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Tax Aspects of Corporate Business Purchase Agreements Funded with Life Insurance

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NOTES

TAX ASPECTS OF CORPORATE BUSINESS PURCHASE AGREEMENTS FUNDED WITH LIFE INSURANCE

Death to a member of a closely held business usually will seriously disrupt the workings of the business organization. Also, the estate of the decedent may find his business interest an unwanted asset. A valuable business interest often must be sacrificed because of the pressing need for cash to pay debts, administrative expenses, and estate and inheritance taxes. Thus, death may place the continued existence of the business in jeopardy, make uncertain the interest of decedent's surviving business associates, and make necessary a forced liquidation of decedent's interest in the business at a sacrifice price. Consequently, a business man may find it advisable to make some provision for the sale of his business interest to his associates upon his death. This is true whether the business is operated as a sole proprietorship, a partnership, or a close corporation. The scope of this note will be limited to the problems facing stockholders of a close corporation.

Although the continued existence of a corporation as a separate legal entity does not depend upon the life or death of its stockholders,[1] the impact of death upon it may have a disastrous result. The continuity or replacement of management, the sale or devolution of the shares of the decedent to individuals who, as stockholders, might not serve the best interests of the corporation,[2] the disturbance of har-

1. A corporation is an entity separate and apart from the stockholders. 1 FLETCHER, CYCLOPEDIA CORPORATIONS § 24 (perm. ed. 1931).

2. Generally, the owner of corporate stock, as in the case of other personal property, has as an incident of ownership the right to transfer his stock, except insofar as such right is restricted by the charter or articles of incorporation, statute, by-law, or agreement. CHRISTY & McLEAN, THE TRANSFER OF STOCK § 36 (2d ed. 1940); 12 FLETCHER, CYCLOPEDIA CORPORATIONS § 5452 (perm. ed. 1932). An absolute restriction on transfer is void. Nicholson v. Franklin Brewing Co., 82 Ohio St. 94, 91 N.E. 991 (1910); Gould v. Head, 41 Fed. 240, 246-47 (C.C.D. Colo. 1890) (dictum). Section 15 of the Uniform Stock Transfer Act — an act adopted in every state, Hawaii, and Alaska — provides that there shall be no restriction upon the transfer of shares by virtue of any by-law unless it is stated upon the certificate. A majority of the courts have interpreted this section as applying to all purchasers irrespective of notice of the by-law. Security Life & Acc. Ins. Co. v. Carlovitz, 251 Ala. 508, 38 So. 2d 274 (1949); Age Publishing Co. v. Becker, 110 Colo. 319, 134 P.2d 205 (1943); Sorrick v. Consolidated Tel. Co., 340 Mich. 463, 65 N.W.2d 713 (1954). Weber v. Lane, 315 Mich. 678, 24 N.W.2d 418 (1946) (alternate holding); Costello v. Farrell, 234 Minn. 453, 48 N.W.2d 557, 29 A.L.R.2d 890 (1951). A minority of the courts have interpreted it as applying only to purchasers without notice. Doss v. Yingling, 95 Ind. App. 494, 172 N.E. 801 (1930); Baumohl v. Goldstein, 95 N.J. Eq. 597, 124 Atl. 118 (Ch. 1924); see BALLANTINE, CORPORATIONS §§ 332, 338 (rev. ed. 1946); Cataldo, *Stock Transfer Restrictions and the Closed Corporations*, 37 VA. L. REV. 229, 232 (1951); 10 ROCKY MT. L. REV. 117, 118 (1938). The majority view has been followed in all of the recent cases, and care should be taken that § 15 be closely adhered to if by-law restrictions on the sale of stock are contemplated. See 8 VAND. L. REV. 640 (1955).

monious working arrangements between the majority and minority stockholders, and the uncertainty of control, are some of the problems that must be faced. Consequently, the best interest of both the decedent's family and his surviving business associates may be served by arranging, during his lifetime, for the sale at death of his business interest to the surviving stockholders by means of a business purchase agreement. This device will assure the decedent's estate and family of a ready market for his interest in the corporation at a fair predetermined price. Surviving stockholders are assured of the ownership and continued existence of the business. Disputes and litigation are avoided.

A business purchase agreement generally obligates the estate of the decedent to sell, and the surviving business associates to buy, the decedent's interest in the business at death. Such an agreement is valid and enforceable;[3] the mutual promises of the parties constitute adequate consideration. It is not testamentary in character.[4] When the agreement is between stockholders (or partners, in the case of a partnership), it is called a "buy-and-sell agreement." When the agreement provides that the corporation will purchase the interest of a deceased shareholder, it is called a "stock-retirement agreement." Where life insurance is used to provide funds with which to make the purchase, the insurance is referred to as "business-purchase insurance." There are other ways of establishing a fund for this purpose, such as setting up a trust fund with each stockholder making periodic deposits, or providing that each stockholder take out additional personal insurance on his own life, and on the death of a fellow stockholder, either use the cash value or borrow against the policy to make full or partial payment of the purchase price. Though these methods are possible, they have not proven as satisfactory as business-purchase insurance. Of course, if all the stockholders and the corporation have an adequate cash reserve so that no funding is necessary, no business-purchase insurance need be carried. However, this is rarely the case, and in discussing business purchase agreements it will be assumed that the parties are providing for a fund by means of business-purchase insurance.

3. See Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); *In re* Howe's Estate, 31 Cal. 2d 395, 189 P.2d 5, 1 A.L.R.2d 1171 (1948); Rankin v. Newman, 114 Cal. 635, 46 Pac. 742 (1896); Casey v. Hurley, 112 Conn. 536, 152 Atl. 892 (1931); Lockwood's Trustee v. Lockwood, 250 Ky. 262, 62 S.W.2d 1053 (1933); Kavanaugh v. Johnson, 290 Mass, 587, 195 N.E. 797 (1935); *In re* Eddy's Estate, 175 Misc. 1011, 26 N.Y.S.2d 115 (Surr. Ct. 1941); Annots., 1 A.L.R.2d 1178 (1948), 73 A.L.R. 983 (1931); Forester, *Legal, Tax and Practical Problems under Partnership Purchase and Sale Agreements Coupled with Life Insurance*, 19 So. CALIF. L. REV. 1 (1945).

4. See McKinnon v. McKinnon, 56 Fed. 409 (C.C.W.D. Mo. 1893); *In re* Howe's Estate, 31 Cal. 2d 395, 189 P.2d 5, 1 A.L.R.2d 1171 (1948); Hale v. Wilmarth, 274 Mass. 186, 174 N.E. 232, 73 A.L.R. 980 (1931).

VALUATION

There are numerous income and estate tax problems relative to buy-and-sell and stock-retirement agreements. One common to both types of agreements is that of valuation. Should the agreement provide the value, or a means of determining the value, of decedent's interest in the corporation? If it does so provide, will the value as determined by the agreement be controlling for federal estate tax purposes?

The agreement should provide for either a fixed purchase price, or a means of determining the purchase price. Otherwise, disputes will likely arise as to what is the fair market value, causing litigation between the estate and the surviving stockholders or the corporation, and probably the Commissioner of Internal Revenue. The Internal Revenue Code requires that the value of the assets in a decedent's estate for tax purposes be determined by the value thereof at the date of death,[5] or at an alternate valuation date.[6] Regulations provide that the value shall be the "fair market value."[7] This, in turn, is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell."[8] Thus, the value is not the price obtainable on a forced sale. "All relevant facts and elements of value as of the applicable valuation date should be considered in each case."[9] Valuation of business interests under the foregoing rules is not a simple matter; valuing closely held corporate stock is even more difficult. No method of ascertaining its value is entirely satisfactory, and there can be no hard and fast rule as to the method to be followed.[10] Dis-

5. INT. REV. CODE OF 1954, § 2031(a).

6. *Id.* § 2032(a).

7. U.S. Treas. Reg. 105, § 81.10a (1942), as amended, T.D. 6038, 1953-2 CUM. BULL. 443.

8. U.S. Treas. Reg. 105, § 81.10a (1942), as amended, T.D. 6038, 1953-2 CUM. BULL. 442.

9. *Ibid.*

10. See, *e.g., In re* Frank's Estate, 123 Ore. 286, 261 Pac. 893 (1927); Annots., 23 A.L.R.2d 775 (1952), 107 A.L.R. 1263 (1937). As a general rule, where corporate stock is listed and actively traded on a stock exchange, its value for estate or inheritance tax purposes is determined, entirely or in part, by the price at which it was selling on the exchange on or about the valuation date. U. S. Treas. Reg. 105, § 81.10b (1942), as amended, T.D. 6038, 1953-2 CUM. BULL. 443; Richardson v. Helvering, 80 F.2d 548 (D.C. Cir. 1935); Roth v. Wardell, 77 F.2d 124 (9th Cir. 1935). However, the term "close corporation" does not appear anywhere in the Code or in the Regulations. Section 81.10c of Regulation 105 does provide general rules for determining the fair market value of securities not listed on any exchange, not quoted on a bid and ask price, not dealt in by brokers, and not sold by the personal representative of the decedent within a reasonable period after valuation. "If actual sales or bona fide bid and ask prices are not available, then in case of shares of stock, valuation shall be determined upon the basis of the company's net worth, earning power dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. Among such other relevant factors to be considered are the values of securities of corporations engaged in the same or a similar line of business which are listed on an exchange. However, the weight to be accorded such companies or any other evidentiary factors con-

putes and protracted litigation with the Government are frequent. Hence, if the value can be pegged through the medium of a business purchase agreement, an important result for tax purposes will have been accomplished. But, more important, the price agreed upon should give to the deceased stockholder's estate the fair value of his stock. There are a number of ways to provide in business purchase agreements for the valuation of a deceased stockholder's interest. They may be classified generally under five headings: (1) fixed price; (2) book value; (3) average earnings formula; (4) appraisal; and (5) a combination (1)-(4).

Fixed Price

Since it is probable that the value of the business will not stay the same, but will either go up or down in subsequent years, this method by itself rarely represents a satisfactory solution. If a provision is added requiring the parties to revalue the business each year, the defect seemingly would be cured. Unfortunately, the parties are unlikely to make the yearly revaluation, and it is advisable to add a further provision that if upon a stockholder's death there has been no revaluation in the last twelve months, an appraisal should be made by an impartial third party. The appraiser, or a method of selecting

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sidered in the determination of a value depends upon the facts of each case." U.S. Treas. Reg. 105, § 81.10c (1942), as amended, T.D. 6038, 1953-2 CUM. BULL. 443. See also Rev. Rul. 77, 1954-1 CUM. BULL. 187, outlining the factors which should be considered in valuing shares of stock of a closely held corporation for federal estate and gift tax purposes. The Treasury has made an attempt to simplify the problem by the application of a formula referred to as the "Years' Purchase Formula," or ARM 34. Appeals Review Memorandum 34, 2 CUM. BULL. 31, provides: "The method is to allow out of average earnings over a period of years, preferably not less than five, a return of 10% upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years' purchase, that is to say, five times the amount available as return from intangibles should be the value of the intangibles....

"The foregoing is intended to apply . . . to . . . businesses of a more or less hazardous nature. In the case, however, of valuation of good will of a business which consists of the manufacture or sale of standard articles of every day necessity not subject to violent fluctuations and where the hazard is not so great, the Committee is of the opinion that the figure for determination of the return on tangible assets might be reduced from 10% to 8% or 9% and that the percentage for capitalization of the return upon intangibles might be reduced from 20% to 15%."

Variations of the application of this formula have been sanctioned by the courts in a number of instances. In Estate of Kellar E. Watson, P-H 1948 T.C. Mem. Dec. ¶ 48019, the Tax Court capitalized earnings over a ten-year period, and in C. F. Hovey Co., 4 B.T.A. 175 (1926), a fourteen-year period was used. In Joseph A. La Fortune, P-H 1940 B.T.A. Mem. Dec. ¶ 40455, the Board of Tax Appeals sustained a valuation which had been arrived at by using a 15% return for the tangibles; and in Plaut v. Smith, 82 F. Supp. 42 (D. Conn. 1949), the court approved omitting entirely from average earnings one or more abnormal years. See Bushman, *Valuation of Close Corporation Securities,* 90 TRUSTS & ESTATES 228 (1951).

him should be designated in the agreement in order to avoid any future dispute.

Book Value

This method of valuation is frequently used. However, the decedent's estate may not receive the fair value of his interest, as books generally reflect cost rather than market value, and good will, in most instances, will not receive adequate consideration.

Average Earnings Formula

This method is in common use and its popularity will probably continue. The company's average earnings (usually the company's average net profits in recent years) are multiplied by the "average earnings multiple," which most businesses have although adjustments may be made for peculiarities of a particular corporation. The result will determine the purchase price of a deceased stockholder's interest. Thus, if a company earned $15,000 in 1950, $20,000 in 1951, 1952, and 1953, and $25,000 in 1954, its average earnings over the five year period would be $20,000. This earnings figure would be multiplied by the "average earnings multiple" in use by the particular industry (which may be, for example, 5, 7, or 10). Because the purchase price is made to depend on the corporation's recent earning experience, this method is much more likely to reflect the true value of decedent's stock than a fixed price or book value.

Appraisal

Provision may be made for appraisal of the value of the business upon the death of a stockholder, by one, two, or three appraisers. This method gives a fair value of the business on the date of decedent's death.

Combination

The parties may provide that some assets of the corporation should be valued at book value, others at a fixed price, others at their appraisal value, and still others, such as good will, by the average earnings formula.

The advisability of using any one of these methods of valuation will depend on the circumstances surrounding the particular business agreement, and the results that the parties hope to accomplish. This discussion is limited to the effect that valuation by any of these methods may have upon the Commissioner's determination of fair market value for estate tax purposes.

When an estate is substantial in amount, the value of the business will be subject to the federal estate tax as well as the state inheritance

tax.[11] It appears from numerous court decisions that the value of a business interest as set out in a business purchase agreement (or as determined in accordance with a formula set out in the agreement) will be determinative for estate tax purposes if the following elements are present:

(1) The transaction is at arm's length. The parties must deal with each other as they would deal with strangers.[12] When the agreement is between members of the same family, the purchase price, or the formula provided for determining the purchase price, should be full and adequate when fixed.[13] If it is not, the agreement may be found not to be an arm's length transaction.

(2) Sale of decedent's interest is restricted during lifetime as well as after death.[14]

(3) The decedent's estate is required to sell his interest.[15]

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11. INT. REV. CODE OF 1954, § 2001, lists the rates. The taxable estate is defined in § 2051 and the sections that follow.

12. There must be no donative intent. However, an "arm's length agreement" can be reached between members of the same family. Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); Estate of Lionel Weil, 22 T.C. 1267 (1954). The price agreed upon (or the method of determining the price) must be the result of bargaining by parties informed of the present value of the business, and of the prospects for future earnings, and concerned with securing a fair price for the interest of a deceased stockholder.

13. John Q. Strange Estate, P-H 1942 B.T.A. Mem. Dec. ¶ 42247; Edith M. Bensel, 36 B.T.A. 246 (1937), *aff'd*, 100 F.2d 639 (3d Cir. 1938). In holding that the purchase price must be reasonable when the contract was made rather that at the time of the purchase, the Tax Court in the *Bensel* case said: "The agreement gave the son an option to purchase the stock at a certain price immediately after the father's death. Although the actual purchase price was much less than the fair market value of the stock at the date of the decedent's death when the purchase was made, an increase in value was a circumstance which was within the reasonable contemplation of the parties at the time they entered into the agreement. . . . The possibility of increase in the value of the shares may have induced the son to enter into the contract. The adequacy of the consideration must be measured at the time the contract was entered into rather than at the time the option was exercised. The consideration in this case was full and adequate in money or money's worth. The contract originally entered into finally ripened into a bona fide sale for an adequate and full consideration in money or money's worth. It was not a substitute for a testamentary disposition nor a device for avoiding estate tax." Edith M. Bensel, 36 B.T.A. at 253-54. *But see* Hornstein, *Stockholder's Arrangements in the Closely Held Corporation*, 59 YALE L.J. 1040, 1050-51 (1950), in which the author doubts that determination of the purchase price by appraisal will fix the value for estate tax purposes.

14. The decedent must not have been able to dispose of his interest during his lifetime without first offering it to the other party(s) to the agreement at the price provided for in the agreement. If the option becomes effective only upon the death of a stockholder, the purchase price provided for in the agreement will not establish value for estate tax purposes. Clair Giannini Hoffman, 2 T.C. 1160 (1943), *aff'd sub nom.* Giannini v. Commissioner, 148 F.2d 285 (9th Cir. 1945), *cert. denied*, 326 U.S. 730 (1945); Estate of James H. Matthews, 3 T.C. 525 (1944); *accord*, Estate of George Marshall Trammell, 18 T.C. 662 (1952); see Laiken & Lichter, *Tax Aspects of Survivor Purchase Agreements*, 1948 WIS. L. REV. 139, 141-42.

15. Worcester County Trust Co. v. Commissioner, 134 F.2d 578 (1st Cir. 1943); Frederick A. Koch, Jr., 28 B.T.A. 363 (1933); see May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Estate of Albert L. Salt, 17 T.C. 92 (1951);

The courts have upheld the taxpayer when these conditions have been met.[16] If the parties to the agreement hope to peg the value for estate tax purposes, care should be taken to provide for each one of them. Absence of any one may enable the Commissioner to include the business interest at a value other than that determined by the business purchase agreement.[17]

BUY-AND-SELL AND STOCK-RETIREMENT AGREEMENTS COMPARED

The valuation problem discussed above is common to both buy-and-sell and stock-retirement agreement. After the parties determine what method of valuation they want to use, it can be satisfactorily applied in either type of agreement. And in either type, if business insurance is used to provide a fund for the purchase price, there is no danger that both the value of the business interest and the proceeds of the funding insurance will be taxed in the estate of the decedent under the federal estate tax law.[18]

Before a determination can be made as to whether a buy-and-sell or a stock-retirement agreement would be more suitable for the parties to a business purchase agreement, the advantages and disadvantages of each should be examined.

City Bank Farmers Trust Co., 23 B.T.A. 663 (1931). A provision in the articles of incorporation that shareholders, desirous of transferring shares, must first offer them to the directors, who may buy them for the corporation's use at book value, will have a depressing effect on the value of the stock and should be considered in determining its worth for estate tax purposes, but will not fix the market value. The provision did not obligate the estate of a deceased shareholder to sell. Worcester County Trust Co. v. Commissioner, *supra*.

16. May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Estate of Albert L. Salt, 17 T.C. 92 (1951); John Q. Strange Estate, P-H 1942 B.T.A. Mem. Dec. ¶ 42247; Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938); Rose Newman, 31 B.T.A. 772 (1934); *accord*, Estate of Lionel Weil, 22 T.C. 1267 (1954); Estate of Maddock. 16 T.C. 324 (1951); see Ness, *Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death*, 49 COLUM. L. REV. 796 (1949). Two cases— Frederick A. Koch, Jr., 28 B.T.A. 363 (1933), and City Bank Farmers Trust Co., 23 B.T.A. 663 (1931)—are sometimes cited as reaching a contrary result. Bushman, *Valuation of Close Corporation Securities*, 90 TRUSTS & ESTATES 228, 234 (1951). The *City Bank* case has been distinguished by the Tax Court on the ground that there was no restriction on decedent's right to dispose of his stock during lifetime. Estate of Lionel Weil, *supra* at 1274. However, it appears to this writer that the agreement in the *City Bank* case did restrict decedent's right to dispose of his interest during his lifetime, but did not obligate his estate to sell his interest on death. City Bank Farmers Trust Co., *supra* at 665, 666. Neither was the estate bound to sell in the *Koch* case. Frederick A. Koch, Jr., *supra* at 364. Both cases are distinguishable on this ground. See cases cited note 16 *supra*.

17. See notes 12-16 *supra*.

18. Estate of G. C. Ealy, P-H 1951 T.C. Mem. Dec. ¶ 51137; Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938); *accord*, Estate of 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).

Buy-and-sell Agreements

As previously mentioned, a buy-and-sell agreement is an arrangement among individual business associates (in this case, stockholders) which provides for the survivors' buying the interest of a deceased associate. It is generally conceded that cross-business life insurance is the most desirable method of funding such an agreement.[19] Each stockholder applies for and becomes owner of an insurance policy on the life of each of his business associates. The proceeds should be made payable to the applicant-owner.[20] When a stockholder dies, the proceeds of insurance received by each of the remaining stockholders are used to purchase the interest of the decedent in the corporation.

A. Advantages:

(1) Cross-purchase steps up the cost basis of the surviving stockholders' interest and thereby minimizes their capital gains tax exposure upon a subsequent sale of their interest in the corporation.

(2) The agreement is valid and enforceable.[21] In the case of a

19. Among others, the advantages of using business life insurance to fund the agreement are: (1) a specific amount of money will be available to purchase decedent's interest when it is needed; (2) the decedent's estate will receive cash at a time when it is most in need of it; (3) the entire proceeds paid in a lump sum are received without paying any federal income tax (there is an exception to this general statement which will be discussed later). For a general discussion of the advantages and disadvantages of using business insurance to fund the business purchase agreement, see Fahr, *The Business Purchase Agreement and Life Insurance*, 15 LAW & CONTEMP. PROB. 319 (1950); Forster, *Legal, Tax and Practical Problems under Partnership Purchase and Sale Agreements Coupled with Life Insurance*, 19 SO. CALIF. L. REV. 1 (1945); Laiken, *Death, Taxes and Your Business*, 85 TRUSTS & ESTATES 372 (1947), 86 TRUSTS & ESTATES 13 (1948); Mannheimer, *Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements*, 29 TAXES 393 (1951); Redeker, *Analyzing the Buy and Sell Agreement*, 4 J. AM. SOC'Y C.L.U. 354 (1950).

20. The insurance proceeds payable on the death of an insured are included in his gross estate only if (1) the proceeds are payable to his estate, or (2) the insured possessed any incidents of ownership in the policy at the time of his death. A reversionary interest in the policy which exceeds 5% of the value of the policy immediately before death is considered an incident of ownership. The premium payment test, of § 811 (g) of the 1939 Code was eliminated by the 1954 Code. INT. REV. CODE OF 1954, § 2042. The insurance proceeds payable on the death of a stockholder, who is a party to a business purchase agreement, clearly would not be included in decedent's gross estate.

Life insurance proceeds payable to a taxpayer by reason of the death of an insured are not included in his gross income and are therefore exempt from income taxes, unless there has been a transfer of an interest in the life insurance contract for a valuable consideration. INT. REV. CODE OF 1954, § 101(a). See disadvantage (1) under "Buy-and-Sell Agreements."

21. The agreement may provide that the survivors have an option to purchase decedent's interest in the corporation, but are not bound to purchase it. Since the decedent's estate is bound to sell his stock in the corporation (if the value placed on his interest is to be binding for estate tax purposes), it seems only fair that the survivors should be bound to purchase his interest. The business purchase agreement should protect the estate of decedent as well as the survivors — and the estate gets no real protection unless it can force the survivors to purchase decedent's stock in the corporation. Furthermore, as a practical matter, surviving stockholders are usually the only prospective

stock-retirement agreement, there may be some doubt as to the enforceability of the agreement.[22]

(3) A smaller amount of insurance is needed than in a stock-retirement agreement.[23] However, this may not be an advantage, as the amount that the decedent's estate will receive in exchange for his stock is correspondingly smaller.

(4) The agreement avoids redemption problems which might otherwise arise under section 302 of the Internal Revenue Code. Section 302 provides that, unless certain conditions are met, a redemption of part of a shareholder's stock in a corporation will be treated as a dividend to the stockholder and taxed as such.[24]

(5) Less gross earnings of the corporation will be needed to pay premiums on the funding insurance when the stockholders are in lower tax brackets than the corporation and the premiums can be paid out of salary increases, which are deductible by the corporation, rather than dividends. For example, if a corporation is in the 52% tax bracket, and its stockholders are in 40% tax brackets, and premiums on the insurance policies cost $4,800 annually, it would take $10,000 gross income for the corporation to pay the premiums, but only $8,000 for the stockholders to pay the premiums if they were paid out of increased salary. Of course, if the taxpayer is in a higher tax bracket than the corporation, or if salary increases will be treated as dividends, it may be more costly for the stockholders to pay the premiums.[25]

B. *Disadvantages:*

(1) Surviving stockholders incur an income tax problem upon their purchase of the cross-insurance policies owned by a deceased stockholder. Generally, life insurance proceeds payable to a taxpayer by reason of the death of an insured are not included in his gross income, and, therefore, are exempt from federal income tax.[26] However, when there has been a transfer of an interest in a life insurance contract for a valuable consideration, only an amount equal to the consideration paid plus subsequent premiums paid by the transferee are exempt

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purchasers of stock in a closely held corporation. If there is no enforceable obligation, the estate will probably find that there is no market for the stock, and this could cause real hardship if cash rather than stock was needed.

22. See disadvantage (2) under "Stock Retirement Agreements."

23. If a corporation has four stockholders, each owning 300 shares of stock valued at $100 per share, on the death of a stockholder his estate would receive $10,000 from each surviving stockholder, a total of $30,000. If the corporation rather than the stockholders owned the policies, and received the proceeds on the death of a stockholder, the insurance proceeds should be included in the assets of the corporation in determining decedent's share. See disadvantage (3) under "Stock Retirement Agreement" and note 48 *infra*.

24. The special problems peculiar to § 302 redemptions will be discussed under "Stock Redemption Agreements."

25. See disadvantage (3) under "Buy-and-Sell Agreements."

26. INT. REV. CODE OF 1954, § 101(a)(1).

from tax.[27] This transfer-for-value rule does not apply where the transfer is to (1) the insured, (2) a partner of the insured, (3) a partnership in which the insured is a partner, or (4) a corporation in which the insured is an officer or a shareholder.[28] There is no exception to the general rule when the transfer is to an individual who owns stock in the same corporation in which the insured was a stockholder. The rule can cause serious difficulty. For example, suppose *A*, *B*, and *C* form the *X* Corporation, and enter into a buy-and-sell agreement funded with life insurance, each stockholder purchasing a life insurance policy on the lives of the other two stockholders. When the first stockholder dies—assume it to be *C* — *A* and *B* receive the proceeds of the insurance policies that they carried on *C*'s life, and use these funds to purchase *C*'s interest in the corporation. *C*'s estate has insurance policies on the lives of *A* and *B*. *B* would like to purchase the policy on *A*'s life, and *A* the policy on *B*'s life, in order to increase the amount of insurance payable to either on the death of the next stockholder, thereby furnishing a fund sufficient to pay for his increased interest in the corporation. (*A*'s and *B*'s interests in the corporation increased 50 percent when they purchased *C*'s stock.) This cannot be done without coming within the transfer-for-value rule. Consequently, it would probably be necessary to make the transfer to the corporation itself, and then set up a new agreement on a stock-retirement basis instead of a buy-and-sell basis.

(2) More insurance policies are needed. Where there are four or five stockholders, the buy-and-sell method is unwieldly and cumbersome. Each stockholder must purchase an insurance policy on the life of every other stockholder. When there are five stockholders, this would require twenty insurance policies. By using the stock-retirement method, only five policies would be necessary.[29]

(3) If the individual stockholders are in higher federal income tax brackets than the corporation, payment of the insurance premiums by them will be more costly than payment by the corporation. Even if the corporation is in a higher tax bracket than the stockholders, if salaries of the stockholders cannot be increased, or if an increase might be treated as a dividend, it would be advisable for the corporation to pay the premiums in order to avoid a double tax. Otherwise, the corporation would first be required to pay corporate income tax on money received, and then the stockholder, who is to pay the premium, would be taxed for the receipt of a dividend.[30]

(4) Disparity in ages and interest may work a substantial hard-

27. INT. REV. CODE OF 1954, § 101 (a) (2).
28. *Ibid.*
29. See advantage (2) under "Stock Retirement Agreement."
30. See advantage (3) under "Stock Retirement Agreement."

ship on some stockholders. A stockholder who is a young man will have great difficulty paying the premiums for the insurance policies on the lives of his older associates. Likewise, because he will probably be a minor stockholder, he must carry a large amount of insurance on the lives of his older associates in order that he may purchase his share of their stock.

Stock-Retirement Agreements

In this type of agreement, the corporation agrees to purchase or is given an option to purchase the stock of the corporation owned by each stockholder at his death. The purchase price of the stock is paid with corporate funds. To provide a fund for redemption of shares, the corporation may take out life insurance on the life of each stockholder. The corporation applies for and is owner of the policy, pays the premiums, and is the beneficiary.[31]

A. *Advantages:*

(1) There is no transfer-for-value problem.[32] The corporation owns all of the insurance policies.

(2) Fewer insurance policies are needed. If there are five or six stockholders, the corporation need only purchase one policy for each stockholder. In a buy-and-sell arrangement, twenty policies would be needed if there were five stockholders, thirty policies if there were six stockholders.[33]

(3) If the corporation is in a lower income tax bracket, payment of the premiums by the corporation will be advantageous taxwise. Furthermore, even if the corporation is in a higher tax bracket, if an increase in salaries for the payment of premiums by stockholders would be treated as a dividend and thus exposed to double taxation, it would be advisable for the corporation to pay the premiums.[34]

(4) There is a psychological advantage in the corporation's paying the insurance premiums. Often the main advantage from the stock-

31. A corporation has an insurable interest in the life of an officer on whose services the corporation depends for its prosperity, and whose death will be the cause of a substantial loss to it. This rule has been applied to various corporation officers. United States v. Supplee-Biddle Hardware Co., 265 U.S. 189 (1924) (president); Keckley v. Coshocton Glass Co., 86 Ohio St. 213, 99 N.E. 299 (1912) (principal stockholder, director and employee); Murray v. G. F. Higgins Co., 300 Pa. 341, 150 Atl. 629 (1930) (vice-president, director and stockholder); Wurzburg v. New York Life Ins. Co., 140 Tenn. 59, 203 S.W. 332, (1918) (general manager); Mutual Life Ins. Co. v. Board, Armstrong & Co., 115 Va. 836, 80 S.E. 565 (1914) (president, general manager, and principal incorporator). If the corporation has an insurable interest in an officer when the policy is taken out, the policy remains valid although the officer subsequently severs his connection with the company. Wellhouse v. United Paper Co., 29 F.2d 886 (5th Cir. 1929); Wurzburg v. New York Life Ins. Co., *supra; accord,* Connecticut Mut. Life Ins. Co. v. Schaefer, 94 U.S. 457 (1876).

32. See disadvantage (1) under "Buy-and-Sell Agreements."

33. See disadvantage (2) under "Buy-and-Sell Agreements."

34. See advantage (3) under "Buy-and-Sell Agreements."

holder's viewpoint is that he does not have to pay premiums out of his own pocket. It is less painful for the corporation to pay.

B. *Disadvantages:*

(1) The surviving stockholders will not get a stepped-up cost basis. The cost basis of their stock for federal income tax purposes remains the same, though there has been an increase in the proportional interest of each stockholder in the corporation.[35] However, this will not be damaging unless a surviving stockholder desires to sell his interest before his death. If the surviving stockholders still own their stock at death, the stock will acquire a new cost basis at that time — market value at the date of death.[36]

(2) A corporation may not be permitted under the laws of the state of its creation, or under its charter, to purchase its own shares; or such power may be dependent on the existence of surplus or earned surplus.[37] The corporate charter can be amended to rectify this situation. Although state laws cannot be changed with the same facility, various provisions are available which would help guarantee a surplus at the time of death. The agreement could provide that, if necessary, capital should be reduced and surplus increased. Surplus might be created by revaluing assets carried at cost or at a normal value. Or the agreement might provide that the shareholders must buy the stock of decedent if the corporation is unable to carry out its agreement. However, usually there will be a surplus when the agreement is funded with life insurance.

(3) A greater amount of insurance must be purchased on each stockholder's life. The agreement will work a substantial injustice to the party to the agreement who dies first unless the purchase price of his shares is based on the assets of the corporation after the stockholder's death. That is, the corporation's assets for the determination of the purchase price of a deceased stockholder should include the

35. In the case of a partnership, the 1954 Code provides for an increase in the cost basis of the interest of the surviving partners even where a partnership entity type agreement is used. INT. REV. CODE OF 1954, § 705(a)(1)(B).

36. INT. REV. CODE OF 1954, § 1014.

37. See 6A FLETCHER, CYCLOPEDIA CORPORATIONS §§ 2847, 2848 (perm. ed. rev. repl. 1950); Note, *Stock Repurchase Abuses and the No Prejudice Rule*, 59 YALE L.J. 1177 (1950). Topken, Loring & Schwartz v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928), is sometimes cited to show that even if the corporation finds itself (after decedent's death) in a position where it is able to carry out its agreement without violating the law, stock retirement agreements are unenforceable in New York. Williams, *A Useful, Unenforceable Contract*, 3 J. AM. SOC'Y C.L.U. 325, 327 (1949). But the *Topken* case has not been followed and it appears that it may be disregarded. Hamilton, *Should the Corporation Be a Party to a Stock Purchase Agreement?*, 4. J. AM. SOC'Y C.L.U. 44, 47-48 (1950); Mannheimer, *Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements*, 29 TAXES 393, 402 (1951); Mannheimer & Wheeler, *Buy-and-Sell Agreements — Are Stock Retirement Plans Enforceable?*, 88 TRUSTS & ESTATES 717 (1949).

insurance proceeds received on his death, which have increased the value of his stock.[38]

(4) As the policies acquire substantial cash surrender value, the corporation may run the risk of becoming subject to the special federal surtax on improper accumulations of earnings.[39] However, it would appear that if the purchase agreement serves a proper business purpose,[40] and if the dictum in *Emeloid Co. v. Commissioner*[41] correctly interprets the law, this danger is non-existent.

(5) Payment of premiums by the corporation may be found to be payment of dividends taxable to the stockholders.[42] There has been no court decision to date in which this position was taken, and since the decision in the *Emeloid* case, it seems unlikely that the objection has any validity.[43]

(6) Payment of the purchase price by the corporation when the

38. "[T]he stock retirement and partnership entity types of agreement are frequently set up to work a substantial injustice to the party to the agreement who dies first. To illustrate this . . . assume that Mr. A and Mr. B [sole stockholders] are each 35 years of age and in good health and each owns 50 shares of the stock of the corporation. Mr. A and Mr. B. and the corporation enter into a stock-retirement type of agreement under which the corporation agrees to purchase the stock of the stockholder first to die for $50,000 and takes out $50,000 of funding insurance on the life of Mr. A and $50,000 of funding insurance on the life of Mr. B.

"Mr. A dies and the corporation collects the $50,000 of insurance, but now we find that we have not a $100,000 corporation, but a $150,000 corporation. Premiums on the funding insurance were paid with corporate funds and should therefore inure to the benefit of Mr. A just as much as to the benefit of Mr. B, but under the agreement as set up, Mr. B will be the sole beneficiary of the insurance and Mr. A's estate will receive only $50,000 for stock which on the basis of the figures assumed, has a clear value of $75,000." Davis, *Recent Developments in Business Purchase Agreements,* 94 TRUSTS & ESTATES 284, 329 (1955).

39. INT. REV. CODE OF 1954, § 531.

40. U. S. Treas. Reg. 118, § 39.102-3 (1953). For a thorough discussion of the "business purpose doctrine" and the *Emeloid* case, see Rappoport, *Corporation Stock-Purchase-Insurance Trust Agreement,* 29 TAXES 835 (1951).

41. "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 the trust to insure its continuation. Petitioner apparently anticipated that should one of its key stockholder-officers dies, those beneficially interested in the estate might enter into active participation in corporate affairs and possibly introduce an element of friction. Or his estate, not being bound by the 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 unchartered shoals." Emeloid Co. v. Commissioner, 189 F.2d 230, 233 (3d Cir. 1951) (dictum).

42. Premiums are not deductible. INT. REV. CODE OF 1954, § 264; *cf.* Ernest J. Keefe, 15 T.C. 947 (1950).

43. Prior to the *Emeloid* decision, Paramount-Richards Theatres, Inc. v. Commissioner, 153 F.2d 602 (5th Cir. 1946), was usually cited to show that there was some risk of premiums being held to be constructive dividends. Danzig, *Taxes — Insurance — and Stockholder Survivor Agreements,* 28 TAXES 213, 217-18 (1950); Smith, *Disposition of Business Interest at Death,* 28 TAXES 1238, 1242 (1950). However, the case has been distinguished. Mannheimer, *Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements,* 29 TAXES 393 (1951); Mannheimer & Friedman, *Stock Retirement Agreements,* 28 TAXES 423 (1950).

stock is redeemed may be considered a dividend to the surviving stockholders. Where the corporation is obligated to make the purchase, this objection appears to have no validity.[44] However, if the obligation is upon the surviving stockholders and the corporation purchases decedent's stock for them, the doctrine of *Wall v. United States*[45] would require treatment of the purchase price as a dividend to the survivors.

(7) If the corporation became insolvent, the insurance policies may be subjected to payment of creditors.

In listing the advantages and disadvantages of each type of purchase agreement, it has been assumed that a complete redemption was contemplated by the parties. However, in some cases a partial redemption may be advisable, and, if so, there are special problems peculiar to partial redemptions which must be considered.

A complete redemption,[46] or a redemption of stock up to an amount equal to the total of the federal estate tax, state inheritance tax, and the funeral and administration expenses,[47] is treated for federal income tax purposes as a distribution in exchange for the stock redeemed. However, if less than the full amount of the decedent's stock is redeemed, and the amount redeemed exceeds the amount of death taxes, funeral and administration expenses, a portion of the redemption may be treated as a dividend unless the requirements of section 302 of the Internal Revenue Code are met.[48] Under section 302, a partial redemption is treated as an exchange for the stock redeemed, rather than a dividend, unless (1) it is not essentially equivalent to a dividend,[49] or (2) it is substantially disproportionate with respect to the stockholders.[50] If the redemption does not come within one of these ex-

44. See Mannheimer, *Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements*, 29 TAXES 393, 400 (1951).
45. 164 F.2d 462 (4th Cir. 1947).
46. INT. REV. CODE OF 1954, § 302(b) (3).
47. INT. REV. CODE OF 1954, § 303(a). In order that distribution be given § 303(a) treatment, three conditions must be met:
(1) the stock must constitute part of the decedent's gross estate for estate tax purposes, and
(2) the value of the stock is either more than 35% of the gross estate or 50% of the taxable estate of the decedent (for purposes of the 35% and 50% requirements, stock of two or more corporations, with respect to each of which there is included in determining the value of decedent's gross estate more than 75% in value of the outstanding stock, shall be treated as the stock of a single corporation), and
(3) the distribution is made after decedent's death and within ninety days after the expiration of the period for the assessment of the estate tax, or if there is a Tax Court proceeding within 60 days after the Tax Court decision becomes final. INT. REV. CODE OF 1954, § 303(b).
48. Section 301 of the 1954 Code provides in effect that every corporate distribution for which special treatment is not provided by some other section of the Code is a distribution taxable as a dividend.
49. INT. REV. CODE OF 1954, § 302(b) (1).
50. INT. REV. CODE OF 1954, § 302(b) (2). For a redemption to be substantially disproportionate, three conditions must be met: (1) the percentage of all the voting stock which the shareholder owns immediately after the redemption must be less than 80% of the percentage of the voting stock which the share-

ceptions, it is treated as a dividend. However, the problems peculiar to partial redemptions are of no great concern, as the usual business purchase agreement contemplates the complete redemption of a deceased stockholder's interest.

CHOICE OF AN AGREEMENT

Since the *Emeloid* decision, the stock-retirement method has been used in the great majority of business purchase agreements involving corporations. This popularity can be explained on a number of grounds: (1) the stockholder is afraid that any salary increase enabling the stockholders to pay the premiums on cross insurance would be treated as a dividend; (2) it seems much easier for the corporation to pay the premiums than the stockholders; (3) the stockholder thinks that he may reach an income tax bracket higher than the corporation's, even if it is not that high when the agreement is drawn.

A factor which makes buy-and-sell agreements unpopular when there are more than two stockholders is the transfer-for-value rule. It may be advantageous from the standpoint of the federal income tax to use a buy-and-sell agreement when the contract is first made, but a later transfer of the insurance policies owned by the decedent to the surviving stockholders is a transfer for value, and therefore, the proceeds of the policies transferred will not be received by the purchasers free of income tax. If the stockholders are in lower tax brackets than the corporation, it might be advisable to provide for a buy-and-sell agreement until the first stockholder dies. At that time, the corporation could purchase the insurance policies owned by the decedent's estate. There would be no transfer for value (transfer to a corporation is an exception to the general rule), and the corporation would thereafter pay the premiums, own the policies, and be the beneficiary. It might be advisable for the corporation to purchase policies owned by the surviving stockholders as well, thereby changing the entire arrangement to a stock-retirement agreement. If the stock-retirement method is used, and a partial redemption is contemplated, it should be reasonably easy to avoid the dangers of sections 302 and 303 of the Internal Revenue Code by using care in drawing up the agreement. The statute is clear as to which redemptions will be treated as dividends, and which will not. As a practical matter, when a business purchase agreement is used, the corporation usually purchases the entire interest of the decedent in the corporation. If

holder owned immediately before redemption; (2) the same 80% rule applies to all common stock whether voting or non-voting; and (3) the shareholder must own immediately after the redemption less than 50% of the total voting power of all voting stock.

this is the case, there is no danger of the redemption being treated as a dividend, unless a family corporation is involved.[51]

If the stockholders who may survive anticipate a sale of their stock in the foreseeable future (*i.e.,* before their death), a buy-and-sell agreement offers one real advantage — the cost basis of the stock owned by the survivors is stepped up after the purchase of a deceased stockholder's interest. However, if there are more than two stockholders, any advantage gained by a stepped-up basis must be weighed against the cumbersomeness and unwieldiness of the buy-and-sell method, and the transfer-for-value problem which may arise.

From this discussion, it should be evident that there is no general rule by which to determine the better type of agreement. One type will be more suitable under one set of circumstances, the other under other circumstances.[52] The factors which seem most important in selecting the proper agreement for a particular situation are: (1) tax brackets of the corporation and the stockholders; (2) number of stockholders; (3) whether a sale by the surviving stockholders of their interest in the corporation is anticipated; and (4) the law of the state of incorporation respecting power of a corporation to purchase its own stock.[53] Usually factors (1) and (2) will be the controlling ones, as corporations usually can buy their own stock under certain conditions, and the surviving stockholders do not anticipate a sale of their interest before death. However, depending on the situation, other considerations not mentioned here may be and frequently are controlling in choosing an agreement. This is evidenced by the popularity of the stock-redemption agreement regardless of the comparative tax brackets of the corporation and the stockholders. Selection of the proper agreement will be accomplished only by weighing the various factors in favor of each method, and selecting the one which seems most suitable under all the circumstances.

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51. If a beneficiary of the estate of a deceased shareholder owns any stock in the corporation, then, unless the stock of such shareholder is also redeemed with the stock owned by the estate, there is a danger that the amount distributed by the corporation in redemption of the stock owned by the estate will be considered a distribution of a taxable dividend. This results from the provisions of sections 302 and 318(a) of the 1954 Code. However, if the redemption meets the requirements of section 303 — distributions in redemption of stock to pay death taxes — then there is no danger of the receipt of a taxable dividend.

52. See Redeker, *Business Insurance Agreements,* 93 TRUSTS & ESTATES 386 (1954).

53. Note, *Stock Repurchase Abuses and the No Prejudice Rule,* 59 YALE L.J. 1177 (1950).