Post-Mortem Access To Funds From Closely Held Business Interests

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How to make estate taxes less traumatic for a family already coping with the greatest trauma of all.

ONE OF THE MORE CHALLENGING ASPECTS of planning for the owners of closely-held businesses is to provide sufficient liquidity to pay estate taxes and expenses of administration. Generally, planners hope that this issue is presented in the planning phase, so it can be addressed during the owner's lifetime, for that provides the largest range of options. At times, however, we are called in after the death of the owner, when planning has been inadequate or nonexistent; even in those instances, however, there are multiple options to be considered and evaluated.

The types of options generally available to provide liquidity for business owners' estates include:

- Various life insurance options, which obviously must be addressed during the lifetime of the owner;
- Using funds from the business interests themselves, which is better addressed during lifetime, both because of the significant tax

hurdles that are present in many instances, and also because the testamentary documents of the owner may be affected by how redemptions are structured;

- Tax deferral options, which are statutorily provided under sections 6166 and 6161 of the Internal Revenue Code. (All section references are to the Code unless otherwise indicated.) Qualification for at least the first statutory provision is better addressed during lifetime;
- Various loans to the estate, including so-called Graegin loans.

There are two other options that are available in limited circumstances. One is to elect special use valuation to reduce the value of the business that is subject to tax in estates that can qualify under section 2032A. The other is the creation and funding of an ESOP to which the estate could make a sale of some stock or a sale of the owner's stock to an existing ESOP. These two options are much more limited in scope and available to far fewer estates, and therefore will not be considered in this analysis.

So when the planner meets with clients to discuss estate planning, they need to consider the assets that will be available post-mortem to satisfy estate tax and administrative expenses, not to mention the beneficiaries' needs for living expenses. If the estate consists largely of a closely held business, the planner needs to seriously consider the decedent's business as one strong candidate for a source of cash. The rules for doing so, however, vary depending upon whether the entity is a corporation or a partnership or an LLC. The planner must recognize these differences and avoid potential traps to ensure that the funds are available. This article provides a general discussion of tax issues when accessing funds from closely held business interests, while touching on considerations unique to cashing out upon death. As with insurance, the use of the business as a liquidity source is best done in the planning stage. Unlike insurance, however, it can be viewed in the post-death situation, but sometimes the options are narrowed.

CORPORATE DIVIDENDS AND REDEMPTIONS • Due to legislation in 2003, the playing field for the means of accessing cash in a corporation was leveled dramatically. Despite these legislative changes, however, all means of accessing cash are still not created equal.

A dividend is a shareholder distribution from a corporation's "earnings and profits." The recipient shareholder is taxed on the dividends to the extent of the corporation's earnings and profits. Since the Job and Growth Text Relief Reconciliation Act of 2003 (JGTRRA), most corporate dividends are taxed at the same lower rate at which capital gains are taxed. If the amounts distributed to shareholders are greater than earnings and profits ("E&P"), then they are treated as a return of basis; if the distributions are in excess of basis, they receive sale/exchange treatment. §301(c).

A corporate redemption is a purchase of a shareholder's stock by a corporation, which can be partially or totally redeemed by the corporation. Section 302(b) controls whether the purchase of stock by the corporation is subject to sale/exchange treatment and thus capital gains rates to the shareholder. Generally, unless section 303 can apply (as discussed below), if the section 302(b) tests are not satisfied, the recipient shareholder is subject to section 301 dividend treatment and will be considered to have received dividends to the extent of the corporation's earnings and profits, with any distributions in excess of E&P being treated as discussed above. §§301(c)(1) and 316.

Obtaining Sale/Exchange Treatment

Notwithstanding the current favorable treatment of dividends under JGTRRA, redemptions have an advantage over dividends, because shareholders can deduct their tax basis against any redemption proceeds. In other words, there is the chance that taxation could be avoided entirely, particularly in an estate situation where the stock basis is adjusted under section 1014 to the fair market value at death. To do so, the transaction must qualify for redemption treatment under one of the sub provisions of section 302(b). These will be examined separately.

Complete Termination Of Interest

Initially, planners should focus on the complete termination provisions in planning for a redemption for liquidity purposes. Thus, the Code provides that, if a shareholder sells all of his or her stock back to the corporation, and the transaction qualifies for a sale/exchange treatment, then the shareholder is entitled to preferential capital gains treatment pursuant to section 302(b)(3). This "complete redemption" approach is the easiest way to qualify for sale exchange, for the question of whether or not the shareholder holds any stock after the transaction is fairly clear. But in analyzing qualifications for complete redemption treatment, the planner should be aware of the section 318 attribution rules discussed below, particularly as they apply to estates and trusts.

Substantially Disproportionate Distribution

If a shareholder is redeemed but does not give up all of his or her stock, the redemption still creates sale/exchange treatment to the shareholder if it constitutes a "substantially disproportionate distribution" under section 302(b)(2). To be considered a substantially disproportionate distribution, the shareholder must own less than 50 percent of the total combined voting power of all the classes of voting stock following the redemption. Furthermore, the redeemed shareholder's voting stock must be less than 80 percent of his or her voting stock before the redemption period. Again, the planner must be aware of the section 318 redemption rules in applying this test.

Not Essentially Equivalent To A Dividend

If a transaction fails both the complete redemption and the substantially disproportionate distribution tests, the shareholder can still qualify for sale/exchange treatment if the distribution is "not essentially equivalent to a dividend." §302(b)(1). This test is much more difficult to apply, because it is a facts and circumstances analysis of whether the redemption results in a "meaningful" reduction. *U.S. v Davis*, 397 U.S. 301 (1970); Rev. Ruls. 75-502, 75-512, and 78-401. As such, it is not really a provision to be relied upon for planning, but is really more of a "last resort."

Partial Liquidation

The shareholder also can reach sale/exchange treatment under section 302(e) if a distribution is deemed a partial liquidation. It will be considered a partial liquidation if:

- It is not essentially equivalent to a dividend;
- 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;
- The distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business which the corporation has actively conducted for the five years immediately before the distribution; and
- The distributing corporation is actively engaged in the conduct of a qualified trade or business.

Suffice it to say that if one can get to sale/exchange treatment by virtue of the complete redemption test or substantially disproportionate distribution tests, the planner's analysis will be much easier.

The Attribution Rules

The attribution rules under section 318 must be given careful consideration when determining whether a shareholder fits into one of the section

302(b) rules. Under section 318, stock owned by family members, trusts, estates, corporation, or partnerships may be attributed to a shareholder, even if the stock is not owned by the shareholder. Section 318(a). If the corporate entity is considered to be a source for the needed liquidity in an estate plan, therefore, these attribution rules must be carefully considered by the planner. Often, how the estate planning documents for the business owner are drafted can affect qualification and the application of these rules, so special care is always required in the planning process when a closely-held corporation is involved.

Section 318(a)(1) sets forth the family attribution rules, and it provides that stock owned by designated members of a taxpayer's family will be deemed constructively owned by the taxpayer. Attribution will occur with respect to stock owned by the taxpayer's spouse, children (to include legally adopted children), grandchildren, parents, and spouse.

The entity attribution rules under section 318(a)(2) apply to partnerships and corporations, as well as to estates and trusts. Stock owned by an entity is deemed to be proportionately owned by the owners of the entity. Additionally, stock owned by those having an interest in the entity is generally attributed in full to that entity, with the exception that corporate stock will not be attributed to or from a shareholder unless the shareholder owns 50 percent or more in value of the stock in a given corporation. §318(a)(2)(C).

Stock owned (directly or indirectly) by an estate is considered as owned proportionately by the estate beneficiaries. §318(a)(2)(A). An estate beneficiary will include any person entitled to receive property under the terms of the will or by the laws of descent and distribution. Treas. Reg. §1.318-3(a). Once an individual is no longer considered a beneficiary of an estate, the estate attribution rules no longer apply. An individual is no longer considered a beneficiary of an estate if the property to which he or she is entitled has been distributed and received; he or she no longer has a beneficial claim against the estate; and there is only a remote possibility that the estate would seek contribution from the individual to satisfy claims against the state. Treas. Reg. §1.318-3(a). Planners should note, however, that estates will not be able to satisfy these elements if the beneficiary is a residuary beneficiary, as discussed below. The attribution rules also apply to trusts. Thus, consistent with the treatment for estates, stock owned (directly or indirectly by a trust other than a ESOP trust) is considered to be owned proportionately by the trust beneficiaries according to their actuarial interest in the trust. §318(a)(2)(B). Not surprisingly, stock owned by a grantor trust will be considered to be owned by the grantor. §318(a)(2)(B)(ii).

Exemption From Attribution Rules

These attribution rules become even more complicated because of the rules that attribute stock that is owned (directly or indirectly) by or for a beneficiary of an estate or a trust as being owned by that estate or trust. §318(a)(3). Again, stock owned by trusts for qualified plans is exempt. There also is an exemption for interests that are considered "remote contingent interests." This is statutorily defined as an interest that if, "under the maximum exercise of discretion by the trustee in favor of [the] beneficiary, the value of such interest, computed actuarially, is five percent or less of the value of the trust property." §318(a)(3)(B)(i). Thus, the planner who is looking to a corporate entity for liquidity must ensure that these rules are observed, and particularly must be aware of how these corporate exceptions are interpreted by the Service and the courts, in order to ensure that the funds are completely available to the entity on a redemption treatment, which generally means that—given the step up in basis under section 1014—all the redemption proceeds will be received income tax free. In preparing such a plan, however, the planner needs to avoid the trap that is set out below.

A Trap For The Unwary

The typical post-death redemption deals with all stock of the deceased owner, and it appears to be a "complete redemption." But if, after the redemption, the estate's beneficiaries own stock, directly or indirectly, then ownership is attributable to the estate, and any redemption from the estate will not qualify as a complete redemption for tax purposes. §318(a)(3)(A). From the planning standpoint, therefore, an estate beneficiary should receive not only stock, but the entire interest from the estate before the redemption takes place, which means that the beneficiary cannot be a residuary beneficiary, nor a beneficiary of a testamentary trust. If any portion of the estate remains to be distributed to the beneficiary, the estate-beneficiary relationship continues, even though the stock has been distributed from the estate. Accordingly, any estate plan must take into account these rules and provide for a distribution of the interests of anyone who owns stock, so that these rules can be satisfied.

Attribution Waivers

Additionally, because of the family attribution rules, stock ownership of family members that continues after the redemption could prevent "complete termination" unless the attribution can be waived. §302(c)(2). Thus, as noted above, if an estate beneficiary owns stock, that stock is attributed to the estate, so if the estate sells all of its interest (but not that of the beneficiary), there has not been a complete termination of the estate's interest—even though it no longer owns any stock itself. The use of an attribution waiver can be extremely helpful in avoiding this problem, but there are limitations, which relate to the difference between the family attribution rules and the estate or trust beneficiary attribution rules.

In *Crawford v. Comm'r,* 59 T.C. 830 (1973), the court held that the family attribution rules could be waived if stock was redeemed from both the estate and the decedent's sole beneficiary and after the redemption the beneficiary's children were the only stockholders. *Robin Haft Trust v. Comm'r*, 62 T.C. 145 (1974), *vacated and remanded*, 510 F.2d 43 (1st Cir. 1975) held that family attribution rules could not be waived in connection with the estate beneficiary rules. *Rickey v. U.S.*, 592 F.2d 1251 (5th Cir. 1979), responded by holding that estate-beneficiary rules could be waived, as well as family attribution rules. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress essentially adopted *Crawford*, and allowed waiver of family attribution rules, but not the estate beneficiary rules, thereby overruling *Rickey*.

By now, it can be seen that revisions of the complete termination of interest and substantially disproportionate redemption aspects of the Code are likely the most frequently available in planning for the estates of owners of closely-held businesses. In both of these circumstances, the critical element is usually the application of these attribution rules that have been set out above. Redemption treatment is jeopardized where family members will continue to hold interests in the business following redemption, unless attribution among family members can be avoided or waived. Obviously, when family members will not have a continuing ownership interest, these restrictions represent no impediment to planning for the availability of the section 302 redemption. Frequently, however, the family nature of the stockholdings will result in only the complete termination provision being available, because of the waiver of family attribution provisions of section 302(c)(2). Because no similar waiver of family attribution exists for purposes of applying a mechanical test in substantially disproportionate redemptions, the use of that provision is precluded in many closely-held corporations.

Recapture Tax

When the focus is on a complete termination of interest, section 302(c)(2) provides rules for the waiver of family attribution and the filing of an agreement with the Service that the distributees, if they are reacquiring an interest in the corporation within 10 years, will be liable for a "recapture tax." §302(c)(2). This recapture tax is, in effect, an extension of the statute of limitations in the requirement and notification of the Treasury of an impermissible reacquisition of stock during the 10-year period. As noted, however, this waiver is available only for the family attribution rules and does not apply to attribution by reason of a beneficiary owning stock in the enterprise. Thus, the estate can waive attribution rules in such a way that its beneficiaries will not be treated as owning the stock for purposes of reattribution to the estate, but only if the redemption will terminate the estate's ownership of stock and there was no *direct ownership of stock by any beneficiary*. No waiver is available when any stock is actually held by any of its beneficiaries. §302(c)(2)(C). The Code provides that the entity can waive in the attribution only if both the entity and each related person has no interest in the corporation following the redemption. Thus, an estate may waive attribution where the sole beneficiaries are the decedent's children and the remaining shareholders are the decedent's family members, but only if the children will own no shares in the corporation directly after the redemption. In other words, this statutory exception permits entity waivers of reattribution to its related parties.

For planning purposes, if the planner desires to preserve the availability of a section 302 redemption for estate flexibility, it is essential that the ownership of corporate stock as of the date of death be estimated and taken into account. When it is likely that lifetime stock transfers will result in the creation of ownership structures that preclude waiver of the family attribution rules, both the complete termination of the interest provision and the substantially disproportionate dividend provision could be rendered unavailable. There is, unfortunately, no substitute for a close tracking of stock ownership (current and anticipated), with the admitted complexities of the attribution rules, in planning for corporate transfers or buy-sell arrangements. Obviously, however, the estate plan of the primary owner must take all of these into account and, to the extent possible, ensure that waivers are available.

Section 303

With these limitations on redemptions in the estate context, it also is important to consider the availability of section 303, which is a taxpayer-friendly provision treating a stock redemption at the shareholder's death as a capital transaction. To qualify for section 303 treatment:

- The redemption cannot exceed the total of all death taxes and funeral and administrative costs allowable under section 2053;
- The value of the stock in the corporation as held by decedent must be at least 35 percent of the adjusted gross estate of decedent; and
- The distribution must be within 90 days after the expiration of the three-year limitations period for the assessment of estate tax set forth in section 6501(a) (subject to extensions by Tax Court proceedings and section 6166 elections).

By now, it should be clear that while a client's closely-held corporation stands as a prime candidate for access to cash in an estate, it does not come without its problems. It is important to consider the foregoing to successfully avoid these pitfalls.

ENTITIES TAXED AS A PARTNERSHIP • A partnership or LLC presents a good source of cash to an estate, although the tax ramifications can be as complicated as they are for corporations. Indeed, although these entities are not taxed themselves, they provide even more traps for the uninformed.

In general, for entities taxed as partnerships, section 731 provides that neither the partner/member, nor the entity itself, recognizes gain or loss on a distribution of money or property to the partner/member, except when the distributed money (or marketable securities treated as money) exceeds a partner/member's basis in his or her entity interest. The partner/member will then recognize a gain from the sale or exchange of his or her entity interest (capital gain) to the extent of the excess. §§731(a)(1); 731(c)(1). Generally, current distributions never result in a loss, although liquidating distributions can cause a partner/member to recognize a loss on the sale of an entity interest if the distributions consist solely of money, unrealized receivables, or inventory. §731(a)(2).

Generally speaking, there is no recognition of gain or loss on an in-kind distribution of property, but property distributions will be treated as distributions of cash in two instances. First, if a distribution of property reduces a partner/member's share of entity liabilities, then the reduction is treated as a cash distribution under section 752(b). Second, a distribution of marketable securities will be treated as a distribution of cash in most cases under section 731(c).

When the entity has debt, redeeming a partner/member's interest is going to force a reallocation of the partner/member's share of the entity's liabilities, which might entail immediate tax consequences. Under section 752(b), a reduction in a partner/member's share of liabilities is a deemed distribution of money to that partner/member, and section 731(a) then requires a partner/member to recognize gain to the extent the money distributed exceeds the adjusted tax basis of the partner/member's interest.

Marketable Securities

As mentioned above, all or some of distributed marketable securities may be treated the same as a money distribution under section 731(c), unless the distribution falls within two common exceptions to the "marketable securities are money" rule. First, if the security was contributed to the entity by the partner/member receiving the distribution, section 731(c) does not apply, except to the extent the security's value is attributable to other marketable securities or money contributed to the entity to which the distributed security relates. §731(c)(3)(A)(i); Treas. Reg. §1.731-2(d)(1)(i). Second, section 731(c) does not apply to distributions of marketable securities by investment partnerships to eligible partners. Treas. Reg. §1.731-2(e)(1). An "investment partnership" is defined by section 731(c)(3)(C)(i) as a partnership that never has been engaged in any trade or business and whose assets have always substantially consisted of money, stock, notes and bonds, interest rate or currency contracts, foreign currencies, interests in or derivative financial instruments of certain assets, and other specifically prescribed assets. An eligible partner is a partner who has contributed only the aforementioned types of assets to the partnership.

Under section 704(c), any gain from the sale of appreciated property contributed to an entity is to be allocated among the partners/members in a manner that takes into account the property's built-in gain at the time of contribution. This built-in gain must be allocated to the contributing partner/member. Any gain in excess of the built-in gain can be allocated as the partner/members agree among themselves.

The Seven Year Rule

The "Seven Year Rule" under section 704 (c)(1)(B) was devised to keep partners from avoiding their section 704(c) gain or loss by having the partnership distribute their contributed property to another partner/member within seven years of its original contribution. If section 704(c) property is distributed to any partner/member—other than the contributing partner/member—within seven years of the original contribution, the contributing partner/member must recognize gain or loss and the amount in the character that such property would have been allocated under section 704(c)(1)(A) had it been sold to the recipient partner/member at its fair market value on the date of the distribution. To plan for this rule, it is important for the planner to understand that the estate is not considered the contributing partner; only the individual contributor satisfies this rule. As a result, the rule applies if assets are distributed to the contributing partner's estate within seven years. As a result, the only way to avoid this result is simply to wait longer than seven years to distribute the property.

Gain (but not loss) to a contributing partner/member also can be triggered under section 737 if, within seven years of a contribution, the contributing partner/member receives a distribution of property, other than the property he or she contributed. The partner/member is required to recognize gain equal to the excess distribution (meaning the excess of the distributed property's value over the partner/member's outside basis) or the partner/member's net pre-contribution gain or pre-contribution gain not previously recognized. Again, much like with section 704(c), section 737 applies only to contributions made within seven years preceding a distribution. And, as under section 704, section 737 applies only to the individual partner's contributions, and there is no attribution to that contributor's estate.

When an entity redeems a partner/member's interest in full, section 736(a) provides that payments may be deductible to the entity and ordinary income to the selling partner/member. The partner/member does have the ability to choose to apply section 736(b), so that the payments are nondeductible to the entity and capital gain to the partner/member. Generally, the redemption agreement can provide that as much or as little of the redemption payments as the parties agree may receive treatment under section 736(a) or (b). In no event, however, may capital gain payments exceed the fair market value of the withdrawing partner/member's share of the entity property (Treas. Reg. §1.736-1(b)(5)(iii)), nor may they include certain payments for goodwill, accounts receivable, and inventory. §736(b)(2).

Basis adjustments also need to be given careful consideration. Section 754 can be very important to an estate, given the income tax consequences related to the step-up in basis of the decedent's entity interest. Section 754 allows for the entity to equalize the inside basis (the entity's basis of the partner/member's pro rata portion of the underlying property) with the outside basis (the partner/member's basis in his entity interest). This election is particularly useful if the entity consists of depreciable property like rental real estate; the election allows the entity to depreciate the property once again using the higher basis for the deceased partner/member, making additional income tax deductions available to the estate and its beneficiaries.

If there is no section 754 election in place at the time of the partner/member's death, and the partnership will not make the election, the estate can still proceed under section 732. A section 732(d) election can be made by the estate without the consent of the entity or of any of the partner/members, because it does not affect the entity or the other partner/members. A section 732(d) election only applies to distributions of entity property to the estate within two years of death, and cannot be used for purposes of establishing the estate's share of any depreciation or gain or loss on the sale of the entity property by the entity.

BUY-SELL AGREEMENTS AND SECTION 2703 • The advantages of a buy-sell agreement are many, such as restricting the transfer of the business to outside parties and protecting S corporation status by preventing transfers to disqualifying shareholders. More important to the considerations of this article, a buy-sell agreement provides a guaranteed market for the owner's interest and ensures the liquidity of the business interest on the death of the owner. If the buy-sell agreement is among family members, however, it is important to be wary of section 2703.

For purposes of determining the taxable estate of a deceased business owner, the fair market value of the business interest will have to be established as of date of death. Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Treas. Reg. §20.2031-1(b). A buy-sell agreement, by its very nature, seems to satisfy the definition of fair market value, but section 2703 suggests otherwise. Thus, for gift, estate and GST tax, section 2703(a) provides that the value of any property shall be determined without regard to any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or any restriction on the right to sell or use such property.

Abuses Targeted

The usual abuse section 2703 attempts to address is a scenario involving a parent and child setting an artificially low buy-out price, whereupon the surviving shareholder is allowed to purchase the interest for less than the fair market. Absent section 2703, the below-market price that the child would pay to the deceased parent's estate for the stock would establish the value for estate tax purposes, due to the estate's legal obligation to complete the contract at the designated price. Under section 2703, the IRS can ignore the value established by such an agreement, even though it does not affect the contractual obligation of the decedent's estate to convey the stock at that price.

In the worst-case scenario, the parent's estate could be obligated to sell at the lesser value, while still having to pay a much higher transfer tax based upon the IRS's determination of fair market value. If that discrepancy in value is large enough, the estate may be in a position where the sale price for the stock could fail to satisfy the estate tax liability stemming from the stock. This issue is particularly of concern when there is a marital deduction gift involved. Thus, if there is a buy-sell agreement in place, and it does not satisfy section 2703, the difference between the redemption price at which the estate is obligated to sell, and the fair market value for estate tax purposes, will be a "phantom" asset. This phantom asset cannot qualify for the marital deduction, because it cannot "pass" to the surviving spouse. §2056(c). As a result, it will not qualify for the marital deduction, thereby triggering an estate tax, even where there is a formula ostensibly avoiding any tax. Once again, care by the planner must be taken to avoid this result. Often, this is done by simply having the buy-sell arrangement be at a price equal to the "fair market value as finally determined for federal estate tax purposes." Because there won't be any estate tax under those circumstances, the impact is much less than trying to establish a fixed price that could be challenged by the Service.

Section 2703 Exemption

When these issues are not a concern, section 2703 sets out the general rule that the property subject to a restrictive agreement is valued for transfer tax purposes without regard to such restrictions, although there is an exception to the general rule. Section 2703(b) provides that the general rule shall not apply to any option, agreement, right, or restriction if: 1) it is a *bona fide* business arrangement; 2) the agreement is not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and 3) the terms of the agreement are comparable to similar arrangements entered into by individuals engaged in an arm's length transaction.

The first requirement of the section 2703(b) exception is that the buy-sell agreement must be a "*bona fide* business arrangement." Case law provides some reasons for entering into a buy-sell agreement that constitutes a *bona fide* business arrangement.

These, as you might expect, reflect the various reasons a buy-sell agreement is useful in the first place, such as to prevent the transfer to an unrelated party, to provide a market or the equity interest, and to allow owners to plan for future liquidity needs.

Courts have split the section 2703(b)(2) test (the agreement "is not a device to transfer property to members of the decedent's family for less than full and adequate consideration") into two-parts: the "testamentary purpose test" and the "adequacy-of-consideration test." In *Estate of True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), one of the seminal cases in this area, the court listed many factors that might indicate a buy-sell agreement would fail the testamentary-purposes test, including that the decedent was in poor health when he entered into the agreement; there was no negotiation of buy-sell agreement terms; the parties failed to seek significant professional advice in selecting a formula price; there was no periodic review of the formula price; or the decedent's business arrangements fulfilled his testamentary intent (for example that the transfers were reflective family relationships, not reflective of the management roles of the family members).

Under the adequacy-of-consideration test, the Tax Court has taken the position that consideration is adequate if it requires a price that is not lower than that which would be agreed upon by persons with adverse interests dealing at arm's length. The standard as set out by the Tax Court mandates a battle among expert witnesses.

The first two requirements of section 2703 are taken from the Eighth Circuit's opinion in *St. Louis County Bank v. U.S.*, 674 F.2d 1207 (8th Cir. 1982), which was enthusiastically adopted by the IRS in PLR 8710004. In other words, merely because an agreement is a bona fide business arrangement, it will not be sufficient to cause the value determined under the agreement to be the value that will be used for federal estate tax purposes, if it can still be shown that the agreement is the "device" to transfer property through the family for less than full and adequate consideration.

If this were the only effect of Chapter 14, then planners would still have some certainty regarding buy-sell agreements. Unfortunately, section 2703 adds the third requirement (the "terms [of agreement] are comparable to similar arrangements entered into by persons in an arms length transaction"), and this raises the bar considerably and has generated even more uncertainty for practitioners. While the first two requirements are hard to satisfy, the third requirement makes it very difficult to prevail, given that comparable arrangements could be impossible to find. Additionally, the statute places the burden of proof on the taxpayer. Indeed, the Senate Committee Report indicates that the third requirement means a planner must show that the agreement was one that "could have been obtained in an arms length bargain," a showing that "requires the demonstration of a general practice of unrelated parties." This reflects an intention to have expert testimony on this issue, which is not unlike the valuation of businesses. The Conference Report indicates that general business practices may recognize more than one valuation methodology, and the conferees indicated an intention of any of these could satisfy this requirement. Revenue Reconciliation Act of 1990, H.R. 5835.

A Smell Test?

When evidence of an arms length transaction does not appear to be readily available, perhaps planners should resort to an informal "smell test," and ask the client/business owner if they would enter into such an agreement with nonrelated parties. If their response is uncertain, then until there is further regulatory guidance as to the implementation of these provisions, the drafter should approach family buy-sell agreements very tenderly. This is not to say that they should be avoided, for often the benefit of the agreement is as much the certainty of retained ownership of the interest within the family than it is establishing estate valuation, but certainly any attempt to the fixing of price in terms of current value now seems to be prohibited, and even a formula value, rather than the value to be determined at death, is subject to these potential estate tax problems under section 2703.

As noted, the application of section 2703 is very broad, but it is limited to arrangements between family members. If more than 50 percent of the value of the property subject to the right or restriction is owned directly or indirectly by non-family members, the three-part test of section 2703(b) is deemed to have been met. So, then, who is a family member? Under Treas. Reg. §§25.2703-1 and 2, a "member of the family" includes the transferor, lineal descendants of the parents of the transferor or the transferor's spouse, and applicable family members, who include the transferor's spouse, ancestors of the transferor and the transferor's spouse, and the spouses of such ancestors. Additionally, a member of the family includes any other individual who is a natural object of the transferor's bounty. The Regulations do not define natural objects of decedent's bounty, but the breadth of this concept could allow the IRS to argue that a gift has occurred when the recipient merely has a history of personal relationships extending to his partner's family.

Section 2703 applies to buy-sell agreements entered into on or after Oct. 8, 1990, but it also applies to a pre-Oct. 8, 1990, agreement that has been "substantially modified" after that date. A substantial modification is any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a *de minimis* change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction. When contemplating the limits of substantial modification, it is important to note that the IRS may deem a failure to update a right or restriction that requires periodic updating under the terms of the agreement as a substantial modification. In other words, failure to modify could constitute a substantial modification.

Although section 2703 was created primarily to address perceived abuses in connection with buy-sell agreements, it is widely applicable to other types of agreements, such as partnership agreements, operating agreements, options, by-laws, and articles of incorporation. Indeed, recently section 2703 arguments have been resurrected with a measure of success in family limited partnership cases. See *Holman v. Commissioner*, 130 T.C. 170 (2008).

CONCLUSION • Certainly, a client's business represents a life's work in value, but it can't be taken for granted that the business will easily yield up its value when it is needed upon the death of the owner. Careful planning is necessary to tap into the cash represented by business interests. This article represents an overview of the more common considerations and pitfalls presented in these circumstances. It is definitely preferable to take hold of these issues in planning; once the client is gone, getting cash from a business may not be so easy… if it ever was.