Chapter One

INTRODUCTION

A. Definition

For the purposes of this monograph, a buy-sell agreement is an agreement between the owners of a business, or among the owners of the business and the entity, to purchase and sell interests of the business at a price set under the agreement upon certain future events. These events may include death or disability of an owner, an offer to purchase an owner’s interest, and termination of an owner’s employment. While most of the considerations are the same whether the business operates as a corporation (either a C or an S corporation), a partnership, or a limited liability company (LLC), there are some important differences among these forms, as noted in the text.

B. Background: Choice of Entity

The development of noncorporate business entities has taken place over the life of the current federal tax code. S corporations, partnerships, and LLCs have been popular since the Tax Reform Act of 1986 (TRA 86). Because of TRA 86’s repeal of the General Utilities doctrine, gain on the disposition of an interest in a C corporation in many cases is subject to two levels of income taxation—one at the corporate level on the corporation’s earnings and one at the shareholder level on the receipt of a dividend. For example, assume Shareholders A and B each purchase a $100,000 parcel of real property on January 1 and immediately contribute both parcels to form AB Corporation. Assume that on December 31, when the fair market value of each parcel is $125,000, A and B decide to go their separate ways. They therefore cause AB Corporation to liquidate and distribute one parcel to A and the other to B in complete redemption of their stock. Section 336(a) of the Internal Revenue Code (IRC) causes AB Corporation to recognize $50,000 in capital gain on the distribution of the parcels to A and B. However, unlike the case with S corporations and partnerships, there is no corresponding increase in each shareholder’s basis to reflect the gain recognized by the corporation: A and B each retain a respective basis in their stock of $100,000. Consequently, upon AB Corporation’s liquidation, A and B each recognize $25,000, less one-half of the tax paid by the corporation on its capital gain, in capital gain under IRC § 331(a). Based in large part on this result, many owners of closely held businesses prefer to organize as S corporations or limited partnerships, despite the accompanying ownership restrictions in the case of an S corporation, or liability exposure, in the case of a general partner in a limited partnership.

In response to the demand for an alternative means by which the corporate benefit of limited liability for investors, continuity of life, and centralized management could be had without the burden of double taxation, state legislatures adopted statutes authorizing the formation of LLCs. Today, all fifty states and the District of Columbia have LLC acts. Prior to January 1, 1997, the federal income tax treatment of LLCs depended upon the presence or absence of a majority of the four traditional corporate characteristics, namely limited liability, continuity of
life, free transferability of interests, and centralized management. If an LLC possessed three of
the four characteristics, it was taxed as a corporation; otherwise, it was taxed as a partnership.
Since in most cases an owner of a closely held business wanted the corporate characteristics of
limited liability, continuity of life, and centralized management, it was not possible to use an LLC
without either incurring a corporate level of tax or sacrificing one of the desired characteristics.

By adopting its “check-the-box” regulations in December 1996,¹ the IRS solved
the dilemma by eliminating the conditional tax treatment of LLCs and other unincorporated
business entities in favor of a more easily administered classification regime. Today this regime
permits LLC members to choose with certainty whether they will be taxed as a corporation or as
a partnership (in the case of a multiple-member LLC) or the equivalent of a sole proprietorship,
branch, or division of the owner (in the case of a single-member LLC). The resulting flexibility
in structuring an LLC without losing the desirable single-level tax treatment has popularized the
use of LLCs for closely held businesses. In this monograph, it is assumed that an LLC will be
classified as a partnership for income tax purposes, and, unless the context indicates otherwise,
references to a partnership are intended to include an LLC.

Finally, IRC § 2703, added by the Revenue Reconciliation Act of 1990 (RRA 90),
maintains certain requirements that must be satisfied in order for the price established under an
agreement executed after October 8, 1990, to be accepted for federal transfer tax purposes as the
value of an interest in a family-controlled business for federal estate tax purposes.

¹ Treas. Reg. §§ 301.7701-2, -3.