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Planning for the Transition Of a Real Estate Business: A Primer on Buy-Sell Agreements

By J. Robert Turnipseed, Esq., and Shelby L. Wilson, Esq.[*]

If you are reading this article, chances are you frequently represent small businesses. On that assumption, perhaps the best way to begin is to inform you *why* this topic is so important, which can be summed up with the following statement: over 75% of your small business clients will fail to survive past the second generation.[1] It is widely reported that small businesses make up the bulk of all businesses in the United States. According to reports from the Small Business Administration, small businesses (defined as an independent business with fewer than 500 employees) make up 99% of U.S. employer firms, with more than 27.9 million small businesses nationwide (as opposed to 18,500 large employers), and constitute almost 50% of private sector employment.[2] And yet the majority of these businesses will not survive beyond the life of their initial owners.

The results of the failure of a small business can be devastating to the owner or his/her family, especially when the business is the main asset and/or the main source of income of the deceased owner's estate. Although there are situations where the dissolution or liquidation of a business is unavoidable, the great majority of these business terminations are avoidable with proper planning. Typically speaking, most small businesses in the United States today either consist of some form of partnership, whether a limited liability partnership or a limited liability company or other partnership, or have been created as a corporation and have elected to be treated as an S corporation. The reason for this lies in the flow-through tax treatment these entities receive under the Internal Revenue Code. But regardless of the choice of entity, each of these small businesses suffers from specific, common problems which, if left unaddressed, will lead to its demise, including the following:

- Improper planning for transition to next owners and/or sale of business;
- No publicly established value and a limited market for sell;
- Lack of liquidity for both the estate of the deceased owner and for the business;
- Impact of transfer taxes on the business or family members.
- Conflict among the owners and/or their heirs.

For small businesses whose focus is primarily on real estate, some of the issues are particularly challenging. Most importantly, the issue of valuation of a business interest poses a particular problem in a real estate business. Furthermore, because so much of the value of the company is tied up in real estate, the issue of liquidity is extremely important when dealing with a real estate business, as the business typically will not have readily available capital at its disposal for the purchase of interests.

Each of these issues can and should be addressed by the tax advisor, through the preparation of a buy-sell agreement. This article addresses the main issues that are present in dealing with buy-sell agreements for real estate businesses, addressing the estate taxes

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[1] Morton A. Harris, *Planning for the Successful Transition of a Family Business to the Next Generation: A Family Business Survival Guide for Owners and Advisors*, ABA Section of Taxation, Joint Fall Meeting, at 7 (Sept. 20, 2103) (citations omitted).

[2] Small Business Administration Office of Advocacy, *Frequently Asked Questions About Small Businesses*, at 1 (Sept. 2012).

issues; the income tax issues; liquidity issues and solutions; and ultimately discussing the necessary components of a proper buy-sell agreement.

THE BASICS OF BUY-SELL AGREEMENTS

Before delving into the more technical aspects of buy-sell agreements, it would be helpful to address exactly what they are. A buy-sell agreement is an agreement among owners of a business addressing the ultimate disposition of an interest in the business upon the occurrence of certain events. Another more simplistic definition of the term is as follows: ''Buy-Sell Agreements are contracts by which the owners of a business (stockholders or partners) agree to impose certain restrictions on their right to transfer their interests in the business freely to whomever they wish, whenever they wish, and on whatever terms they wish.''[3]

These agreements are intended to provide for an orderly transition of the business to the non-selling owners and to assure the heirs of the selling owner of a market for his or her interest. Buy-sell agreements preserve the value of the business interest of the selling owner, while transitioning control of the business to the other owners, which if done properly keeps the business in operation. The best way to understand the importance of a buy-sell agreement is to understand what can (and frequently does) happen when no such agreement is in place for the transfer of an owner's interest. The following list is a sample of the possible negative results that can occur in the absence of effective planning:

- Conflict among family members and/or owners of the business
- Excessive transfer taxes
- Excessive or unnecessary income taxes
- Transition of control to unqualified or contentious owners
- Uncertainty of leadership/management of the business
- Loss of value of the business interest
- Complete liquidation of the business

A properly structured buy-sell agreement can avoid (or at least minimize) all of these issues. For the surviving owners, a properly structured buy-sell agreement can provide a contractual obligation that the decedent's estate will sell its interest, either to the surviving owner or to the company. It can establish a price or price mechanism that is agreed to by all owners beforehand. It can provide liquidity to the company (or non-selling owners) to accomplish the buyout without rendering the company insolvent. Buy-sell agreements can provide for a smooth transition to the surviving owners and avoid unwanted partnership with incapable or contentious partners. It can provide for continued stability of the business on the death of a key owner and give the surviving owners the best opportunity to preserve the value of that asset.

Concomitantly, a properly structured buy-sell agreement extends multiple benefits to the estate or heirs of the deceased owner. First and foremost, a buy-sell agreement provides a contractually obligated purchaser of the deceased owner's interest, which otherwise would have had a limited market of potential buyers. It assures a fair price (possibly even negotiated in advance) for the surviving family members or heirs of the decedent. It establishes a value for the deceased owner's estate, which if properly structured will be recognized by the IRS for estate tax purposes. It provides a funding mechanism for the buy-sell agreement, with a contractual obligation that those funds be paid to the deceased owner's heirs. Ultimately, a properly structured buy-sell agreement preserves the value of what is typically the most valuable asset in the deceased owner's estate.

Tax considerations are also important for buy-sell agreements. Properly structured buy-sell agreements contain provisions which ensure maintenance of the company's Subchapter S election. It can, if structured properly, establish the value of the interest for estate tax purposes, which can minimize or eliminate the taxes. Buy-sell agreements can also assure the proper characterization of the sale proceeds, typically as a sale or exchange. They can also establish timing of the payments, which are useful for a variety of reasons under the tax code.

Typically speaking, buy-sell agreements can be drafted in one of two ways, either as an agreement from the company to redeem the interest (i.e., redemption agreement) or an agreement for the surviving owner(s) to purchase the interest at issues (i.e., cross-purchase agreement). Some buy-sell agreements provide a hybrid of both options, typically drafted as an option contract. As will be explained, each of these forms of agreement has different tax consequences and is appropriate for different kinds of circumstances.

With this quick summary of buy-sell agreements, let us now turn to the main issues. The most important and controversial issue regarding buy-sell agreements is the issue of value.

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[3] Howard M. Zaritsky, *Structuring Buy-Sell Agreements* §1.01 (Warren, Gorham & Lamont, 2002 and 2009 Cum. Supp).

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ESTATE TAXATION — FIXING THE VALUE

For any kind of business entity, valuation is an essential component of any buy-sell agreement. As discussed above, a properly structured buy-sell agreement can provide some flexibility in establishing the price of a buyout on the death of an individual shareholder that will survive IRS scrutiny. Valuation of business interests is a highly subjective and specialized process, and any valuation should be prepared by a qualified appraiser. This is especially true in cases of real estate companies that own multiple categories of real estate. In some instances, it might be appropriate to utilize the skills of a combination of appraisers that may have different sets of skills or familiarity with different uses of the property.

Basics of Estate and Gift Taxation

Before delving into the issue of valuation, it is important to review the basics of estate and gift taxation. While the federal estate and gift tax regime has undergone its fair share of changes over time, and in particular over the last 15 years, the underlying tax structure has remained intact. The federal estate and gift tax, at its most basic level, is a tax on the transfer of wealth between generations. Under the current tax code, an estate is entitled to transfer a cumulative amount of up to $5.43 million (called the ''annual exclusion amount'') to a non-spouse, free of estate and gift tax, either during lifetime or at death.[4] In addition, an estate may claim an unlimited marital deduction for transfers to spouses, during lifetime and at death.[5] Under certain circumstances, a portability exemption allows a surviving spouse's estate to use any remaining unused applicable exclusion amount of the predeceased spouse.[6] Due to just these two exclusions and deductions, a married couple may pass up to $10.86 million to succeeding generations without incurring any federal estate tax, with very minimal planning.[7]

For instances where the death of a client requires the filing of an estate tax return and results in an estate tax liability, the liability must be paid within nine months of the decedent's death in order to avoid the imposition of interest and penalties.[8] This tight deadline is particularly relevant to families with businesses holding significant real estate assets, as the value inherent in the underlying assets may be illiquid. Borrowing against the asset or raising the cash to pay the resulting tax may prove to be very difficult, and can even be prohibited by the company's operating documents. While there are a number of specific post-death actions that may be taken to mitigate the impact of this tax, most such actions pose difficulties and can be avoided with pre-death planning.

The federal estate and gift tax is wholly separate from any other tax imposed by the federal government. While the increase in exemptions over the last decade has resulted in fewer individuals and families being subject to the federal estate and gift tax, the IRS's auditing capabilities in this arena remain strong. Unlike other departments, most, if not all, of the auditors for federal estate and gift tax are attorneys who are very skilled in this area of law. Therefore, while filings of estate tax returns have become far less common, it is still common for an estate tax return to be subjected to audit, especially in cases where estates exceed the combined exemption amounts or are close to the line. By far, the biggest red flag for an audit of an estate or gift tax return lies in the issue of valuation of a small business interest.

Valuation of a Business

Because the tax is based on the value of the decedent's assets on the date of death, valuation becomes a key component in the estate settlement process. In the event the estate of the decedent owning the interest in the company exceeds the federal estate tax exemption (currently $5.43 million) and the estate tax return becomes the subject of an audit, it is highly likely that the value of the business interest will be challenged as part of the proceeding. It is therefore critical to keep this in mind when addressing the issue of valuation in drafting a buy-sell agreement, to assure that the valuation will be respected by the IRS.

In general, for estate tax purposes, valuation is based on the principle of ''fair market value,'' or the price at which the property would change hands between a willing buyer and seller, when the buyer is not under any compulsion to buy and the seller is not under any compulsion to sell, with both parties having reasonable knowledge of relevant facts.[9] Under Reg. §20.2031-3, net value is determined on the basis of all relevant factors including the following:

(a) a fair appraisal as of the applicable valuation date of all of the assets of the business, tangible and intangible, including goodwill;

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[4] §2010. Except as otherwise indicated, references to ''§'' are to sections of the Internal Revenue Code, and references to ''Reg. §'' are to the Treasury regulations promulgated thereunder.

[5] §2056.

[6] §2010(c)(5)(A).

[7] There are additional deductions and exclusions for federal gift and estate taxation that can be used as well, including the annual exclusion (which allows gifting of up to $14,000 per person every year to as many recipients as he or she wants), and the charitable deduction (which is unlimited for gift and estate tax purposes).

[8] §6075(a).

[9] Reg. §20.2031-1(b).

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(b) the demonstrated earning capacity of the business; and

(c) the other factors set forth in Reg. §20.2031-2(f) and Reg. §20.2031-2(h) relating to the valuation of corporate stock, to the extent applicable.

The present value of an asset is a determination of the sum of the future benefits that the asset is expected to produce, discounted to a present value at an appropriate discounted rate. In general, future benefits may take the form of annual earnings or cash flow, expected proceeds from a sale of the underlying property, or expected proceeds from liquidating the entity. Discounting becomes a function of the time value of money, and the level of uncertainty of the future benefits.

The IRS originally issued Rev. Rul. 59-60[10] to assist taxpayers in determining the fair market value of closely-held business entities for estate and gift tax purposes. In that ruling, the IRS noted that no general formula applies to the valuation of interests in closely-held businesses.[11] According to Rev. Rul. 59-60, the following factors are relevant in determining the fair market value of a closely-held business:

- The nature and history of the business;
- The economic outlook for the economy in general and for the particular industry;
- The book value of the stock and financial condition of the business;
- The earning capacity of the business;
- The dividend-paying capacity of the business;
- The goodwill or other intangible value of the enterprise;
- Other sales of the stock and the volume of stock to be traded; and
- The market price of stocks of public corporations engaged in similar businesses.

Business valuation is a mix of art and science, and can be highly subjective. It is not uncommon for a business to be valued by a number of different methods in which an average, or weighted average (giving more weight to some methods than to others) is used to determine fair market value. Appraisers use a variety of approaches in valuing a business. The following sections address some of the possible valuation methods.

Discounted Future Returns

This method examines projected future earnings of the company and applies a discount to such earnings to determine the present value of the projected income stream. The purpose of this method is to provide a reasonable estimate of the fair market value of the business based on its estimated future cash flow.

The Discounted Future Returns Method forecasts a stream of future payments by:

- Adjusting for overstated or understated expenses
- Adjusting for cost of management
- Looking at historical experience

The analysis then discounts the stream of payments and considers:

- Cost of capital
- Time value of money and risk

Capitalization of Earnings

This method looks at the company's history of earnings and cash flow (either gross or net), usually over a period of five (or more) years. The average annual return is then divided by a capitalization factor based on the nature of the business being valued. This method considers the following factors:

- Adjustments to the market
- Weighted earnings
- Excessive compensation and rent payable to shareholders

A capitalization factor is a multiple or divisor used to convert anticipated economic benefits of a single period into value. Typically, the higher the rate reflects the higher perceived risk and the lower the value of the business. Considerations that affect the capitalization factor include the following:

- Price/earnings ratio of comparable companies
- Required return
- Nature of the business
- Risk involved
- Stability or irregularity of earnings

Fixed Value

The fixed value of a business is typically the fair market value of its underlying tangible assets on its books, taking into consideration depreciation or intangible factors (e.g., good will, trademarks, patents). In

[10] 1959-1 C.B. 237.

[11] It is important to keep in mind that, in valuing underlying real estate assets, the IRS has consistently held the position that real estate assets be valued at highest and best use. IRM 4.48.6.2.4 (07-01-2006).

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the context of buy/sell agreements, this method of valuation typically establishes an unchanged value over time, and usually provides no method of adjustment. This rigidity in the value is often perceived to be unfair to the parties, and typically does not meet the test under §2703(b) and corresponding regulations for establishing credible estate and gift tax values.[12]

Book Value

Book value is sometimes referred to as carrying value, and typically represents the fixed assets minus liabilities and depreciation of the assets. This is a method used for valuing an operating business, and is based on the company's period financial statements. This can typically result in a significantly different value than the Fixed Value approach, and is typically not viewed as a good indicator of fair market value for most businesses beyond the start-up phase. Although it is relatively easy to determine the book value of a business, it can be viewed as being drastically different from fair market value, unless adjusted for such considerations as (1) the company's accounting method; (2) differences between fair market value and book value of such as real estate, equipment, and other fixed assets; (3) differences between the book value and fair market value of intangibles; (4) adjustments to account receivable to reflect collectability; and (5) adequacy of reserve accounts.[13]

Income Approach

The income approach to valuation considers the present value of the income that the business is expected to produce in the future, and through certain mathematical processes, a fair market value is determined. This method is most useful in valuing properties that produce significant cash flow, such as rental property, commercial real estate, or properties that produce significant natural resources (i.e. oil wells, mines, etc.). This is not always appropriate for business assets that produce little or no income, which may be evaluated more accurately using an appraised value of the underlying business assets.

Appraisal Value

This method requires the evaluation of the business by independent appraisers when an event occurs that trigger the terms of a buy-sell agreement. While the appraisal approach may not always be the most practical valuation method of choice due to the time and expense involved, this method might also be perceived as being the most equitable to the shareholders. This is typically the case in the context of businesses with significant real estate holdings, as operating factors, goodwill, and other considerations are relatively insignificant, and the value in the company can be determined in large part by its fixed assets.

In some instances, buy-sell agreements can be structured to allow each of the seller and purchaser to choose an appraiser, who together will choose a third appraiser if the parties cannot agree. While this may be perceived to be the most accurate method of determining current fair market value in the eyes of the IRS (and appraisals would most likely need to be conducted as part of any estate tax proceeding), it can result in added expense and potential dissention among shareholders.

"Agreed Upon" Value

This is a method that is based on values periodically agreed upon by the parties to the shareholders agreement. This method requires periodic adjustments by the parties, typically accompanied a provision requiring some type of alternative valuation mechanism in the event such adjustments are not made by the parties. While these arrangements are frequently used, there is a potential for disagreement on the value of the interests over time. This is especially true in instances where there is a disparity in ages between the shareholders. Practically speaking, in many instances, parties to the buy-sell will go several years without establishing an agreed upon value. In addition, this method may be subject to challenge by the IRS if the values do not represent fair market value, or does not pass muster under §2703.

Adjustments to Value — Discounts

Any of the above approaches, or a combination of them, may be utilized by an appraiser to determine the value of the business itself. However, the IRS and courts recognize that a business interest is not necessarily equal to a *pro rata* share of the value of the business. That recognition leads to an adjustment of the business interest, which is obtained through the use of discounts. A variety of factors are considered in adjusting the value of an interest in a closely held business. The burden of proof on valuing a closely held business interest and on substantiating discounts is on the taxpayer.

Discount for Lack of Marketability

Discount for Lack of Marketability (DLOM) is based not on the size of the interest but, rather, on the difficulty of converting the business to liquidity. The fact that the value of the business cannot be readily converted to cash requires that the sale price between

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[12] Reg. §25.2703-1(b). *Estate of Blount v. Commissioner*, T.C. Memo 2004-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).

[13] Morton A. Harris, *Buy-Sell Agreements for Closely Held Family Businesses: Tax and Practical Considerations*, ABA Section of Taxation/ Section of Real Property, Trust & Estate Law Joint Program, Denver, Colorado (Oct. 22, 2011).

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the willing buyer and a willing seller be discounted. There may be no ready market for the interest or restrictions which may be in place affecting ownership rights (options, right of first refusal, buy-sell agreements or voting trust).

DLOM can range from 25%–50%, but actual discount is fact-specific and needs to be supported by a qualified appraisal. The DLOM is usually the most significant discount for transfer tax purposes. In *Mandelbaum v. Commissioner*, the Tax Court stated that ''[a]scertaining the appropriate discount for limited marketability is a factual determination.''[14] The court, persuaded by either party's experts, set forth its own valuation analysis (using factors similar to those set forth in Rev. Rul. 59-60) to determine the appropriate discount for the lack of marketability of unlisted stock, citing the following factors in its analysis:

- The cost of a similar corporation's stock;
- Analysis of the company's financial statements;
- Dividend paying capacity and dividend history;
- Nature of the corporation, its history, its position in the industry and its economic outlook;
- The strength of a company's management;
- The degree of control transferred with the block to be valued;
- Any restriction on the transferability of the corporation's stock;
- The period of time for which an investor must hold the subject stock to realize a sufficient profit;
- The corporation's redemption policy; and
- The cost of effectuating a public offering of the stock to be valued.[15]

Additionally, courts and experts will consider the price obtained in any recent arm's-length transaction if available.[16]

Minority Interest Discount

A minority interest in a closely held business is worth less than a proportionate share of the value of the assets of the business because such minority ownership eliminates the ability of the owner to have any significant control or influence over the operations of the business. Minority interest discounts reflecting the lack of control over the business can range from 15%–49%. However, the degree of discount is fact-specific and must be supported by a qualified appraisal.

Courts and experts consider a number of factors in determining the appropriate minority discount, including:

- Ability to select managers of the business;
- Ability to control management policies and salaries; and
- Whether or not there is a concentration of ownership in the remaining interest.

There are conflicting views as to whether the ability to compel a liquidation or dissolution of the business is a factor to consider in determining a minority discount. One theory is that if a minority owner can trigger liquidation or dissolution, then the owner has greater control than his ownership interest would indicate and he would have the right to obtain a proportionate amount of his interest.

Another view is that the power to liquidate or dissolve an entity might be available, but it should not impact a minority discount because it would likely take time to wind up the affairs of the business, and ultimately it would not enhance the value of the minority ownership interest.[17]

Control Premium

In many instances, investors value control, and there can be an increase in value for majority interest control known as a control premium. Shareholders holding a controlling interest in a business typically are in the position control such factors as the nature of the business, and can oversee and select management enter into contracts, buy, sell, and pledge assets, borrow money, issue and repurchase stock, register stock for public offering, and liquidate, sell, or merge the company. The controlling party may also set management compensation and perquisites, declare (or not declare) dividends, make capital distributions, and control contracts and payments to third parties. In closely held businesses, and particularly those holding significant real estate interests, minority stockholders often have minimal influence on these important activities.[18] While the extent to which control premiums affect valuations on controlling interests depends on numerous factors, it is essential to understand that this is an issue to consider in the drafting of buy-sell agreements, as it may be likely that a shareholder may acquire a controlling interest as the result of a trigger-

[14] T.C. Memo 1995-255, *aff'd without op.*, 91 F.3d 124 (3d Cir. 1996).

[15] *Mandelbaum v. Commissioner*, T.C. Memo 1995-255.

[16] *Discount for Lack of Marketability*, Job Aid for IRS Professionals (Sept. 25, 2009).

[17] *See generally* Louis A. Mezullo, Bloomberg BNA Tax Management Portfolio 831 T.M., *Valuation of Corporate Stock*, at VII.

[18] *Estate of Simplot v. Commissioner*, 112 T.C. 130 (1999), *rev'd*, 249 F.3d 1191 (9th Cir. 2001).

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ing event. The Court in the *Simplot* case held that a control premium may not exceed what would otherwise be fair market value for the interests purchased in an arm's-length transaction.[19]

Impact of Buy-Sell Agreements on Valuation

Buy-sell agreements can establish values of business interest in any number of ways. In particular, the owners of a small business will choose the method by which the interest in the business will be valued.

The main valuation formulas used in buy-sell agreements include fixed value, book value, appraisal method, and formula method. The parties to a buy/sell agreement are free to choose whatever method fits their particular business and their objectives. There are benefits and problems with each method that they could choose. For example, fixed value is more certain than other methods and may reflect an accurate value when set, but it may not take into account changing or unforeseen circumstances in the future. The appraisal method may provide more accurate value, but it can be very expensive and can lead to disputes among the owners. The formula method can be more realistic and designed to reflect what an actual independent buyer would consider important, but are inherently complex and have to be adjusted over time. Book value is easy to calculate, but is viewed as inherently suspect by the IRS because it typically does not reflect fair market value.

Because of the possibility of significant devaluation of a business interest by a buy-sell agreement, the IRS has always reviewed provisions on valuation in buy-sell agreements closely to determine whether or not the amount called for in the buy-sell agreement reasonably approximates the fair market value of the interest. How the IRS reviews these agreements depends on when the buy-sell agreement was drafted, as different rules apply for agreements drafted before 1990.

Pre-1990 Buy-Sell Agreements

The manner in which the IRS treated buy-sell agreements before 1990 is primarily determined by case law. There is a brief regulation on this issue found in Reg. §20.2031-2(h), which states as follows:

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

From this brief regulation, courts devised a four-part test to determine whether or not the value dictated by the buy-sell agreement will be accepted. Those factors are as follows:

1. The estate is obligated to sell the stock at the fixed price at the time of the decedent's death;
2. The buy-sell agreement establishes a reasonable and ascertainable price for the stock;
3. The decedent cannot sell the stock during his lifetime at a price that is greater than that fixed by the buy-sell agreement; and
4. The buy-sell agreement is not a device to transfer the business interests to the natural objects of the decedent's bounty for inadequate consideration.[20]

The final requirement, commonly referred to as the ''device test,'' is by far the most subjective, and is subject to many conflicting rulings by the IRS and the courts. Moreover, the device test is typically applied to intrafamily transfers, as transfers among non-related business owners would seem to fall outside the rule. Relevant factors for this test include, for example, the health of the owners, failure to honor the agreement in previous instances, and other factors indicating that the proposed price in the agreement is merely intended to effectuate a transfer to the decedent's family and avoid taxation.

[19] *Id.*

[20] *See, e.g., Estate of Gloeckner v. Commissioner*, 152 F.3d 208 (2d Cir. 1998).

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The 2001 case of *Estate of True v. Commissioner*[21] provides a good example of the application of this test in an intrafamily scenario. In this case, multiple buy-sell agreements were entered into by family members involved in several different businesses. These buy-sell agreements were very restrictive in nature, and the buy-sell terms were triggered by instances such as failure to work in the business, failure of a spouse to work in the business, death, disability, and any attempt to transfer the business. Any triggering of these provisions would require the remaining shareholders to purchase the departing owner's interest in a formula price listed in the buy-sell agreement and based on the book value of the interests. The Tax Court considered the first three prongs of the devise test as being met, but held that buy-sell provisions rose to the level of a testamentary device that was designed to transfer interests to members of the decedent's family for inadequate consideration in money or money's worth.

The IRS applies the rule to unrelated business owners when it deems it appropriate, especially where the value fixed for the business interest is significantly less than fair market value.[22] However, courts are less likely to find that the test is met in such circumstances, because the main purpose of the test is to avoid transfer of actual stock or other ownership interest to family members, and not unrelated co-owners.[23]

Post-1990 Buy-Sell Agreements

Section 2703 was added to the Code in 1990, and applies to all buy/sell agreements executed after October 9, 1990. Under this section, the IRS can ignore any value established by a buy/sell agreement for purposes of estate taxes, unless certain requirements are met. Those requirements are as follows:

a. The agreement or restriction is bona fide business arrangement;

b. The agreement or restriction is not a device to shift the subject property to members of the decedent's family for less than full and adequate consideration; and

c. The terms of the agreement or restriction are comparable to similar arrangements entered into among unrelated parties dealing at arm's length.

The provisions in §2703 exist in addition to the traditional four requirements for buy/sell agreements. Essentially, the first two requirements modify the ''device test'' found in prior case law by separating the test into two parts. BOTH (1) proof that the agreement represents a ''bona fide business arrangement''; and (2) proof that the buy-sell agreement is not a device to transfer the property to the decedent's family for less than adequate consideration must be established by the taxpayer. Prior cases indicated that where a taxpayer successfully argued that the agreement was a bona fide business arrangement, then that fact could be used to argue that the device test was met. Under §2703, any conflict on this issue, at least as it pertains to related party transactions covered by the provision, is now resolved.

Under the final requirement of §2703, the taxpayer must establish that the agreement was one that could have been obtained in an arm's-length bargain involving unrelated parties. Under the regulations, the buy-sell agreement will be considered a ''fair bargain'' among unrelated parties if it conforms with the general practice of unrelated parties under similar negotiated instruments.[24] This determination will entail consideration of factors such as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and adequacy of any consideration given in exchange for the rights granted.

In *Estate of Blount v. Commissioner*, the Tax Court concluded that the provisions of a buy-sell agreement did not satisfy the third requirement, based in large part on the failure of the taxpayer to introduce ''evidence of agreements actually negotiated by persons at arm's-length under similar circumstances and in similar businesses that are comparable to the terms of the challenged agreement.''[25] As a result, the Tax Court held that the agreement failed to meet the requirements of §2703(b). Similarly, in *Estate of Smith v. United States*, the only evidence submitted to validate the third prong of the test under §2703(b) were affidavits of two attorneys which stated that installment payments and charging interest at the applicable federal rate are common in partnership agreements among family members and in transactions among unrelated parties.[26] The court found this testimony inconclusive, and held, in part, that the requirement of §2703(b) was not met.

The cases interpreting §2703 are fact intensive, and should be reviewed and considered in context with the

[21] T.C. Memo 2001-167.

[22] *See, e.g., Estate of Carpenter v. Commissioner*, T.C. Memo 1992-653.

[23] *Id.*

[24] Reg. §25.2703-1(b)(4).

[25] T.C. Memo 2004-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005).

[26] 2004-2 USTC ¶60,490, 2004-2 USTC ¶85,672 (W.D. Pa. 2004).

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regulations in preparing buy/sell agreements.[27] One of the leading cases addressing §2703 is *Holman v. Commissioner*.[28] This case involved a partnership consisting solely of publically traded stock. The deemed purposes of the partnership were to preserve and protect the assets long term, and to provide for the education of the founding partner's children. The Tax Court concluded that the taxpayer's attempt to assign a value in the partnership interest at less than its pro rata share of the partnership's net asset value should be disregarded under §2703(a) because it did not satisfy all three requirements. First, the court held that the stated purpose of the entity did not constitute a closely held business, and the reasons for forming the partnership did not represent a bona fide business arrangement. Second, the right to purchase the LLC interests at a value of less than the *pro rata* share the partnership's net asset value was considered a device to shift the subject property to members of the decedent's family for less than full and adequate consideration, as the value of the children's interests would be increased. The court did not reach a conclusion as to whether the provisions of the agreement were comparable to an arm's-length transaction.

A contrasting case to *Holman* is *Estate of Amlie v. Commissioner*, in which the Tax Court upheld the value of closely-held business interests set forth in the buy-sell agreement and held that all three prongs of the §2703 test had been met. In this case, the main assets held by the business consisted of stock in a closely-held bank, and the deceased shareholder's conservator had secured the agreement.[29] The court contrasted the situation in this case from that in *Holman* by arguing that the establishment of a partnership and the securing of a buy-sell arrangement sought to exercise prudent management of the deceased shareholder's assets, by minimizing the risks of holding minority interests in a closely held entity. Therefore, the court found that there was a valid business purpose. In the *Amlie* case, the shareholders to the agreement had a history of a tumultuous relationship, and there were two different shareholder's agreements that were negotiated before the decedent's death. The other salient fact was that the conservator, in valuing the interests, had a valuation specialist validate the price set forth in the agreement. For these reasons, the Court held that the last two prongs of the test had been met, and upheld the valuation set forth in the buy-sell agreement.

Buy-sell agreements that were established before October 8, 1990 are exempt from the restrictions set forth in §2703, unless such agreements were ''substantially modified'' after that date. Courts have suggested that a change in valuation formula is considered a substantial modification for purposes of §2703, but a change in one of the factors included in the formula does not. In addition, the mere addition of parties to the agreement does not give rise to a substantial modification.[30]

Safe Harbor Exception for §2703 for Unrelated Parties

Under the regulations, specifically Reg. §25.2703-1(b)(3), the IRS will presume the buy/sell agreement meets the three statutory exceptions to §2703 if more than 50% of the value of the property subject to the buy-sell agreement is owned directly or indirectly by individuals who are not members of the transferors family. Accordingly, for non-family businesses which have buy-sell agreements in place, the first issue that should be reviewed is whether or not §2703 even applies due to this exception.

Conclusion

Very often, the most difficult issues raised in drafting buy/sell agreements for businesses with significant real estate holdings is the lack of liquidity inherent in the business itself, as there is typically insufficient income or assets to fund any resulting obligations without liquidating the underlying assets. This may lead to a predisposition against carrying on this type of planning, as sufficient periodic appraisals to obtain a respectable fair market value set forth in a buy-sell arrangement can be expensive and burdensome to businesses that are already strapped for cash. However, similar to any type of business, valuation issues are key in determining whether a particular buy-sell arrangement will be respected for federal estate and gift tax purposes. The consequences for having an arrangement that is not respected for valuation purposes can be detrimental to the business.

INCOME TAX CONSIDERATIONS — MAKING THE SALE A ''SALE''

An equally important consideration for buy-sell agreements concerns the treatment of the transaction for income tax purposes. This treatment depends on both the form of the transaction and on the form of the entity involved. The ultimate goal in most situations is to structure the transaction in such a way as to receive capital gains treatment on the sale or ex-

[27] Reg. §25.2703-1.

[28] 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

[29] T.C. Memo 2006-76.

[30] *See e.g., Estate of Blount v. Commissioner*, T.C. Memo 2004-116, *aff'd in part, rev'd in part*, 428 F.3d 1338 (11th Cir. 2005). *See also* Reg. §25.2703-1(d) (Examples).

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change. As a general rule, the transaction will be characterized as a dividend, distribution, or as a sale or exchange. Most of the tax issues for both partnerships and corporations are found in redemptions, where the entity purchases the interest, rather than in cross-purchase arrangements.

Why is the characterization of the transaction as a sale or exchange important? For starters, when the transaction is treated as a sale or exchange, less than the full amount of the payment is taxable — only that amount which is in excess of the departing owner's basis will be taxed. In a distribution or a dividend, the full amount of the proceeds received are taxable. Furthermore, characterization of the transaction as a distribution can cause problems where the deceased owner's estate intends to use the installment method under §6166 to pay the estate taxes.[31] No such problem exists for transactions characterized as a sale or exchange. Finally, while the current tax rates for dividends and capital gains are identical, there is no assurance that they will remain so, and the characterization of dividend income is definitely one issue that may change in the future. [32]

With the importance of these issues in mind, let us turn to the actual tax treatment of the distributions. Each form of entity and type of transaction will be taken in turn.

C Corporations

Where the buy-sell transaction involves stock in a C corporation, the transaction will either be characterized as a dividend or as a sale or exchange of a capital asset. In this context, it is typically more beneficial for the transaction to be treated as a sale or exchange, especially in a situation where the stock being transferred has been inherited and has therefore received a stepped-up tax basis.

Entity Purchase

The general redemption rules in §302 apply to redemptions in determining whether the distribution should be construed as a dividend or a capital gain. While the general rule is that the redemption is treated as a distribution (which is then subject to the rules of §301), the redemption will be treated as a sale or exchange if one of five specific exceptions applies:

- The distribution is not essentially equivalent to a dividend. §302(b)(1).
- The distribution is substantially disproportionate with respect to the shareholder. §302(b)(2).
- The distribution completely terminates the shareholders interest in the corporation. §302(b)(3).
- The distribution is in partial liquidation of a non-corporate shareholder. §302(b)(4).
- The distribution is made after the shareholder's death for the purpose of paying estate taxes and other administration expenses. §303.[33]

Each of the exceptions is addressed in a multitude of IRS rulings and case law determinations. However, the following should present a very brief summary of these exceptions.

Redemption Not Essentially Equivalent to a Dividend

Under this particular exception, the IRS and the courts look to whether the distribution results in a "meaningful reduction of the shareholders proportionate interests in the corporation."[34] This subjective standard is based on "the facts and circumstances of each case," and various IRS rulings have listed several factors that may be considered, all of which revolve around whether some aspect of the shareholders "interest" in the corporation has changed.[35] The regulations provide that *pro rata* redemptions will typically not fall under this exception, since such distributions do not change the relative voting power of the shareholders.[36] Case law and IRS rulings since the *Davis* case have fleshed out this exception, focusing on such factors as whether the redemption resulted in the shareholder transferring a majority interest for minority interest in the company; whether voting rights have changed, especially for closely held businesses; whether the other stock is owned by other family members and thus are attributed to the redeemed shareholder; and many other factors.[37] The private letter rulings and cases are widely inconsistent in this area, making it a dangerous exception upon which to rely without clear precedent.

Substantially Disproportionate Redemption

The second exception in §302(b)(2) is much more objective, as it is based on mathematical principles. The IRS considers a distribution to a shareholder as a "substantially disproportionate redemption" if the following mathematical test is met:

- The shareholder owns less than 80% of the total voting stock of the corporation that he or she had

[31] *See* PLR 8134027 ("the provisions of Section 453 of the Code do not apply to a redemption and distribution that is essentially equivalent to a dividend.")

[32] For example, President Obama's 2013 tax budget proposal contained a provision raising the tax rate on dividends for individuals making over $200,000 and couples making over $250,000 to ordinary income tax rates.

[33] *See* Zaritsky, *Structuring Buy Sell Agreements*, §2.02[1].

[34] *Davis v. United States*, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970).

[35] *See* PLR 200552007; Rev. Rul. 75-502, 1975-2 C.B. 111.

[36] Reg. §1.302-2(b).

[37] *See* Zaritsky, *Structuring Buy Sell Agreements,* §2.02[2][b], for a good list of cases and rulings.

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owned before the redemption after the redemption is complete;

- The shareholder owns less than 80% of the total value of the common stock that he or she had owned before the redemption;
- The shareholder owns less than 50% of the total combined voting power of the shares; and
- The redemption is not part of a series of planned redemptions.

The regulation addressing this exception contains an excellent example outlining its application.[38] There are also numerous private letter rulings and revenue rulings which provide additional guidance.[39] All of these examples show that the IRS applies the mathematical tests very strictly, with little room for argument by the taxpayer when the thresholds are not met. When the stock redeemed is not voting stock, the regulations state that this exception is not applicable.[40]

Complete Termination of Shareholder Interest

This exception is as simple as it sounds: when the redemption results in a complete termination of the shareholder's interest, it will be treated as a sale or exchange rather than a distribution.[41] As with other exceptions, the family attribution rules found in §318 can be a major factor and can disqualify the transaction from meeting the exception. However, unlike other exceptions to the dividend treatment rules, the family attribution rules can be waived for the complete termination exception.[42] Because waiver of the family attribution rules is available for this exception, it is perhaps one of the most widely noted and used exception to avoid dividend treatment of redemption distributions for buy-sell agreements.

For this waiver to be effective, the following elements need to be met:

- Immediately after the distribution, the shareholder has no interest in the corporation other than as a creditor;
- The shareholder does not acquire any interest other than stock required by bequest or inheritance within 10 years from the date of the distribution (i.e., ''the look forward rule'') and notifies the IRS if they do acquire any such interest during this period;
- The shareholder has not transferred any stock or received any stock in 10 years prior to the distribution from anyone from whom the stock would have been attributed to the shareholder (i.e., ''the look back rule''); and
- The shareholder elects to waive the attribution rules.[43]

Under the regulations, the waiver must be signed by the shareholder and filed with the shareholder's first income tax return in the year in which the distribution occurs.[44]

The letter rulings and cases addressing this exception pertain mainly to the waiver of family attribution rules.[45] Where no family attribution issue is present, then under this exception the shareholder can retain some role with the corporation, such as in a capacity as an officer or director, but must completely cease being a shareholder in the corporation.[46] However, where the family attribution rules do apply, and the shareholder elects to waive the family attribution rules, he or she cannot serve in any capacity in the corporation.[47] The mere status as a creditor, or the receipt of continued benefits, does not constitute a continued interest in the corporation, but the IRS has shown that it will look closely at the terms of such agreements, and will analyze whether the taxpayer has ''continuing influence'' over the corporation in determining whether he or she has retained a prohibited interest under the waiver of attribution rules.[48] Although the IRS takes an expansive view of the kinds of prohibited interests that can disqualify the shareholder from waiving family attribution, courts have taken a more narrow approach on the issue.[49]

Redemptions in Partial Liquidations of the Corporation

This little-used exception to dividend treatment of C Corp redemptions covers payments made for stock ''in partial liquidation'' of the corporation. The Code defines ''partial liquidation'' in §302(e), with the following:

> (1) For purposes of subsection (b)(4), a distribution shall be treated as in partial liquidation of a corporation if—

[38] Reg. §1.302-3(b).

[39] *See e.g.,* PLR 9514020, PLR 200125010; Rev. Rul. 75-447, 1975-2 C.B. 113, Rev. Rul. 76-385, 1976-2 C.B. 92.

[40] Reg. §1.302-3(a).

[41] §302(b)(3).

[42] §302(c)(2).

[43] §302(c)(2)(A), §302(c)(2)(B).

[44] *See* Reg. §1.302-4(a)(1), §1.302-4(a)(2).

[45] *See, e.g., Lisle v. Commissioner*, T.C. Memo 1976-140, PLR 199914017, PLR 200022020, and PLR 200750001, for good examples.

[46] *Lisle v. Commissioner*, T.C. Memo 1976-140.

[47] *See, e.g.,* Rev. Rul. 70-104, 1970-1 C.B. 66.

[48] *See* FSA 200203021.

[49] *See, e.g., Hurst v. Commissioner*, 124 T.C. 16 (2005) (retention of a security interest through a loan by a former shareholder was not a prohibited interest, even though the shareholder could seize the stock which had been redeemed).

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(A) the distribution is not essentially equivalent to a dividend (determined at the corporate level rather than at the shareholder level), and

(B) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year.

Along those lines, the distribution will not be considered essentially equivalent to a dividend if that distribution can be attributed to cessation of a "qualified trade or business" (which requires a five-year look back), and the distribution is made from the assets of that trade or business.[50]

Redemptions to Pay Estate Taxes and Administrative Expenses

This exception to the general rule on dividend treatment is found in §303, rather than §302. Under this exception, stock that is redeemed from a shareholder which has been inherited from a decedent will be entitled to sale or exchange treatment, to the extent of the estate's total amount of estate taxes and certain administrative expenses (such as funeral expenses).[51] This can be a very important exception in the context of small family-owned businesses with high values but low liquidity (such as a real estate business). For an estate to qualify for this exception, the value of the stock has to constitute at least 35% of a decedent's adjusted gross estate.[52] Under §303(b)(4), the redemption transaction has to occur within four years following the date of the decedent's death.

As an aside, this exception can provide an excellent way to bring liquidity into a cash-poor but value-high estate that owns a family business. The statute allows for the redemption to be for "part or all" of the stock in question.[53] Thus, with proper planning the business can be required to redeem only so much of the decedent's stock as is necessary to pay estate taxes and administrative expenses, and if properly structured the redemption will qualify for sale or exchange treatment (which could result in no income taxes due to the step-up in basis). However, for taxpayers who wish to defer payment of estate taxes under §6166, there are potential problems with utilization of §303.

Taxability of Corporation on Distribution

Typically, in a redemption of C Corporation stock, the corporation would incur no taxes on the distribution and redemption and would receive no deduction for the payments.[54] While the redemption transaction itself won't directly affect the other shareholders, it can affect the company's earnings and profits (E&P), specifically where the redemption fails to qualify for one of the exceptions and is treated as dividend.[55] Where the E&P is reduced, the other shareholders could receive a beneficial effect on later distributions, in that those distributions have a greater chance of being treated as a return of capital or as a sale or exchange, rather than as a dividend (mainly because there is less E&P to offset.)

Result to Non-Selling Shareholders

In most cases, the redemption of stock is a tax-neutral event to the non-selling shareholders for a C Corporation. However, in the rare (and usually unintended) situation where non-selling shareholders are obligated to purchase the shares, but instead choose to have the stock redeemed by the corporation, the result can be disastrous. Under Rev. Rul. 69-608, the IRS held that such an event results in a *constructive dividend* to the shareholders, since the corporation essentially paid for their unconditional obligation. This situation is a trap for the unwary, so practitioners should advise their clients accordingly.

Cross-Purchase Agreement

The issues found in an entity purchase situation for a C Corp are not present in a cross-purchase agreement. Where another shareholder is purchasing the stock, the transaction will qualify for a sale or exchange treatment. There will typically be little or no tax consequences to the seller, since the stock received a step-up in basis at the date of the death. The purchasing shareholders will also receive a step-up basis in the stock, up to the amount of the purchase price. There is an exception for dealers of stock and securities, found in §1221(a)(1), which exempts from the definition of capital assets stock in the trade of the taxpayer that would be considered inventory in the hands of the taxpayer, or held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Otherwise, a cross-purchase will be treated as a sale or exchange.

The main issue involved with cross-purchase agreements involves liquidity, since many of the individual shareholders will not have sufficient funds to be able to pay for the redemption. Thus, cross-purchase agreements typically give rise to insurance agreements to provide for liquidity or require deferred in-

[50] §302(e)(3).
[51] §303(a).
[52] §303(b)(2).
[53] §303(a).
[54] §162(k). Practitioners should also note §311(b) applies to these buy-sell transactions, which can lead to a tax on a corporation where it distributes appreciated property in exchange for the stock.
[55] §312.

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stallment sales, which will be addressed later in this article.

S Corporations

Redemptions of S Corp stock bring up the same major issues as with an entity purchase of a C Corporation stock, and the first question to determine is whether the transaction will be characterized as a dividend or as a sale or exchange. However, the calculations of the taxes are different for S corporations, due to the different accounting rules related to S corporations where the transaction is treated as a dividend. There are also additional issues that must be considered in structuring a buy-sell agreement involving S corporation stock.

Entity Purchase

The same rules for C corporations apply to S corporation redemptions by an entity, and accordingly the same analysis as addressed in the prior section should be undertaken to determine the characterization of the gain. However, because S corporations are not taxable at the corporate level, the calculations of the taxes are different, and require an examination of the S corporation's E&P for corporations formed prior to 1983 or which were operated as a C corporation after that time and then converted to an S Corp. For pure S corporations, i.e., ones that were initially created as S corporations after 1983, the analysis is much simpler, because there will be no accumulated E&P.[56] For those corporations, the shareholder will recover his or her basis in his or her stock, and the remainder will be treated as capital gain.[57]

For non-pure S corporations, the analysis requires a review of the accumulated adjustments account. §1368 provides for the treatment of the redemption where it is treated as a distribution. Where that redemption is treated as a distribution, rather than as a sale or exchange, the taxation is as follows:

- All amounts that do not exceed the accumulated adjustment account (''AAA''), as defined by Section 1368(e)(1), taxed as capital gain, to the extent it exceeds the shareholder's adjusted basis.[58]
- All amounts in excess of AAA will be taxed as a dividend, up to the total amount of the corporation's E&P.[59]
- All amounts in excess of AAA and E&P will be taxed as capital gain, to the extent it exceeds whatever residual basis the shareholder has remaining after adjustments.[60]

Note that the corporation's E&P will be reduced through such a redemption where it is treated as a distribution, which may provide a favorable result for the remaining shareholders, especially if the E&P is eliminated.

Cross-Purchase Agreement

Cross-purchase agreements for S corporations are treated essentially the same as with a C Corp sale, in that they will result in sale or exchange treatment. One very important difference is that the basis of the non-selling shareholders after the sale will be increased to reflect the purchase price of the stock purchase. Basis is a critical issue for shareholders of an S Corporation, since they can receive tax-free distributions up to their basis in the stock,[61] and furthermore can deduct net corporate losses up to their adjusted bases in their stock (and debt).[62] To the extent any increase can be attributed to the remaining shareholders' stock, they can be used to offset future earnings. It can also reduce the amount of gain in the event of a subsequent sale, under the allocation rules under §1368(c).

One Class of Stock Requirement

Perhaps the most unique issue involved with entity redemption or cross-purchase agreements for S corporations lies in the ''one class of stock'' requirement. Simply put, where the buy-sell agreement places restrictions on the sale of S corporation stock, the IRS will review those restrictions to determine whether they create a separate class of stock. Under Reg. §1.1361-1(1)(2)(iii)(A), these kinds of buy-sell agreements will be recognized by the IRS unless ''a principal purpose of the agreement is to circumvent the one class of stock requirements'' and the agreement establishes a purchase price which the IRS finds to be significantly in excess of or below fair market value.[63] Importantly, where the IRS finds this rule to be violated, the S corporation can lose its S election, which is a significant issue for S corporations.

Reg. §1.1361-1(l)(2)(iii)(A) establishes a safe harbor on this particular issue, providing as follows: ''Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are

[56] §1371(c)(1).
[57] §1368(b).
[58] §1368(c)(1).
[59] §1368(c)(2).
[60] §1368(c)(3).
[61] §1368(b).
[62] §1366(d)(1).
[63] Reg. §1.1361-1(l)(2)(iii)(A).

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disregarded in determining whether the outstanding shares of stock confer identical rights.'' The taxpayer's determination of this value will be respected under this safe harbor ''unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence.'' The regulation further states that a determination of book value will be respected where (1) the book value is determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or (2) the book value is used for any substantial nontax purpose.[64]

While this regulation may be worrisome in theory, it is not so troubling in practice, as it is rarely invoked by the IRS. In fact, in most private letter rulings in the area, even those which involve redemption prices which seem much less than fair market value, the IRS has nonetheless determined that the rule was not violated.[65] Nevertheless, practitioners who are planning for the redemption of S Corporation stock should consider the issue, especially where the agreement calls for a purchase price that is less than fair market value, and should structure the transaction to meet the safe harbor from the regulations.

Closing the Books — §1377(a)(2)

One other consideration for cross-purchases or redemptions of S Corp stock is whether the corporation will elect to ''close the books'' for the corporation, when the shareholder completely terminates his or her interest in the corporation.[66] Under this section, the corporation may elect, with the consent of all of the shareholders, to close the corporate books on the date of the redemption or sale, which allows the selling shareholder to reduce any allocation of income/losses to amounts incurred before the date of the transaction.[67] The corporation and all the shareholders must agree to such a proposal, and thus it may be prudent to include a provision in the buy-sell agreement requiring the corporation and shareholders to do so, in order to avoid any misapplication of income or losses after the date the shareholder's interest is terminated in the corporation.

Partnership Interests

The tax treatment of sales proceeds generated from the sale of partnership interests is much different than the sale of a corporate stock, mainly due to special rules that apply to such transactions. The rules on partnership sales are complex, and this article will not address all the issues involved, but the following provides a brief summary of how such a sale will be treated for both an entity purchase as well as a cross-purchase.

Entity Purchase

Redemptions of partnership interests are governed under §736. The treatment of the redemption is different depending on whether the partnership is a service partnership or is a non-service partnership or the partner is a general versus limited partner. For general partners in service partnerships, the payments will either be considered §736(a) payments or §736(b) payments. The latter of those payments cover all of payments made in exchange for the partner's interest other than amounts for unrealized receivables or goodwill. Those payments are treated as liquidating distributions, which means they will be characterized as a sale or exchange. However, payments considered received as a payment for goodwill are treated as distributive share of partnership profits, rather than as capital gain, or are treated as a guaranteed payment.[68]

For general partners and service partnerships, it is important to address the allocation to be made under §736 for the redemption payment. The selling partners will typically want the payments to be considered as §736(a) payments, mainly because that will reduce any allocations of profits to them by the amount paid to the retiring partner. The retiring partner will typically want to allocate the majority of the sale proceeds under §736(b) as a payment for partnership property. The IRS will review the allocations for ''reasonableness,'' but the regulations and cases acknowledge that the inherit tension between the respective wishes of the partners will typically produce a fair result.[69]

For non-service partnerships or for limited partners, the rules are somewhat different, in that §736(b)(2) will not apply. What this means is that payments for goodwill are not excluded from the capital gains treatment found in §736(b), and thus the tax advantage for limited partners or non-service partnerships is greater for the buyer than in service partnerships.

One main difference in partnership redemptions lies in application of the ''hot assets'' rules in §751. Where the redemption is treated as distributive share or guaranteed payment under §736(a), unrealized receivables and inventory are not included in the overall sales price as a ''hot asset.''[70] However, where the transaction falls under §736(b), the hot assets rules of §751(b) apply, which means that the amount of the sales proceeds attributable to unrealized receivables or inventory will be taxed as ordinary income, with

[64] Reg. §1.1361-1(l)(2)(iii)(C).

[65] *See, e.g.,* PLR 200914019, PLR 9803008.

[66] §1377(a)(2).

[67] Reg. §1.1377-1(b)(3).

[68] §736(a).

[69] *See* Reg. §1.736-1(b).

[70] §751(b)(2)(B).

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the remainder being taxed as capital gain to the extent it exceeds the partner's basis in the interest. This issue is important for real estate partnerships that own real estate, since depreciable real estate (either held as rental or held for resale) will be considered an unrealized receivable, but only to the extent of depreciation recapture under §1250. Since all real estate companies depreciate their real property holdings (except for raw land, which is not depreciable), the selling partner will have to recognize ordinary income up to the amount of §1250 recapture, with the remainder being recognized as capital gain.

For inventory in redemption transactions, the §751 hot asset rule includes inventory, but only if it is ''substantially appreciated.'' Under Reg. 1.751-1(d), inventory items are substantially appreciated if ''the total fair market value of all inventory items of the partnership exceeds 120% of the aggregate adjusted basis for such property in the hands of the partnership.''

Cross-Purchases

The purchase of a retiring or deceased partner's interest in a partnership by other partners is treated typically as a sale or exchange under §741. However, §751 applies to partnership cross purchases as well, and the selling partner will be required to recognize as ordinary income certain portion of the sales price as attributable to unrealized receivables or inventory, as if the assets were sold at fair market value.[71] Unlike in a redemption transaction, *all inventory* is included as a ''hot asset'' in a cross-purchase, regardless of whether it is substantially appreciated. Under §741, all other amounts received will be treated as capital gain to the extent the amount exceeds the selling partner's basis in the partnership.

Basis Issues — The 754 Election

For a sale or exchange of a partnership interest or in the situation where an interest is transferred to other parties due to death of a partner, basis is an important issue for the parties to consider. Specifically, either of these situations can cause a disparity between the buyer's outside basis (i.e., the purchase price for the interest or stepped-up basis) and his or her share of inside basis (i.e., basis in the partnership assets). In such situation, the possibility of double taxation (or the loss of the benefit of the stepped up basis) exists if the partnership later sells any of the partnership assets, since the selling partner has presumably paid taxes on the gain from the sale of the interest, but will now be allocated his or her share of gain on that sale even though that gain has effectively already been recognized in the purchase of the partnership interest.

[71] *See* §751(a).

Section 754 was designed to address this disparity of basis, to allow the partnership to adjust the inside basis of the assets pursuant to the provisions of §743 to equalize the partner's inside and outside basis. This election allows the purchasing shareholders to adjust their basis in the partnership assets by the amount paid to the selling partner, to avoid double taxation on the appreciation of the partnership assets. Note, however, that under §708(b)(1)(B) if 50% or more of the interests in the partnership's capital and profits are sold within a 12-month period from the date of the transaction, the partnership will terminate for tax purposes, and will be deemed to contribute its assets to a new partnership and then distribute new interests in the partnership to the partners.

The issues of a possible §754 election should be considered in drafting the buy-sell agreement, and a provision should be included in the agreement which will allow the partnership to make the election if deemed advisable.

FUNDING THE AGREEMENT

For clients owning business interests in businesses consisting of significant real estate holdings, often the biggest challenge in establishing a solid buy-sell agreement is to determine how the non-selling party will pay for the transaction. In order for the buy-sell agreement to accomplish its objectives, the terms must not only provide that the seller must be obligated to sell, but that the buyer will have sufficient funds (or time) with which to purchase the interest. This can be difficult in the realm of real estate businesses, where cash may not be readily available to effectuate an immediate purchase of a deceased shareholder's interest.

Life Insurance Planning

In instances where sufficient cash is available, one common method of funding buy-sell agreements involves the purchase of life insurance on the owners of the business. In the context of a cross-purchase arrangement, this would typically involve individual shareholders purchasing policies on one another, and serving as owners and beneficiaries of such policies. The owners of the policies would typically receive a tax-free cash benefit on the death of a shareholder that could then be used to purchase the interests of the deceased shareholder.[72]

While this is a relatively simple arrangement, a number of issues may arise that could create conflict among the parties to these types of arrangements. Consideration must be given to the number of share-

[72] §101(a).

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holders that are party to the agreement, and the specific rights given to all of the parties to the buy-sell agreement. If there are multiple shareholders to the agreement, then the number of policies may become unmanageable, unless a trusteed agreement is used. Trusteed agreements are typically effectuated through a trust agreement that employs a third-party trustee (serving as the owner of multiple life insurance policies) to collect the proceeds from the policies and purchase the interests from the deceased shareholder's estate. The trustee will then reallocate the deceased shareholder's interests based on the specific terms of the buy-sell agreement.

Another issue to consider is the relative ages of the shareholders that are parties to the agreement. For example, if the agreement involves a buyout across multiple generations, the burden of life insurance premiums in a cross-purchase arrangement may not be spread evenly among the owners. Finally, a cross-purchase arrangement funded by policies on individual shareholders can prove to be difficult to enforce if one or more shareholders fails to pay premiums, or if the value of the insurance in the hands of the shareholder become subject to his or her creditors.

Although funding a cross-purchase arrangement with life insurance can present numerous challenges, there are certain practical advantages that cannot be overlooked. First, and perhaps most importantly, this structure permits the surviving shareholders to use a tax-free benefit to purchase membership interests at a stepped-up basis, which increases the purchasing shareholder's overall basis in their interests while resulting in minimal tax consequences to the selling shareholder. Second, if the company's earnings permit a full or partial redemption without the insurance, the surviving members can retain a tax-free benefit. However, in instances where the remaining shareholders are obligated to purchase the interests from the deceased shareholder, but due to alternate provisions in the buy-sell agreement the business redeems the shares, the transaction may be treated as a constructive dividend to the shareholders. To avoid this treatment, the buy-sell agreement should give the shareholders the option to purchase the shares, but should not require such purchase.[73] Third, the policies are in the hands of individuals, and are not subject to creditors of the business.

The second type of arrangement requires the corporation to serve as the owner and beneficiary of the policy on each shareholder. This is most typically used in arrangements for redemption agreements, where the business is given the option of purchasing, or is required to purchase, the interest from a deceased shareholder. There are several advantages to this arrangement, including the simplicity of having one life insurance policy per owner, and having all premium payments allocated according to percentage ownership in the entity. A redemption agreement funded by the business may also better insure compliance with the terms of the buy-sell agreement.

While redemption arrangements funded by life insurance owned by the business can structured in a relatively simple fashion, there are several disadvantages to this type of arrangement. First, upon the death of an owner, the surviving owners will not increase their basis in their ownership interest.[74] Therefore, any lifetime disposition of their interests may result in increased capital gain. Second, from a practical standpoint, the insurance policies may be attached by the creditors of the business.[75] Third, if the business is a C Corp, the life insurance proceeds may be subject to the Alternative Minimum Tax (AMT).[76] Fourth, if the policies are overfunded to provide additional benefits to the remaining shareholders, these amounts could be characterized as taxable income to the remaining shareholders.

There are several income tax issues to consider when funding a buy-sell agreement with life insurance. In general, there is no deduction for payment of premiums by the shareholders of the business.[77] Assuming that the business is the beneficiary of the policy, the premiums paid by the shareholders are not taxable income to the insured, nor are premiums paid by the business taxable to the individual shareholders. In addition, the proceeds from the life insurance are not taxable income to the shareholders or the business, although receipts of proceeds may subject the business to the alternative minimum tax.[78]

Another crucial consideration in funding buy-sell agreements with insurance occurs when a client attempts to use existing personally owned or corporate-owned policies to fund a shareholder cross-purchase agreement. This is due to the transfer for value rules in §101(a)(2), which provides that if a policy or any interest in a policy is transferred for valuable consideration, the death proceeds will be exempt only to the extent of the consideration paid by the transferee and the net premiums paid by the transferee after the transfer, subject to the following exceptions:

[73] Robert F. Reilly, *Tax Considerations of Close Corporation Buy/Sell Agreements*, Insights (www.willamette.com), Spring 2012.

[74] §1366(a)(1)(A), §1367(a)(1)(A), and §705(a)(1)(B).

[75] Morton A. Harris, *Buy-Sell Agreements for Closely Held Family Businesses: Tax and Practical Considerations*, ABA Section of Taxation/ Section of Real Property, Trusts & Estate Law, Denver, Colorado, Oct. 22, 2011.

[76] §55(e).

[77] §264(a)(1).

[78] §55.

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(a) If the sale or transfer is to the insured;

(b) If the sale or other transfer is to a partner of the insured, to a partnership in which the insured is a partner or to a corporation in which the insured is an officer or shareholder; or

(c) If the policy does not result in a change of the tax basis of the individual assets transferred.

For planning purposes, and in order to avoid the transfer for value rules in the insurance context, it may be advisable to form a partnership entity (which could take the form of an LLC), to hold the insurance, with the shareholders of the business entity as the partners.

Deferral Arrangements

When life insurance is not a viable or practical option, and particularly in the context of businesses with significant real estate holdings, deferral arrangements are commonly used to allow the business, or the individual shareholders, to purchase a deceased shareholder's interest over a specified period of time. The exact terms and timing of the purchase would be set forth in the buy-sell agreement. The overall purpose of this type of arrangement is to provide for the continuation of the business, by providing reasonable financing arrangements for the purchase of the deceased shareholder's interest. This arrangement may offer terms that are preferential to third-party financing, or may simply eliminate third-party financing altogether.

Although these arrangements can be advantageous to the non-selling shareholders who wish to purchase additional interests in the real estate business, it is important to examine the potential effects of these purchases on a deceased shareholder's estate, and any resulting estate tax liabilities that could be incurred by such purchases. In particular, one of the key planning tools practitioners have available to them for payment of estate taxes involving a closely held business lies in the estate tax deferral provision in §6166. This provision allows a personal representative to elect to spread out the payments of estate taxes, with interest only payment being made the first five years, followed by 10 annual installment payments being made thereafter. This tool can be critical for decedents who own small businesses with low liquidity and high value, especially where the taxes will be paid through income earned by the business. In terms of buy-sell agreements, the typical plan would be to allow for redemption of the stock over time, and then utilization of the rules in §303 to assure sale or exchange treatment to the seller of the stock.

The trap for the unwary under this rule is found in §6166(g), which provides that deferral is not available when the estate sells 50% or more of the decedent's business interests during the deferral period. Redemptions under §303 are specifically excluded from this rule.[79] However, that rule only covers redemption agreements that do not exceed the estate tax payments due within one year of the redemption.

Accordingly, where the buy-sell agreement calls for redemption of stock beyond that required for payment of estate taxes, or where the buy-sell agreement is for a partnership, and the amount to be redeemed exceeds 50% of the interest of the decedent, the deferral provisions of §6166 are not available. Rev. Rul. 86-54[80] provides a detailed explanation of the relationship between §303 and §6166. In that revenue ruling, the IRS affirms the ''series redemption'' approach under §303 in order to take advantage of the deferral under §6166, stating that each payment during the 10-year period will be treated as a separate redemption. Thus, the buy-sell provisions can be drafted to provide for a series of redemptions or sales to pay only the amount required under the installment of deferred estate taxes.[81]

Note, however, that for this approach to work, the buy-sell agreement must be structured as a redemption rather than as a cross purchase, because §303 only applies to redemptions of the stock. Thus, where the buy-sell agreement is structured as a cross purchase, even if it is done through a series of purchases, the 50% rule under §6166(g) will apply, and all practitioners should be careful to make sure that the transaction complies in order to avoid acceleration.

In summary, there are many issues that arise in connection with funding buy-sell agreements. In the context of families holding real estate businesses, clients may be somewhat limited in their ability to generate outside resources sufficient to fund buy-sell arrangements through cash or borrowing, especially if the real estate is leveraged. However, these factors must be carefully considered as part of the overall plan for transferring businesses between generations.

DESIGNING THE AGREEMENT

With the legal and tax issues in mind, we now turn to actually drafting and designing the buy-sell agreement for your individual clients. Designing a buy-sell agreement is a mix of practical and tax considerations, each of which is should be tailored to the client at issue. However, in the real estate context, many buy-sell agreements will be similar because of the common issues involved with such companies, mainly

[79] §6166(g)(1)(B).

[80] 1986-1 C.B. 356.

[81] *See* PLR 9202020 (affirming such an approach).

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concerning valuation issues and issues of liquidity. Practical issues involved in drafting a buy-sell agreement include the intent of the owners regarding continuity of the business; the liquidity of the company; the basis of the company in those assets; the relationship of the owners and their respective families; the existence of ''problem'' heirs and potential creditors of the owners; the need or lack of need, of the surviving heirs of a particular owner immediate cash to pay taxes or expenses; the health of the owners; and many other practical factors. Tax considerations can involve an analysis of basis, value of the business and owner interests, characterization of the sales proceeds, and many other factors that come into play in determining the design of the buy-sell agreement.

Regardless, each buy-sell agreement should consider and incorporate the following provisions.

Restrictions on Transferability

Provisions restricting the transferability of business interests in a small business are required for effective buy-sell agreement planning. Indeed, Professor Zaritsky calls this the ''primary function of every buy-sell agreement.''[82] Without such restrictions, each owner is able to freely assign their interest to whomever they desire, which forces the surviving owners to share control with persons not of their choosing. This is extremely critical in situations where the input and expertise of the partners is important to the administration of the business.

The most standard restriction on transferability is simply a provision requiring unanimous consent (or some other percentage of vote) of the non-selling owner to approve the assignment of the selling owner's interest in the company. Most corporate acts do not contain any provisions restricting the alienability of corporate stock, although most will allow the owners to restrict the transfer in certain circumstances by voluntary agreement.[83] Under most state limited liability companies acts, financial interests in the company are freely transferable,[84] but an assignee cannot become a member of an LLC except by unanimous consent of all the remaining members.[85] These state laws are default rules only and are modifiable by agreement of the owners. For example, in many family situations, the buy-sell agreement will contain a provision allowing for transfers to certain ''permitted transferees,'' such as lineal descendants or spouses, without the need for unanimous consent of the other owners. Regardless, the issue of transferability of an interest in either a corporation or partnership should be addressed by the agreement.

As noted earlier regarding an S corporation, there is an additional problem as it related to transferability, involving the ''one class of stock'' requirement found in the S corporation regulations.[86] Where the IRS finds this rule to be violated based on restrictions placed on the buy-sell agreement, the corporation can lose its S election, which can have devastating consequences on both shareholders and the company.

Additionally, restrictions on the sale of S Corporation stock are important in order to prevent the sale of the interest to nonqualified shareholders, which can also lead to termination of the S Election.[87] This restriction should typically be placed on the stock certificate itself, but language must also be included within the company by-laws to assure that any transfer of the stock to a non-qualified shareholder will not be authorized or recognized by the company.

For either stock or partnership interests, restrictions on transferability can have a significant role in devaluing the business interests, especially for purposes of estate taxes. Where properly drafted, the restrictions can be utilized to establish various discounts on the value of the stock, or to establish the value itself where a fixed value is utilized.

There are a few other issues to consider when drafting restrictions for buy-sell agreements. First, under §2056(b)(1), a marital deduction will be denied for a transfer subject to a terminable interest, i.e., where the transferred interest will terminate or lapse on a particular event or condition, and someone other than the surviving spouse will receive the property upon the event. Buy-sell agreements can run afoul of this rule where stock is transferred to a surviving spouse subject to an obligation that the stock be sold at a price less than fair market value to another party. A good example of this can be found in PLR 9147065, in which the marital deduction was denied for stock devised to a surviving spouse subject to a right of the decedent's sons to purchase the stock at a price less than fair market value. The IRS held that this right effectively converted the spouse's interest in the stock into a ''terminable interest'' under §2056(b)(1), and therefore, the marital deduction was denied for the trust.

[82] Zaritsky, *Structuring Buy-Sell Agreements*, 1.02[1].

[83] *See, e.g.,* Revised Model Business Corporation Act §6.27 (2006).

[84] *See, e.g.,* Model Limited Liability Company Act §502 (2006).

[85] *See, e.g.,* Model Limited Liability Company Act §401 (2006).

[86] *See* §1361(b)(1)(D); Reg. §1.1361-1(l)(2)(iii)(A).

[87] §1361(b)(1)(B), §1362(d)(2).

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Case law on this issue seems to confirm the IRS's position on this Private Letter Ruling.[88] Accordingly, care should be taken by a practitioner in leaving stock subject to a right of purchase at less than fair market value, at least where the estate is relying upon use of the marital deduction to avoid estate taxes.

Another issue to consider regarding restrictions on transferability lies in the restrictions potential effect on the annual exclusion. The annual exclusion is found in §2503(b), and allows any person to transfer up to $14,000 (or $28,000 per couple) to another donee free of gift tax. To qualify for the annual exclusion under §2503(b), a gift must constitute a "present interest."[89] The impact of restrictions on the sale of stock or membership interests in a closely held business has been subject to numerous cases, and the courts review the restrictions in making a determination as to whether it is a transfer of a present interest.

For example, in the seminal case of *Hackl v. Commissioner*, the Seventh Circuit addressed whether the annual exclusion could apply to the gift of certain interests in a family-owned LLC.[90] The interest transferred was subject to numerous restrictions, including a requirement to offer to sale the interest to the LLC and a requirement of manager consent for any third-party sells. The donor in *Hackl* essentially kept total control over the interests he had gifted to his children, and because of these restrictions, the Tax Court held that the gift was not one of a present interest and the annual exclusion did not apply. The court applied this substantial present economic benefit rule to determine whether the transfers constituted a present interest, and found the test was not met because all potential economic benefits were clearly in the future, rather than in the present. Accordingly, practitioners must give some thought in a situation where interests are being gifted to family members and the taxpayer intends to utilize the annual exclusion for the gifts.

Triggers for Buy-Sell Provisions

Every buy-sell agreement will contain specific triggers for when the buy-sell provisions will apply. Obviously, the most prevalent trigger would be the death of an owner, but many other common triggers are used. One such trigger is the voluntary transfer of the interest, i.e. where one of the owners sells their interest to a third party in violation of the buy-sell agreement. Another trigger can be disability of one of the members, which is especially prevalent in situations where the participation of the owners in the management of the business is critical. Other involuntary transfers, such as divorce, can invoke the buy-sell agreement, and indeed providing that divorce is a trigger is important in order to assure that the owner's spouse does not have any entitlement to become an owner of the business interest through a court decree.

An additional trigger that can be included in a buy-sell agreement involves retirement of the owner, or termination of employment, or disability of the owner. The business can agree that upon the retirement of the owner at whatever age is specified by the agreement, the company will buy the interest of the retiring owner. However, great care should be taken to avoid the application of §409A in the drafting of such a provision. Section 409A applies to payments received under agreements that are considered to be non-qualified deferred compensation, which includes severance agreements of employees and retirement agreements with owners. Section 409A places many new requirements on the drafting of severance agreements, including timing rules, exemptions, new terminology, and many other conditions which are outside the scope of this article. Violation of §409A in the drafting of severance agreements can lead to immediate recognition of all deferred income in the immediate year, plus a 20% penalty on the full amount of compensation.[91]

Many buy-sell agreements based on retirement or disability of an owner may contain a variety of payments, some of which could be construed as non-qualified deferred compensation subject to §409A, rather than as a buyout of the equity interest. Thus, the practitioner should evaluate the issue closely and structure the agreement either to avoid application of §409A or to comply with the mandates of the section.

Bankruptcy of one of the owners can also be a trigger for a buy-sell agreement. There is some controversy regarding this issue stemming from provisions in the Bankruptcy Code that allow a trustee to avoid restrictions on alienability of interests. First, under 11 U.S.C. §365 of the Bankruptcy Code, a trustee has the power to avoid executory contracts, and this power has been interpreted by some courts to include buy sell agreements which are conditioned on bankruptcy. Under §365(e)(1), a bankruptcy trustee may disregard provisions in an executory contract that trigger an action upon the filing of bankruptcy by a debtor.[92] Furthermore, under §541(c)(1) of the Bankruptcy Code, the bankruptcy trustee may disregard terms that re-

[88] *See, e.g., Renaldi v. United States*, 38 Fed. Cl . 341 (1997), *aff'd*, 178 F.3d 1308 (Fed. Cir. 1997).

[89] Reg. §25.2503-3(b).

[90] 335 F.3d 664 (7th Cir. 2003).

[91] *See* Alson R. Martin, *Buy-Sell Agreements and Section 409A (With Sample Provisions)*, The Practical Tax Lawyer 25 (Fall 2009), for a general explanation of the technical requirements of §409A.

[92] *See, e.g., Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995).

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strict assignability of the interest, where the buy-sell agreement is considered non-executory.[93] Thus, whether the buy-sell agreement is considered executory or non-executory, a bankruptcy trigger in the agreement may be subject to challenge by a bankruptcy trustee.

Regardless, consideration must be given by the owners as to exactly what circumstances will trigger the obligations of the company to purchase the interests and/or the owner to sell the interest under the buy-sell provisions.

Types of Buy-Sell Agreements

As indicated earlier, buy-sell agreements can either be structured as a redemption agreement, in which the company itself is obligated to purchase the interest at issue, or as a cross-purchase agreement, wherein the other owners are obligated to purchase the interest. If the owners opt for a redemption agreement, then typically the buy-sell agreement will be included in the corporate operating documents. For an LLC, this would be the operating agreement, whereas for a corporation the buy-sell provisions would be included the by-laws of the company.

For cross-purchase agreements, typically the parties will enter a separate agreement among themselves to document the agreement, such as a shareholder agreement or member agreement, wherein all owners will obligate one another to the terms of the buy-sell agreement. There is no need for the company to be a party to a cross-purchase agreement, unless the parties intend for the company to have a right of first refusal on the purchase of the interest.

It should be noted that hybrid agreements, which contain elements of redemption and cross-purchase agreements, are increasingly being used by small business owners. A hybrid agreement typically provides the company with a right of first refusal for a repurchase of an owner's interest, and would thereafter provide each owner with a right to purchase the departing owners interest.

Valuation Provisions

How the interest to be transferred is going to be valued is perhaps the heart of any buy-sell agreement. To be sure, the issue of valuation is the one most fraught with peril in the eyes of the IRS. The methods of valuation were explained earlier in this article, and will not be reiterated here. Suffice it to say, the parties must agree on a manner of valuation, whether it is a fixed price, an adjustable fixed price, fair market value or some other standard.

These provisions must be contained in the buy-sell agreement itself and should be evaluated by qualified counsel to assure that the valuation method chosen will withstand IRS scrutiny. In intra-family transfers, great care should be taken to comply with the mandates of §2703 regarding the setting of the price of the interest, since those agreements are given heightened scrutiny by the IRS under that section.

Optional Versus Mandatory Sale Provisions

Buy-sell agreement can either obligate the company or other owners to purchase the departing owners interests, or simply give them an option to purchase. This is a key issue in the development of a buy-sell agreement, because when the company is obligated to buy the interest, the owner or the owner's heirs is correspondingly obligated to sell the interest. In a contentious matter, where the family's main goal is to liquidate the interests, this is a critical provision for buy-sell agreement, especially in cases where there is little or no marketability of the interest.

The alternative to a mandatory buy-out provision would be simply an option to purchase or right of first refusal. These provisions can be written as loosely or as tightly as needed and can be drafted in a more restrictive manner, such as if the parties wish to give the company a right to purchase the interests for a fixed price. The buy-sell agreement can provide alternatively that the other owners themselves can exercise the option to purchase the interest at a price agreed upon by the parties if the company does not exercise its option. Typically, the option contracts would then provide that if neither the company nor the other owners exercise their option, then the departing owner or his or her heirs would then be permitted to sell the interest to a third party.

Even then, the buy-sell agreement will typically provide that while the financial rights of the interests are assignable, the actual interest itself cannot be assigned unless all remaining shareholders or owners consent to the assignment. For S corporations, this provision can be important because only qualified persons can be shareholders of an S corporation. Without such a limitation, the heirs of the departing owner can threaten to sell the interest to a non-qualified person for a lesser amount, which would cause the corporation to lose the S election, even if such a threat is only to leverage a greater purchase price. The standard rule for LLCs is that a person cannot become a substitute member without unanimous consent of all other owners, but this rule can be modified by the agreement so

[93] *See, e.g., In re Garrison-Ashburn, LLC*, 253 B.R. 700, 708 (Bankr. E.D. Va. 2000) (holding LLC operating agreement was non-executory and thus restrictions on transfer of interests contained therein could be disregarded).

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a practitioner should give some consideration to how to address the issue in the buy-sell agreement.

Funding/Payment Provisions

How the buy-sell agreement will be funded is another critically important provision, and again depends on the circumstances. If insurance is going to be utilized for the purchase of the interest, there should be a provision in the agreement requiring the insurance to be maintained, either by the company or by the respective owners in the case of a cross-purchase agreement. Where the valuation standard is based on fair market value, there should be a provision that requires a revaluation of the interest, so that the parties can know how much life insurance will be required to fund the buy-sell agreement. Typically, redemption agreements would contain a provision stating that while insurance is required to be maintained by the company, the company will be responsible for payment of any amounts in excess of available insurance out of its own assets.

For agreements not funded by insurance but which will be funded by the company out of continued profits of the business, the agreement must contain provisions to allow for payment of the purchase price over time. As noted earlier in the article, these provisions should be designed to comply with §6166 of the Internal Revenue Code in order to allow the deceased owner's estate to defer the payment of estate taxes as a result of inclusion of the interest.

Security Provisions

Especially in situations where the buy-sell agreement provides for a deferral arrangement for payment of the purchase price, the parties should consider providing the departing owner with security for the payment. This can include a provision that the stock will be provided as security until full payment. The parties can also provide for personal guarantees from the other owners for the purchase price. It could also include a mortgage on real estate owned by the company. When the payment will be deferred over time, it is important for the practitioner to negotiate a proper security provision for the seller, especially if there is a possibility that the business could have profitability issues due to the death or departure of the selling owner.

Dispute Resolution Provisions

All buy-sell agreements should typically provide for an expeditious method for resolving disputes. The most standard provision would be a forum selection clause, which would allow the parties to identify the specific forum where any disputes would be addressed. However, of increasing use recently are dispute resolution provisions providing for arbitration of the disputes. There are many arbitration groups that can be utilized, including the American Arbitration Association, JAMS, National Arbitration and Mediation (NAM), and other nationally recognized groups. Typically, the costs of arbitration are less than the costs of a state or federal court case, due to more limited rights of discovery, so providing for arbitration regarding the buy-sell agreement can be a less expensive way to resolve any disputes.

More limited, self-designed dispute resolution provisions can be utilized as well, especially on the issue of valuation. For example, if the parties agree that fair market value will be utilized for the valuation of the interests, they can agree to provide for an independent appraisal of the interests or to have the interest valued by a board of local appraisers, in order to assure the parties as to the fairness of the valuation. Typically, such a provision would allow each side to appoint their own appraiser, who would then have to agree on a third appraiser, or it would provide that an independent party, such as a local judge, would appoint the appraisers.

Typically, internal operating agreements and bylaws are going to have provisions relating to dispute resolution, and the authors recommend that those dispute resolution procedures be reviewed to determine their applicability as it relates to the buy-sell agreement.

CONCLUSION

Designing and implementing an exit strategy and transition strategy for a small business is a crucial task to avoid numerous potential unpleasant consequences that can result from a lack of planning. Whether the goal is to provide for loved ones, to plan for a seamless transition of management, or to minimize tax consequences, the owners of a small business can reach their goal through effective planning with a buy-sell agreement.

And yet, owners of small businesses routinely ignore this critical task, and often wait until it is too late to make the decisions and to take the steps that are necessary for effective transition planning. Thus, perhaps the most important job that a practitioner can engage in, especially practitioners with multiple small business clients, is simply to convince clients to begin the process of planning. As with the related topic of business succession planning, the failure to plan for the transition and/or sale of a business interest is still a plan — it is usually just a very bad one — and the stakes involved, which can include the complete loss of the most valuable interest in a client's estate, are

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too high to ignore.

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