayers, investment interest expense is deductible to the extent of their net investment income. I.R.C. § 163(d)(1) (1988).

48. I.R.S. Notice 89-35, 1989-1 C.B. 675.

continuing shareholders will purchase the policies on the other shareholders' lives from the deceased shareholder's estate. These purchases are transfers for value.

Instead of a purchase by the continuing shareholders, one solution would be to transfer the policies owned by the deceased shareholder to the corporation. Such a transfer is not subject to the transfer-for-value rules;⁴⁹ therefore, a continuing shareholder may avoid including the insurance proceeds in income upon the subsequent deaths of the other shareholders. The drawback to this solution is that it constitutes a redemption arrangement that may subject the corporation to the AMT. A better alternative to the transfer to the corporation is the previously discussed shareholders' insurance trust. This trust is created to hold the policies that fund the buy-out under the cross-purchase arrangement.

V. NET OPERATING LOSS CARRYOVERS

Section 382 applies when a significant ownership change has occurred in a loss corporation.⁵⁰ Instead of eliminating or reducing the loss carryover upon an ownership change, section 382(a) provides an annual limit on the amount of income earned after an ownership change that can be offset by losses incurred prior to the change.⁵¹ An ownership change may be caused by either an ownership shift or an equity structure shift. An ownership shift occurs when there has been more than a fifty percentage point change in ownership by one or more five-percent shareholders⁵² during any three-year period. In general, an equity structure shift applies to reorganizations under section 368(a)(1).⁵³

For purposes of determining whether an ownership change has occurred, stock of a loss corporation that is subject to an option is treated as acquired pursuant to an exercise of the option if the deemed exercise would result in an ownership change.⁵⁴ This is the "deemed exercise" rule and it applies even though the option is contingent or not currently exercisable.⁵⁵ Thus, the holder of an option to purchase stock pursuant to a buy-sell agreement is considered to own the stock itself if that ownership would cause an ownership change under section 382.

While the application of the option attribution rules may operate to cause an ownership change, certain options are excepted from attribution. Relevant exceptions in the context of buy-sell agreements include:

49. I.R.C. § 101(a)(2)(B) (1988).

50. A loss corporation is a corporation that has losses incurred before the requisite ownership change.

51. The annual limit is equal to the value of the corporation immediately prior to the ownership change multiplied by the long-term tax exempt rate defined in section 382(f). Monthly revenue rulings publish the prescribed interest rate.

52. Non-five-percent shareholders are aggregated and treated as a single five percent shareholder group. I.R.C. § 382(g)(4)(A) (1988 & Supp. 1991).

53. I.R.C. § 368(a)(1) (1988).

54. I.R.C. § 382(1)(3)(A)(iv) (1988); Temp. Treas. Reg. § 1.382-2T(h)(4) (1987).

55. Temp. Treas. Reg. § 1.382-2T(h)(4)(iii) (1987).

1. Options exercisable only upon the death, complete disability, or mental incompetency of the owner.⁵⁶
2. Options exercisable solely upon the retirement of individual shareholders who actively participate in the management of the business, provided the option was issued before the corporation was a loss corporation.⁵⁷
3. Options deemed exercised which lapse unexercised or the owner of such option irrevocably forfeits the right to acquire stock under the option.⁵⁸

While the exceptions to option attribution address many of the triggering events under a buy-sell agreement, they do not necessarily cover all triggering events. Moreover, the section 382 limitation may apply not only to loss corporations currently entering into buy-sell agreements but also to loss corporations whose agreements were executed before pre-ownership change loss years. As a consequence of the deemed exercise treatment, a buy-sell agreement may accelerate an ownership change even in the absence of the actual exercise of the options.

The government recently issued proposed regulations replacing the deemed exercise rule. The new regulations constitute a welcomed approach and provide that options generally are not to be treated as exercised unless the options were issued or transferred for an abusive principal purpose.⁵⁹ An abusive principal purpose concerns manipulating the timing of an ownership shift to avoid or ameliorate the impact of an ownership change either by treating the option holder as an owner prior to exercising the option or facilitating the creation of income to offset corporate losses before the option is exercised.⁶⁰ The proposed regulations contain the following list of non-exclusive factors to determine whether the abusive principal purpose is present:

1. Transactions entered into by the loss corporation with a view to accelerate income or defer deductions, losses, or credits.
2. Pricing the option substantially below the value of the underlying stock at the time the option is issued or transferred.
3. Making contributions to the capital of the loss corporation.

56. Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(D) (1987). This exception is available for both cross-purchase and redemption agreements.

57. Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(H) (1987). An option with terms described in both Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(D) and (H) (1987) are not subject to option attribution. *Id.*

58. Temp. Treas. Reg. § 1.382-2T(h)(4)(viii) (1987). These lapsed or forfeited options are treated as if they were never issued. The loss corporation may, therefore, file an amended return for previous tax years that the section 382 limitation would have been inapplicable. Of course, the ability to file an amended return is subject to applicable statutes of limitation. *Id.*

59. Prop. Treas. Reg. § 1.382-4(d)(2), 57 Fed. Reg. 52,747 (1992).

60. Prop. Treas. Reg. § 1.382-4(d)(2)(ii), 57 Fed. Reg. 52,747 (1992).

4. Allowing the option holder to participate in management decisions of the corporation.
5. Making dividend or liquidating distributions to the option owner.⁶¹

VI. ESTATE TAX ASPECTS OF BUY-SELL ARRANGEMENTS

A. *The Law Before Section 2703*

Under prior law, buy-sell agreements were popular estate planning devices used to freeze the value of stock. A properly drafted agreement could serve to fix the value of a deceased shareholder's stock for estate tax purposes. To be effective for such purpose, the following requirements had to be satisfied:

1. The purchase price, which had to be reasonable only as measured at the time the agreement was made, had to be fixed or determined by a formula.
2. The estate had to be obligated to sell at the contract price. A right of first refusal (which provides that if the estate elects to sell, the corporation or continuing shareholders have the option to acquire) is not sufficient to meet this requirement.⁶² In contrast, if the estate is required to sell and the other party must buy, or has an option to buy, the requirement is satisfied.⁶³ Thus, while the estate must be obligated to sell, the purchaser is not required to buy.⁶⁴
3. The decedent could not be free during his lifetime to sell the shares at a price higher than the contract price.⁶⁵ Many buy-sell agreements provide that the shareholder may make gifts of stock to permitted transferees, e.g., family members or trusts for their benefit. Such provisions are subject to attack as devices representing a potential for avoiding the agreement and the lifetime transfer restriction requirement. If authority for these transfers must be included in the agreement, they should be coupled with a provision that the shares remain subject to the terms of the buy-sell agreement.

61. Prop. Treas. Reg. § 1.382-4(d)(2)(iii)(B), 57 Fed. Reg. 52,747 (1992). The facts and circumstances approach incorporated in the proposed regulations should be made available to taxpayers through an elective retroactive application. At the present time, the regulations only apply to testing dates after November 4, 1992.

62. *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970). See also *Worcester County Trust Co. v. Commissioner*, 134 F.2d 578 (1st Cir. 1943). A first refusal right does not operate to obligate the holder to sell.

63. *United States v. Land*, 303 F.2d 170 (5th Cir. 1962) (mandatory purchase); *Lomb v. Sugden*, 82 F.2d 166 (2d Cir. 1936) (option to buy).

64. Treas. Reg. § 20.2031-2(h) does not require the sale to be completed.

65. *Baltimore Nat'l Bank v. United States*, 136 F. Supp. 642 (D. Md. 1955); *Estate of Matthews v. Commissioner*, 3 T.C. 525 (1944); *Fiorito v. Commissioner*, 33 T.C. 440 (1959).

4. The buy-sell agreement had to be a bona fide business arrangement rather than a testamentary device to transfer the shares for less than full and adequate consideration.⁶⁶ Until 1982, caselaw had established that this requirement was satisfied where the purpose of the agreement was to maintain control by the ownership group or to assure continuity of business management.⁶⁷ However, in *St. Louis County Bank v. United States*,⁶⁸ the Eighth Circuit concluded that the business purpose of maintaining control did not prevent the agreement from constituting a testamentary device.⁶⁹ As a consequence, an agreement would not fix value either where it did not serve a bona fide business purpose or where it was a testamentary device to avoid tax despite serving a business purpose.⁷⁰

B. Section 2036(c)

Under section 2036(a), if a decedent, prior to death, transfers property while retaining the right to the income from, or the enjoyment to, the property, the property is included in his gross estate at its fair market value as of the date of death.⁷¹ In 1987, Congress enacted section 2036(c), which was aimed at the traditional estate freeze techniques covering corporate recapitalizations and partnership restructurings. Section 2036(c), as amended by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA),⁷² provided that if a taxpayer held a substantial interest (ten percent or more) in an enterprise and transferred a disproportionately large share of the potential appreciation in the enterprise, while retaining an interest in the income of or other rights in the enterprise, the entire value of the property (the retained property and the transferred property) would be included in the taxpayer's estate under section 2036(a).⁷³ The broad statutory language under section 2036(c) ensnared a far wider range of

66. This requirement, which can be found in Treas. Reg. § 20.2031-2(h) (1992), is echoed in Rev. Rul. 59-60, 1959-1 C.B. 237.

67. Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977); Estate of Reynolds, 55 T.C. 172 (1970); Roth v. United States, 511 F. Supp. 653 (E.D. Mo. 1981).

68. 674 F.2d 1207 (8th Cir. 1982), *rev'g* Roth v. United States, 511 F. Supp. 653 (E.D. Mo. 1981).

69. *Id.* at 1210. *St. Louis County Bank* illustrates the subjectivity inherent in the business purpose/testamentary device requirement. The Eighth Circuit found evidence of a testamentary device from the existence of family members, the decedent's poor health when the agreement was entered into, and the fact that the agreement was ignored when another family member had died. *Id.*

70. The legislative history and regulations under section 2703, discussed *infra* at notes 82-98, follow *St. Louis County Bank* by treating the business purpose and testamentary device requirements as independent tests.

71. I.R.C. § 2036(a) (1988).

72. Pub. L. No. 101-508, 102 Stat. 3342.

73. I.R.C. § 2036(c), *repealed by* Revenue Reconciliation Act of 1990, § 11601(a), 104 Stat. 1388-490.

transactions than corporate recapitalizations and partnership freezes. As a consequence of the TAMRA amendments, it was clear that buy-sell agreements were covered by section 2036(c). TAMRA did create a safe harbor for certain options and other agreements to buy or sell property at the fair market value at the time the option was, or rights under the agreement were, exercised.⁷⁴ In Notice 89-99,⁷⁵ the Internal Revenue Service indicated that a formula price, which could be expected to result in a purchase price that approximates fair market value at the time of sale, would satisfy the safe harbor. Consequently, despite the ability to establish a purchase price by formula, a buy-sell agreement which satisfied the safe harbor had limited value in fixing value for estate tax purposes below current market rates. Section 2036(c) did not apply to buy-sell agreements entered into before December 18, 1987. Purchases pursuant to grandfathered agreements after December 17, 1987, likely would not have been subject to section 2036(c).

The legislative history to TAMRA indicated that certain amendments made to grandfathered agreements after December 17, 1987, could have caused the loss of protection. Thus, to preserve the ability to fix estate tax values, extreme caution was advised prior to changing existing grandfathered agreements.

C. Discussion Draft Bill—Section 2036(c) Reform

Due to its harshness and complexity, section 2036(c) was criticized by both practitioners and the business community. In response to the public outcry, Representative Rostenkowski introduced a "Discussion Draft" of a bill that would retroactively repeal section 2036(c) and replace it with new provisions adopting a valuation approach aimed at accurate valuation of retained and transferred interests at the time of gift.⁷⁶

Section 2702 of the Discussion Draft provided that an option to purchase property held by a family member (including a buy-sell agreement) generally would be disregarded in determining value. The option would be respected for valuation purposes, however, if it was exercised and the following conditions were met: (i) the property was sold pursuant to the agreement; (ii) the price was determined by a formula that had been reviewed within three years of the sale, and, at the time of the review, the price was reasonably expected to approximate fair market value at the time of sale; (iii) the property did not have a readily ascertainable market value; and (iv) the acquired property was not resold within six months following the decedent's death to a person related to the decedent.⁷⁷

74. I.R.C. § 2036(c)(7)(A)(iii) (1988).

75. I.R.S. Notice 89-99, 1989-2 C.B. 422.

76. House Comm. on Ways and Means, 101st Cong., 2d Sess., Discussion Draft (Comm. Print 1990).

77. *Id.* § 2702(a)-(b).

Following a House Ways and Means Committee hearing on the Discussion Draft, on August 1, 1990, Representative Rostenkowski introduced H.R. 5425, a modified version of the earlier released Discussion Draft. With respect to buy-sell agreements, H.R. 5425 eliminated the three year review requirement but unfortunately continued to require that the formula price approximate fair market value at the time of sale.⁷⁸ Thus, H.R. 5425, like section 2036(c), was of little use in fixing estate tax values.

On September 26, 1990, Senator Bentsen introduced a bill to retroactively repeal and replace section 2036(c). The Senate bill provided rules generally intended to modify the gift tax valuation rules in an effort to value more accurately various interests at the time of the initial transfer. Under the Senate bill, the value of property was determined without regard to any option, agreement, right, or restriction unless the same met the following requirements:

1. It must be a bona fide business arrangement;
2. It must not be a device for transferring property to members of the deceased shareholder's family for less than full and adequate consideration; and
3. Its terms must be comparable to similar arrangements entered into by persons in an arm's length transaction.⁷⁹

On October 27, 1990, Congress passed the Revenue Reconciliation Act of 1990 (the 1990 Act), and President Bush signed it into law on November 5, 1990. The 1990 Act retroactively repealed section 2036(c) and replaced it with special rules (contained in new sections 2701 through 2704) for valuing transferred and retained interests in transactions between family members. Section 2703(b) incorporated the requirements for buy-sell agreements contained in the Senate bill. This section is effective for agreements entered into or substantially modified after October 8, 1990.⁸⁰

By tracking the Senate bill, section 2703 codifies two of the requirements that buy-sell agreements must satisfy under Treasury Regulation section 20.2031-2(h)⁸¹ prior to the enactment of section 2036(c). However, in addition to these two requirements under section 2703(b), taxpayers will also need to show that the terms of their buy-sell arrangement are comparable to what third parties would have entered into in an arm's length transaction.⁸²

78. H.R. 5425, 101st Cong., 2d Sess. (1990).

79. S. 3113, 101st Cong., 2d Sess. (1990).

80. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-400, 490 (codified in scattered sections of 26 U.S.C.).

81. Treas. Reg. § 20.2031-2(h) (as amended in 1992).

82. I.R.C. § 2703(b)(3) (Supp. 1990). The legislative history states that section 2703 does not otherwise alter the requirements for buy-sell agreements and provides that the lifetime transfer restriction remains intact. Senate Finance Committee Report S. 3209 (October 18, 1990).

1. Substantial Modification

Buy-sell agreements entered into before October 9, 1990, will not be subject to the rules contained in section 2703 unless they are substantially modified after October 8, 1990.⁸³ Substantial modifications of existing agreements are treated as new restrictions as of the modification date.⁸⁴ Because agreements that are substantially modified lose their grandfathered status, it is important to understand what will constitute a substantial modification. Without considering the section 2703 implications, a well intended amendment could result in an increased estate tax obligation (attributable to the increased value of the stock included in the gross estate) that exceeds the amount received under the buy-sell agreement.

The regulations addressing substantial modifications state:

Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification.⁸⁵

Further, a substantial modification can occur through omission. For example, the failure to update an agreement which expressly requires updating is presumptively a substantial modification.⁸⁶ Unless the agreement requires it, the addition of a family member is also treated as a substantial modification. However, even if the agreement does not require the addition of a family member, so long as the added person is assigned to a generation no lower than the generational level already occupied by parties to the agreement, there will not be a substantial modification.⁸⁷ The assignment to a particular generational level is controlled by section 2651 dealing with generational assignments for generation-skipping transfer tax purposes.

The following changes are specifically excepted under the regulations from classification as a substantial modification:

- (i) A modification required by the terms of a right or restriction;
- (ii) A discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction;
- (iii) A modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

83. Treas. Reg. § 25.2703-2 (1992).

84. Treas. Reg. § 25.2703-1(c)(1) (1992).

85. *Id.*

86. *Id.*

87. *Id.*

(iv) A modification that results in an option price that more closely approximates fair market value.⁸⁸

The government has issued several rulings in response to requests from taxpayers concerning whether a grandfathered buy-sell agreement will be subject to section 2703. In Private Letter Ruling 91-52-031, a real estate partnership amended its buy-sell agreement principally to update the value of the partnership interests and to provide that interest paid on installment payments to a withdrawing partner be paid at a rate equal to the applicable federal rate instead of the fixed four percent rate. The government ruled that neither change caused a substantial modification since the increase in value reflected in the new certificate of value more closely approximated fair market value,⁸⁹ and the use of the applicable federal rate was a rate that bore a fixed relationship to a specified market interest rate.

In Private Letter Ruling 92-26-051, partners in a limited partnership had a buy-sell agreement which contained a formula purchase price to value the partnership interests. The agreement further provided that the down payment would equal the greater of ten percent of the formula purchase price or the amount of any insurance proceeds. The partners decided to pay some of the insurance premiums by borrowing against the accumulated cash value in the policies. The partners proposed an amendment to the buy-sell agreement permitting policy loans to pay premiums and providing that the minimum down payment amount would be determined without regard to any policy loans. Because Treasury Regulation section 25.2703-1(c)(2)(ii) protects a discretionary modification that does not change the right or restriction, the proposed amendments would not affect the quality and value of the rights held by the partners. As a consequence, the government held that there was not a substantial modification of the original agreement that would subject the arrangement to section 2703.⁹⁰

2. *Section 2703 and Accompanying Regulations*

Under the general rule contained in section 2703(a), property is to be valued without regard to any option, agreement, right, or restriction.⁹¹ Section 2703(b) creates an exception if all three of the following requirements are satisfied:

1. It is a bona fide business arrangement.

88. Treas. Reg. § 25.2703-1(c)(2) (1992).

89. The existing buy-sell agreement specifically provided for a new certificate of value every five years. Priv. Ltr. Rul. 91-52-031 (Sept. 30, 1991).

90. Priv. Ltr. Rul. 92-26-051 (Mar. 20, 1992).

91. I.R.C. § 2703(a) (Supp. 1990).

2. It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
3. Its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.⁹²

The regulations under section 2703(b) modify the second requirement by substituting "the natural objects of the transferor's bounty" in place of "members of the decedent's family."⁹³ The regulations also provide that each of the statutory requirements is deemed to be met regarding a right or restriction if more than fifty percent of the value of the property subject to the right or restriction is owned directly or indirectly by non-family members.⁹⁴ Where fifty percent or more of the value is owned by related parties, each requirement under section 2703(b) must be met. Even if the business purpose and device requirements can be satisfied, the comparability test may prove troublesome, if not impossible, for taxpayers to meet.

Proof of comparability is inherently difficult because the taxpayer must show that his private agreement is comparable to a private agreement that could be obtained in a fair bargain among unrelated parties in the same business.⁹⁵ An agreement will be considered a free bargain if it conforms to the general business practices of unrelated parties.⁹⁶ The existence of actual comparable arrange-

92. I.R.C. § 2703(b) (Supp. 1990). Treas. Reg. § 25.2703-1(b)(2) (1992) specifically provides that each requirement must be independently satisfied. This approach is consistent with the legislative history which adopted the independent requirement reasoning found in *St. Louis County Bank*.

93. Treas. Reg. § 25.2703-1(b)(1)(ii) (1992). Legislation has already been proposed to retroactively amend section 2703(b) to mirror the "natural objects" language. Neither the regulations nor the proposed legislation define "natural objects of the transferor's bounty," although the preamble to the regulations provides that the class of eligible persons is not necessarily limited to blood or marriage relations. Preamble to Treas. Reg. § 25.2703-1 (1992).

Given the definitional paucity, existing caselaw will no doubt provide guidance. Query whether a descendant may be a natural object of an ancestor's bounty even where there is evidence of hostility between the parties. *Bensel v. Commissioner*, 36 B.T.A. 246 (1937), *aff'd*, 101 F.2d 639 (3d Cir. 1938). In *Hoffman v. Commissioner*, 2 T.C. 1160 (1943), *aff'd*, *Giannini v. Commissioner*, 148 F.2d 285 (9th Cir. 1945), *cert. denied*, 326 U.S. 730, 66 S. Ct. 38 (1945), a brother was found to be the natural object of his deceased brother who died unmarried. Where an uncle died unmarried and without children, the government has treated his nephews as the natural objects of the deceased's bounty. Tech. Adv. Mem. 87-10-004 (Nov. 21, 1986). The government, citing Black's Law Dictionary, has found the term to mean those persons who would take by intestacy. Tech. Adv. Mem. 85-41-005 (June 21, 1985) (revoked by Tech. Adv. Mem. 86-34-004 (May 1, 1986) on other grounds). In Priv. Let. Rul. 92-22-043 (Feb. 28, 1992), the government relied on Treas. Reg. § 25.2703-1(b) to conclude that nieces and nephews are family members for section 2703 purposes.

94. Treas. Reg. § 25.2703-1(b)(3) (1992). Non-family members are persons other than the transferor's family and natural objects of the transferor's bounty. *Id.*

95. Treas. Reg. § 25.2703-1(b)(4)(i) (1992). It should be noted that the "fair bargain" language does not appear in section 2703(b)(3) of the Internal Revenue Code.

96. Treas. Reg. § 25.2703-1(b)(4)(i) (1992). Factors for consideration in resolving the fair

ments does not automatically guarantee satisfaction of the comparability test. This somewhat peculiar result is achieved because of the government's position in the regulations that general business practice is not established by evidence of isolated comparables.⁹⁷ The legislative history indicates the need for expert testimony to establish the existence of a general business practice.⁹⁸

The regulations too narrowly circumscribe the comparability test. Buy-sell agreements are private documents tailored to the specific business in question. Comparability as approached in the regulations serves to create an almost insurmountable hurdle, which precludes meeting the three tests. Courts are frequently called upon to resolve valuation disputes and should be free to rely on existing means at their disposal. Hopefully, the courts, as well as the government, will shift the focus from the need to establish the terms of actual comparable agreements to whether unrelated parties would have entered into the agreement in an arm's length negotiation.

3. *Reforming Section 2703—A Proposal*

Section 2036(c) and its replacement under chapter 14 were aimed at correcting perceived valuation abuses arising out of certain estate freeze transactions.⁹⁹ The approach taken towards buy-sell agreements under section 2703 treats these arrangements as presumptively abusive. This approach is flawed for a number of reasons. Rather than attempt to reduce value and promote valuation abuses, owners of closely held businesses routinely implement buy-sell agreements to achieve sound and legitimate business planning objectives. The regulations and caselaw in existence prior to section 2703 (and its accompanying regulations) provide a suitable framework for scrutinizing these arrangements. Under Treasury Regulation section 20.2031-2(h), a price set in a buy-sell agreement that represents a substitute for a testamentary device will be disregarded. This long enduring standard against which restrictive arrangements have been measured serves to promote the expectations of the contracting parties while simultaneously safeguarding against abusive situations.

The disruption caused by this legislative intrusion goes beyond valuation. For example, suppose a decedent leaves stock to a surviving spouse, and the

bargain question include the expected term of the agreement, the current fair market value of the property, the anticipated changes in value during the term of the agreement, and the adequacy of any consideration given. *Id.*

97. Treas. Reg. § 25.2703-1(b)(4)(ii) (1992).

98. Senate Finance Committee Report S. 3209 (October 18, 1990). If general business practice is to recognize more than one valuation methodology within an industry, use of one of the generally accepted methodologies is sufficient. Conf. Comm. Report. H.R. Rep. No. 964, 101st Cong., 2d Sess. (October 27, 1990). Once again, great emphasis will be placed on the need for expert advice and testimony. A prudent, but costly, strategy may be to offer testimony from an industry expert, a buy-sell agreement expert, and a valuation expert.

99. Corporate recapitalizations and partnership freezes were typically the most common types of transactions.

stock is subject to a required purchase by the business under the terms of the operative buy-sell agreement. If the buy-sell agreement is ignored for federal estate tax purposes, the surviving spouse will be required to sell the stock for less than the amount included in the decedent's federal gross estate. Further, and quite importantly, the mismatch between fair market value and the price established in the buy-sell agreement will reduce the marital deduction and limit its amount to the amount under the agreement.¹⁰⁰ Reducing the amount of the marital deduction will, in turn, further increase the estate tax.¹⁰¹

Appraisals of property are expensive and cause administrative difficulties. Consequently, restrictive agreements frequently contain valuation formula clauses to determine the sale price of property. Under the current statute, the formula must yield a fair market value price measured as of the date of sale. Given the vagaries as to what amount constitutes fair market value and the reality that the buy-sell agreement may not apply until many years in the future, the current statute is too exacting and, therefore, unreasonable.

Short of repealing section 2703, an amendment would be in order to create a valuation safe harbor. The amendment would respect the buy-sell agreement, provided that at any time during a fixed period prior to sale, the sales price was determined by a formula reasonably expected to produce a price which would approximate fair market value at the time of sale.

D. Section 6166-Estate Tax Deferral

Under section 6166 of the Internal Revenue Code, federal estate taxes attributable to a closely held business may be paid over a ten year period beginning up to five years after the regular due date for the payment of the estate tax. To be eligible for this deferral, the closely held business included in the decedent's gross estate must have a value in excess of thirty-five percent of the adjusted gross estate.

Purchases of a decedent's stock effected through a buy-sell agreement may terminate the benefits of deferral afforded by section 6166. Payment of the deferred estate taxes are accelerated if fifty percent or more of the value of the closely held business interest is sold.¹⁰² If the buy-sell agreement permits the purchaser to pay for the decedent's stock with promissory notes rather than an all-cash sale, the estate taxes will also be accelerated, but the estate may lack the cash needed to pay the tax liability.

Section 303 redemptions will not accelerate estate taxes deferred under section 6166, provided the amount distributed is applied against the federal estate

100. I.R.C. § 2056(b) (1988 & Supp. 1990).

101. This same problem may also arise to defeat a charitable deduction for stock or other property left to charity.

102. I.R.C. § 6166 (1988).

tax on or before the earlier of the due date of the next installment payment or one year following the section 303 redemption distribution.¹⁰³

VII. GIFT TAX CONSEQUENCES

Historically buy-sell agreements have not been binding in determining the value of property for gift tax purposes.¹⁰⁴ Support for this position apparently stems from the fact that the donee may very well be able to retain the gifted property because there is no assurance that a triggering event will occur. Without a triggering event, a sale at the price called for in the agreement may never materialize.¹⁰⁵

Suppose A transfers an option to B to purchase property at less than fair market value. Because B has the present right to complete the purchase, a taxable gift has occurred as of the date the option was transferred.¹⁰⁶ However, where no present right to purchase is provided for in the agreement,¹⁰⁷ entering into a buy-sell agreement should not result in a completed gift even if the terms of the agreement allow for purchases below fair market value.¹⁰⁸

Where the optionee exercises the right to acquire the property upon the happening of a triggering event, there is a taxable gift to the optionee to the extent that the value of the property exceeds the option price. In addition, there may be potential gift tax consequences resulting from the optionee's failure to exercise an option.

In Private Letter Ruling 91-17-035, a father and son were the sole corporate shareholders. Under the terms of the buy-sell agreement, they each had a right of first refusal at a price less than fair market value in the event the other shareholders desired to sell or dispose of their stock. For bona fide business reasons, the corporation desired to establish an employee stock ownership plan (ESOP), and father planned to sell some of his stock to the ESOP. To facilitate the sale, the son would not exercise his right of first refusal contained in the buy-sell agreement. The government ruled that the son, as optionee, made a gift to his father, the owner of the stock, measured by the difference between the fair market value of the stock, i.e., the price to be paid by the ESOP, and the option price established in the agreement. In substance, it was as though the son

103. I.R.C. § 6166(g)(1)(B) (1988).

104. Rev. Rul. 59-60, 1959-1 C.B. 237; *Spitzer v. Commissioner*, 153 F.2d 967 (8th Cir. 1946). These agreements have been a factor in determining value. *Spitzer*, 153 F.2d at 971; *True v. United States*, 547 F. Supp. 201 (D. Wyo. 1982); Rev. Rul. 189, 1953-2 C.B. 294.

105. *Baltimore Nat'l Bank v. United States*, 136 F. Supp. 642, 654 (D. Md. 1955). See Jacques T. Schlenger and Harold Nussenfeld, *Valuing Closely Held Business Interests and Planning the Buy-Sell Agreement*, in 44th Annual N.Y.U. Institute on Federal Taxation, § 52.08 (1986).

106. Rev. Rul. 80-186, 1980-2 C.B. 280.

107. This would typically be the case for most buy-sell agreements due to the fact that a triggering event must occur before any option becomes exercisable.

108. Tech. Adv. Mem. 81-40-016 (June 30, 1981).

exercised his enforceable option at the option price and made an indirect gift of the value in excess of the option price.¹⁰⁹

VIII. S CORPORATIONS

A domestic corporation may elect to be treated as an S corporation if it qualifies as a small business corporation as defined under Internal Revenue Code section 1361(b). The statutory definition provides for certain restrictions regarding the number and type of eligible shareholders. An S corporation cannot have more than thirty-five shareholders.¹¹⁰ Corporations, partnerships, and non-resident aliens are not permitted to be S corporation shareholders.¹¹¹ Estates and certain qualifying trusts are permissible shareholders.¹¹² An S corporation cannot be a member of an affiliated group of corporations as defined in section 1504,¹¹³ nor can it have more than one class of stock.¹¹⁴

To preserve S corporation status, a buy-sell agreement should contain several key provisions. The agreement should preclude any transfer that would exceed the thirty-five shareholder limit or result in an ineligible party becoming a

109. Priv. Ltr. Rul. 91-17-035 (Apr. 26, 1991).

110. I.R.C. § 1361(b)(1)(A) (1988 & Supp. 1989). For purposes of the 35 shareholder limit, a husband and wife, and their estates, are treated as one shareholder. I.R.C. § 1361(c)(1) (1988 & Supp. 1989).

111. I.R.C. § 1361(b)(1)(B), (C) (1988 & Supp. 1989).

112. I.R.C. § 1361(b)(1)(B), (c)(2), (d) (1988 & Supp. 1989). The following trusts are permitted S corporation shareholders:

1. A grantor trust;
2. A grantor trust continuing in existence after the death of the grantor, but only for a period of 60 days, which may be extended to two years if the entire corpus of the trust is included in the deceased grantor's gross estate;
3. A trust receiving S corporation stock pursuant to the terms of a will, but only for 60 days from the transfer date;
4. A voting trust;
5. A qualified subchapter S trust.

I.R.C. § 1361(c)(2)(A), (d) (1988 & Supp. 1989).

113. I.R.C. § 1362(b)(2)(A) (1988 & Supp. 1989). A corporation owning 80% or more of the stock of another corporation is not eligible to elect S corporation status. *Id.*: see I.R.C. § 1504(a) (1988).

114. I.R.C. § 1361(b)(1)(D) (1988 & Supp. 1989). The one class of stock requirement expresses congressional concern that stockholders have identical rights in the profits and assets of the corporation. S. Rep. No. 640, 97th Cong., 2d Sess. 8 (1982). The regulations provide that an S corporation has one class of stock if all outstanding shares confer identical rights to distribution and liquidation proceeds. Treas. Reg. § 1.1361-1(l)(1) (1992). Differences in voting rights among the shares of common stock do not create a second class of stock. I.R.C. § 1361(c)(4) (1988 & Supp. 1989). Therefore, an S corporation may issue voting and nonvoting common stock.

The government has held that an agreement restricting the transferability of stock in an S corporation will not create a second class of stock. Rev. Rul. 85-161, 1985-2 C.B. 191. Under regulations recently finalized, redemption and cross-purchase agreements are disregarded in determining whether more than one class of stock exists so long as the agreement is triggered by death, disability, termination of employment, or divorce. Treas. Reg. § 1.1361-1(l)(2) (1992).

shareholder. A provision could be included to restrict any stock issuance that would create a second class of stock. To avoid the creation of an affiliated group, a provision could be added to prevent the S corporation from acquiring more than seventy-nine percent of another corporation. An S election may be revoked at any time by the holders of more than fifty percent of the outstanding shares.¹¹⁵ As a result, appropriate consideration should be given to increasing this percentage threshold.¹¹⁶

An S corporation that issues an installment note in redemption of a shareholder's stock risks termination of S status if the obligation is treated as a second class of stock. To preclude this problem, the terms of the note should be drafted to fall within the "straight debt" safe harbor found in section 1361(c)(5).¹¹⁷ Where the safe harbor cannot be met and a deferred payment obligation is provided, the safest course is the utilization of a cross-purchase agreement rather than a redemption agreement.¹¹⁸

The adoption of a split-dollar life insurance plan for the benefit of certain shareholders of the S corporation implicates the single class of stock requirement. In Private Letter Ruling 92-48-019, the government ruled that the insurance premiums paid by the S corporation were fringe benefits to the employee-shareholders rather than distributions for the purposes of the single class of stock requirement.¹¹⁹ Therefore, the split-dollar arrangement did not create more than one class of stock.¹²⁰

S corporation shareholders are taxed on corporate earnings whether or not those earnings are actually distributed to shareholders.¹²¹ As a result, buy-sell agreements frequently provide for distributions to shareholders to provide cash for the payment of the resulting tax liability. Thus, it is important to exercise care when drafting the distribution formula to avoid disproportionate distributions. A minimum distribution provision calling for payment of the actual tax

115. I.R.C. § 1362(d)(1)(B) (1988).

116. A super majority may be warranted to diffuse potential threats of revocation from a majority shareholder.

117. I.R.C. § 1361(c)(5) (1988 & Supp. 1989). Straight debt is defined as any written unconditional promise to pay on demand or on a specific date a sum certain in money if (i) the interest rate and payment dates are not contingent on profits or the borrower's discretion; (ii) there is no convertibility into stock; and (iii) the creditor is an individual (but not a nonresident alien), an estate, or qualified trust. *Id.*

118. While failure to meet the straight debt safe harbor does not appear to automatically create a second class of stock, Treas. Reg. § 1.1371-1(g) (1992), the risk of termination of the selection may warrant structuring the buy-sell agreement as a cross-purchase.

119. The principal purpose of the split-dollar plan was to provide a fringe benefit to key employees and their spouses rather than a vehicle to circumvent section 1361(b)(1)(D). Priv. Ltr. Rul. 92-48-019 (Aug. 31, 1992); see Treas. Reg. § 1.1361-1(i)(2)(i) (1992).

120. The ruling relied on Rev. Rul. 91-26, 1991-1 C.B. 185, in which the payment of accident and health insurance premiums by an S corporation on behalf of two percent shareholder-employees did not violate the single class of stock rule.

121. I.R.C. § 1366(a)(1) (1988). The shareholder's stock basis is increased for income items and decreased for losses. I.R.C. § 1367(a)(1)-(2) (1988).

may create a second class of stock if the shareholders are in different tax brackets.¹²² A possible drafting solution is to provide for a distribution equal to the maximum individual federal income tax rate multiplied by the pro rata share of corporate taxable income.¹²³

The tax treatment accorded distributions from S corporations depends on whether the corporation has accumulated earnings and profits. For S corporations without accumulated earnings and profits, distributions¹²⁴ are tax free to the extent of the adjusted basis in the shareholder's stock.¹²⁵ Distributions received in excess of adjusted basis are treated as a gain from the sale or exchange of property,¹²⁶ which qualifies as a capital gain if the stock is a capital asset.¹²⁷

A different and more complex hierarchy applies if the S corporation has accumulated earnings and profits.¹²⁸ Distributions to shareholders that do not exceed the accumulated adjustment account (AAA)¹²⁹ of the S corporation are a tax free return of capital to the extent of the shareholder's adjusted basis in the stock.¹³⁰ Distributions which exceed adjusted basis (but within the AAA) most likely receive capital gains treatment.¹³¹ Thus, the S corporation is treated as first distributing S corporation earnings prior to distributing earnings from pre-S corporation tax years. Amounts distributed in excess of the AAA are treated as dividends to the extent of the accumulated earnings and profits of the corporation. Distributions in excess of accumulated earnings and profits are tax free to the extent of the shareholder's adjusted basis in the stock. After adjusted basis is exhausted, any further distributions are taxed as capital gains.

122. Robert E. Brown, *A Checklist for the Planning and Drafting of Shareholder Buy-Sell Agreements*, in 50th Annual N.Y.U. Institute on Federal Taxation, § 4.07 (1992).

123. A distribution formula which also incorporates the maximum state individual tax rate on a shareholder by shareholder basis may cause a problem where shareholders reside in different states with varying rates of taxation. To avoid a potential termination of S corporation status, a better approach would be to select a fixed percentage rate, for example, the highest marginal tax rate among the shareholders.

124. Distributions include cash and the fair market value of property received.

125. I.R.C. § 1368(b)(1) (1988). The shareholder's adjusted basis is measured at the close of the tax year of the S corporation rather than when the distribution is made. I.R.C. §§ 1367-1368 (1988). Distributions reduce the shareholder's adjusted basis in the stock. I.R.C. § 1367(c)(2) (1988).

126. I.R.C. § 1368(b)(2) (1988).

127. See I.R.C. § 1221 (1988). The capital gain will be either long or short term depending upon the shareholder's holding period. See I.R.C. § 1223 (1988 & Supp 1989).

128. The complexity arises because the rules seek to ensure that distributions of accumulated earnings and profits are taxed as dividends, while distributions of previously taxed income are not subjected to a second tax.

129. In general, S corporation earnings already taxed to shareholders minus amounts previously distributed constitute the AAA. I.R.C. § 1368(e)(1) (1988). Essentially, the AAA represents undistributed earnings of the S corporation that have been the subject of taxation.

130. I.R.C. § 1368(c)(1) (1988).

131. *Id.*

The AAA is treated as a corporate level account,¹³² which cannot be directly transferred to a shareholder. Nevertheless, the AAA does not terminate upon stock transfers. As a result, it takes on significance to current holders and to any subsequent holder of stock in the corporation because the balance in the AAA inures to the benefit of the new or remaining shareholders, who can utilize the account to receive tax free distributions.

In general, S corporation items of income, loss, deduction, and credit are allocated among shareholders on a daily pro rata basis.¹³³ A shareholder has two allocation methods available when his interest in the S corporation terminates during the year.¹³⁴ Under the first and general method, items for the entire year are allocated under the daily pro rata formula for the number of days the shareholder held the stock before termination.¹³⁵ In addition, a terminated shareholder is allocated portions of items for the period subsequent to termination through the end of the taxable year of the S corporation.¹³⁶

An alternate method, known as "closing of the books," is available if the shareholders elect to apply it. Under this method, items are allocated as though the year consisted of two tax years comprised of the first short tax year ending on the date the shareholder's interest terminated and the second short tax year for the balance of the year.¹³⁷ Additionally, items are allocated to the terminated shareholder only for the first short tax year and not for the second short tax year after the termination date.

The "closing of the books" method may be attractive to those shareholders who do not wish to be accountable for the tax consequences of transactions taking place after the date that their interest in the corporation terminates. As an elective method, the "closing of the books" alternative requires all shareholders who owned stock at any time during the taxable year to consent to the election.¹³⁸ Shareholders may want to assure application of the "closing of the books" method in advance of any future termination of stock interest. A buy-sell agreement could facilitate this goal by containing a provision that all shareholders agree to consent to utilizing the "closing of the books" method upon the affirmative vote of a majority of the shareholders.

132. See Prop. Treas. Reg. § 1.1368-2(a)(1), 57 Fed. Reg. 24,436 (1992).

133. I.R.C. §§ 1366(a), 1377(a) (1988).

134. I.R.C. § 1377(a)(1)-(2) (1988).

135. I.R.C. § 1377(a)(1) (1988).

136. For example, an S corporation may be operating at a loss at the time the shareholder sells his stock. Subsequent to the sale and before year end, the S corporation operates profitably at a level far in excess of the earlier losses. Consequently, income will be allocated to the shareholder despite the fact that it was earned when he no longer was a shareholder.

137. I.R.C. § 1377(a)(2) (1988).

138. *Id.* Without the requisite election, the daily pro rata method applies. The regulations further condition the availability of the election to a termination of the shareholder's entire interest. Temp. Treas. Reg. § 18.1377-1 (1983).

IX. CONCLUSION

Buy-sell agreements are organic documents relating to corporate governance. Business owners and their advisors must navigate a sea of competing and conflicting tax rules. Recent legislation has only served to add to this tumultuous endeavor. Often times, these rules do little to distinguish between bona fide business arrangements and tax avoidance plans. Compliance with one area of the tax code may be at the cost of failing to satisfy the requirements of another provision.

The estate tax rules do not give sufficient regard to the compelling and valid business reasons underlying the decision to enter into a buy-sell agreement. Rather than provide for a valuation approach that can reasonably be anticipated to yield a figure which approximates fair market value, the new rules attempt to exact precision in the inherently imprecise arena of valuation. Agreements executed today may be triggered by unexpected events many years in the future with little assurance that the contractually binding valuation method will be respected for tax purposes. To the detriment of closely held business owners, this approach fails to foster consistency and predictability.

