BUY SELL AGREEMENTS FOR
CLOSELY HELD BUSINESSES

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BUY SELL AGREEMENTS FOR CLOSELY HELD BUSINESSES

I. INTRODUCTION

A. Generally, a family business is a business where one or more members of a family (or one or more members of several families) have control of the business and the business is not publicly traded. The business may be established as a C corporation, a sub-chapter S electing corporation, an LLC, a partnership or some other type of entity.

B. As of 2010, family businesses in the United States account for approximately 50% of the gross domestic product, 60% of all employment and 78% of new job growth. Approximately 35% of Fortune 500 companies are family owned businesses.

C. Less than one-third of family businesses survive to the second generation and only 13% survive to the third.

D. Reasons for failure to survive can include the following:
   1. Improper planning for transition to next owners and/or sale of business;
   2. No publicly established value and a limited market for sell;
   3. Lack of liquidity for both the estate of the deceased owner and for the business;
   4. Impact of transfer taxes on the business or family members;
   5. Conflict among the owners and/or their heirs.

II. THE PERSONAL ASPECT OF SUCCESSION PLANNING

A. The Top Priority Of The Head Of A Family Business Should Be The Perpetuation Of The Enterprise
   1. Owners view succession planning as an isolated event rather than the continuous process of management that it should be.
   2. Owners begin thinking about succession planning three to five years prior to leaving rather than on the appropriate timetable of ten to fifteen years.

B. Family Business Life Cycle
   1. Formative years, owner gets business off the ground
2. Growth years, growing sales

3. Maturity, significant property accumulated

4. Crossroad years, time for reassessment, owners seek retirement income, children seek growth, transition to new management

C. Competing Objections for Succession Planning

1. Succession planning must take into account many competing interests, from many different people who are involved with the business, including the following:
   - The Entity itself
   - Deceased Owner’s Estate
   - Remaining partners/owners
   - Retiring partners
   - Key Employees

2. Key areas of conflict include the following:
   - Sales price of the interest
   - Tax treatment of sale
   - Funding for purchase
   - Control over entity
   - Providing income for beneficiaries or retiring partner
   - Avoiding significant dilution of interests

D. Managing Succession, Prepare a Strategic Plan for Ownership

1. Most common business exit strategies
   a. A sale to unrelated senior management employees of the business;
   b. A sale, gift or bequest to family members;
   c. A sale to strategic buyer such as a competitor;
   d. A sale to a financial buyer such as a private equity group; or
e. A sale to an employee stock ownership plan (an “ESOP”)

2. Construct a crisis plan to provide direction for the survivors
   a. Who will take control?
   b. Who will deal with customers and creditors?
   c. Who will make financial decisions?
   d. Who will make production decisions?

3. Define all the basic beliefs of the family
   a. What is important to the family today?
   b. What does the family want for the future?

4. Construct the rules for operation
   a. Who may own stock/membership interests?
   b. How will the ownership interest be valued?
   c. When and how should children enter the business?
   d. How should family members be compensated?
   e. How should family conflicts be resolved?
   f. How should family decisions be made?
   g. What will be the future role of present management?
   h. How will estate taxes be paid?
   i. How to treat family members who are not involved in the business?

5. Create a long-term product development and marketing plan:
   a. Response to shifting demand and increasing competition
   b. Capitalize on the talent and energy of children and employees

E. Choosing a Successor

1. Minimum time to begin the search for a successor is ten years prior to retirement
1. One to two years to locate and remaining time for training
   b. Amortization of the cost over time

2. What has company accomplished because of owner's strengths and failed to accomplish because of owner's weaknesses?

3. Establish priorities
   a. Business first, find person with business skills; or
   b. Family first, family member must be trained

4. Searching inside
   a. Quicker transition
   b. Endorsement of the people in the company
   c. Send successor out for experience

5. Searching outside
   a. Valuable experience
   b. No political or credibility barriers
   c. Bring outsider in to gain training

6. Evaluating insiders
   a. Determine the process to be applied
   b. Give candidates the opportunity to be evaluated, special projects, division leadership
   c. Process is complicated when more than one family member is a candidate. The eldest is not necessarily the best choice
   d. Honestly evaluate strengths and weaknesses

7. Successor training includes introductions to develop relationships (bankers, lawyers, accountants, supplies, staff)

8. Transition
   a. Gain people's acceptance of successor through participation in the process
b. Demonstrate confidence in successor

9. Turn over the reins
   a. Owner must admit that his or her position can be filled
   b. Succession is a process and when it is complete owner should accept it

10. Find a useful role for retiring owner
    a. Strategic operations
    b. New products, new markets

III. BUY-SELL AGREEMENTS

A. What Is A "Buy-Sell Agreement"?

1. A buy-sell agreement is an agreement among the owners of a business that sets forth the parties' consensus and agreement as to:
   a. How the business will be operated
   b. Which parties will be responsible for various duties
   c. Under what circumstances shares of stock or other ownership interests in the business may be transferred
   d. Rights of first refusal or other transfer restrictions on ownership interests
   e. The price at which other owners or the business entity can or will purchase an owner's interest at death, disability, retirement, termination of employment or other triggering events

2. Trigger Provisions—these are the events which will cause the buy-sell agreement to become effective. They include the following:
   a. Voluntary transfers
   b. Disability
   c. Retirement
   d. Termination of employment
   e. Death
f. Involuntary transfers, divorce, bankruptcy

B. The Benefits Of A Funded Buy-Sell Agreement

1. To the surviving owners
   a. Guarantees that the deceased's estate will sell
   b. Establishes a price or pricing mechanism agreed upon by all
   c. Provides cash to accomplish the buy-out
   d. Keeps ownership in the hands of the surviving owners and excludes outsiders or unwanted heirs
   e. Provides for the continued stability of the business

2. To the deceased's estate and family
   a. Guarantees a purchaser
   b. Assures a fair price for the surviving family members and beneficiaries
   c. Provides beneficiaries with an income producing asset

3. To both, the funding mechanism provides a liquid reserve for any potential living buy-out or other cash need

C. Types Of Buy-Sell Agreements

1. **Redemption**: the business entity purchases the deceased owner's interest

2. **Cross-Purchase**: the surviving business owners purchase the deceased owner's interest pro-rata (or in some other agreed upon percentages)
   a. Regular
   b. Trusteed

3. **Hybrid**: the entity redeems some of the deceased owner's interest and the surviving owners purchase the rest

4. **“Wait & See”**: the entity has a first option to purchase no less than all of the deceased's interest; the surviving owners have a second option to purchase no less than all of the deceased's interest in specified percentages or pro-rata if the entity does not exercise its option; if no other options are exercised, the entity must purchase all of the deceased's interest.
D. Advantages and Disadvantages

1. Redemption
   a. Advantages
      i. If funded by insurance, fewer insurance policies are needed
      ii. The purchase is funded with entity dollars, not personal dollars (but those dollars are not deductible by either)
      iii. There are no "transfer for value" problems with respect to policies on surviving owners
      iv. Life insurance cash values strengthen the balance sheet
      v. Control over the insurance policies is retained at all times
   b. Disadvantages
      i. Surviving owners of C corporations do not receive an increased income tax basis (although surviving owners of S corporations, partnerships and LLCs will receive an increase in the basis of their interests)
      ii. Constructive dividend problems
      iii. Potential unreasonable accumulations of surplus issues
      iv. Transfer for value problems on switching to cross-purchase
      v. State laws may prohibit the redemption where corporate surplus is deemed inadequate

2. Cross-Purchase
   a. Advantages
      i. Surviving owners receive an increased income tax basis after purchase
      ii. Alternative minimum tax, constructive dividend and unreasonable accumulation of surplus are not issues
      iii. Transfer for value is not an issue on conversion to redemption
      iv. Potential unreasonable accumulation of surplus problems
v. Funding is beyond the reach of the entity's creditors

b. Disadvantages

i. Requires multiple insurance policies on each owner

ii. Premiums are paid with after-tax dollars by individual owners

iii. Insurance costs are not equal among the owners; the younger, healthier owners pay a higher cost than the older, less healthy ones

iv. Little control can be maintained over the multiple insurance policies owned by the various owners unless the agreement is trusteed

E. Purchase Price

1. Fixed Dollar Value: subject to challenge and, if not changed regularly, is not realistic

2. Book Value: generally not realistic and might be subject to challenge

3. Certificate of Value: should include provision to update value every twelve to twenty-four months; Appraisal backup

4. Appraisal Value: can be expensive and uncertain

5. Agreed upon value: can cause conflict and subject to challenge by the IRS.

F. Payment of Purchase Price

1. Payment of insurance proceeds

2. Deferral--balance of payment by note
   a. Interest rate
   b. Payment period

3. Security for payment
   a. Stock pledge
   b. Security agreement

IV. VALUATION ISSUES
A. Valuation is important because it quantifies the client’s exposure for purposes of estate taxes.

1. Valuation is a subjective process.

2. Valuation should be prepared by a qualified appraiser.

B. General Principles of Valuation

1. “Fair market value” is 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. Regs. Sec. 20.2031-1(b).


2. The value of an asset is the sum of the future benefits that the asset is expected to produce discounted to a present value at an appropriate discount rate.

3. Future benefits may take the form of:

   a. Annual earnings or cash flow

   b. Expected proceeds from a sale

   c. Expected proceeds from liquidating

4. Discounting is necessary due to:

   a. Time value of money

   b. Future benefits are not guaranteed

C. Methods of Valuation - Business valuation is a mix of art and science and it is not uncommon to value a business by a number of different methods and use an average (or a weighted average that gives more weight to some methods than to others) of the various methods.

1. Discounted Future Returns:

   a. Forecasting a stream of future payments

      i. Adjusted for overstated or understated expenses

      ii. Adjusted for cost of management
iii. Based upon historical experience

b. Discounting the stream of payments
   i. Cost of capital
   ii. Time value of money and risk

2. Capitalization of Earnings - refers to the return on investment expected by an investor
   a. Service organization
   b. Historical earnings for five previous years
      i. Adjusted to market
      ii. Weighted earnings
      iii. Net income must be adjusted for excessive compensation and rent payable to shareholders
      iv. Valuation period
   c. Capitalization Factor - the higher the rate reflects the higher perceived risk and the lower the value of the business.
      i. Price/earnings ratio of comparable companies
      ii. Required return
      iii. Nature of the business
      iv. Risk involved
      v. Stability or irregularity of earnings

3. Industry Rules of Thumb

4. Asset Value
   a. Manufacturing Company
   b. Liquidation
   c. Book value
      i. Adjusted for market
ii. Adjusted for goodwill (value of excess earnings)

D. Internal Revenue Service Valuation

1. In Revenue Ruling 59-60, originally promulgated by the IRS to assist taxpayers in determining the fair market value of closely held companies for estate and gift purposes, the IRS noted that no general formula is applicable to the varying valuation situations arising in the valuation of interests in closely held companies and set forth the following factors as pertinent in determining the fair market value of shares of a closely held business:

   a. The nature and history of the business;
   b. The economic outlook for the economy in general and for the particular industry;
   c. The book value of the stock and the financial condition of the business;
   d. The earning capacity of the business;
   e. The dividend-paying capacity of the business;
   f. The goodwill or other intangible value that the enterprise has;
   g. Other sales of the stock and the size of the block of stock to be valued; and
   h. The market price of stocks of public corporations engaged in similar business.

2. There is a constantly growing body of case law. Constants include the critical importance of qualified appraisals and the specific facts applicable to the valuation.

E. Adjustments to Value - 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. A combination of valuation discounts may apply.

1. Discount for Lack of Marketability - “DLOM”
   a. DLOM is based not on the size of the interest, but rather, on the difficulty of converting the business to liquidity.
b. The fact that the value of the business cannot be readily converted to cash requires that the sale price between the willing buyer and a willing seller be discounted.

c. 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).

d. 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.

e. In Mandelbaum v. Commissioner, T.C. Memo 1995-255, aff’d 91 F.3d 124 (CA-3, 1996), the Tax Court stated that "[a]scertaining the appropriate discount for limited marketability is a factual determination." The Court, unpersuaded by either party's experts, set forth its own valuation analysis citing the factors listed below (which are similar to those set forth in Rev. Rul. 59-60) in determining the appropriate discount for the lack of marketability of unlisted stock.

i. The cost of a similar corporation's stock;

ii. Analysis of the company's financial statements;

iii. Dividend paying capacity and dividend history;

iv. Nature of the corporation, its history, its position in the industry and its economic outlook;

v. The strength of a company's management;

vi. The degree of control transferred with the block to be valued;

vii. Any restriction on the transferability of the corporation's stock;

viii. The period of time for which an investor must hold the subject stock to realize a sufficient profit;

ix. The corporation's redemption policy; and

x. The cost of effectuating a public offering of the stock to be valued.
Additionally, courts and experts will consider the price obtained in any recent arm's length transaction if available.

2. Control
   a. Minority Discount
      i. 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.
      
      ii. Minority interest discount reflecting the lack of control over the business can range from 15% - 49%, but the actual discount is fact-specific and needs to be supported by a qualified appraisal.

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

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

      iv. 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.

      a) 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.

      b) Another view is that the power to liquidate or dissolve an entity might be available but that it should not impact a minority discount since 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.
v. No discount for lack of control where the transferee held 88.99% of the limited partner interests and had power to remove the general partner. *Estate of Streighoff v. Comm’r*, No 4279-15, T.C. Memo 2018-178.

b. Control Premium

i. Investors value control and there is typically an increase in value for control known as a control premium

ii. Control premium should never make the value of the business greater than its fair market value.


3. Unique Factors of the Business

a. Key personnel

b. Customer base

c. Product diversity

d. Raw materials

4. Restricted securities cannot be sold publicly because they are not registered and are subject to resale restrictions. Rev. Rul. 77-287, 1977-2 C.B. 319.

F. Risks in Valuing the Family Asset


2. Penalties

a. Accuracy Related Penalties

i. Negligence or Disregard of Rules/Regulations – 20% (Sec. 6662(b)(1)).

ii. Substantial valuation misstatement – 20% (Sec. 6662(b)(3)).

iii. Substantial estate or gift tax valuation misstatement – 20% (Sec. 6662(b)(5)).

iv. Gross valuation misstatement – 40% (Sec. 6662(h)).
v. Fraud - 75% of the underpayment.

G. Planning

1. Take advantage of Discounts
   a. Lifetime gifts of small interests
   b. Transfers to reduce control of majority owner
2. Recapitalization and Partnership Freezes
3. Deferred Compensation
   a. Vesting
   b. Dollar allocation
4. Sale to Defective Grantor Trust
5. GRATs
6. CLAT
7. Maintaining small or minority owned business status

H. Selecting and Using an Expert

   a. Courts will consider expert testimony regarding valuation and valuation discounts but need not follow it when it is contrary to a court's judgment. Courts may also be selective in the use of any portion of an expert's opinion.

   b. Expert's valuation must be based on the specific facts of each case.

   c. The quality of the expert testimony provided to the court can substantially affect the size of the discount allowed.

V. FUNDING OF BUY-SELL AGREEMENT WITH LIFE INSURANCE

A. Benefits Of A Funded Buy-Sell

1. Guarantees the seller will sell and purchaser has the ability to purchase
2. Establishes a price agreed to by all
3. Provides cash to accomplish the buy-out
4. Provides for the continued stability of the business
5. Provides decedent's heirs with a guaranteed income producing asset without reliance on the continued success of the business

6. A cash value (whole life, universal, survivorship joint life or a split dollar) life policy can provide a liquid reserve for a living buy-out or other cash need.

B. Insurance Ownership

1. Cross purchase: shareholders are owners and beneficiaries of policies on one another. If more than two shareholders, the number of policies grows exponentially unless a trusteed arrangement is used

2. Redemption: the corporation is the owner and beneficiary of the policy on each shareholder

3. Hybrid: the shareholders and/or the corporation are the owners and beneficiaries of the policies

4. Trusteed cross purchase: the trustee is the owner and beneficiary of the policies

C. Income Taxation

1. Deductibility of premiums: no deduction for shareholders or corporation

2. Taxation of premiums: premiums paid by shareholders are not income to the insured nor are premiums paid by the corporation taxable to the shareholders (assumes the corporation is the beneficiary of the policy).

3. Taxation of Proceeds: proceeds are not taxable income to the shareholders or the corporation. With the repeal of corporate AMT under the 2017 Tax Act, proceeds are also no longer subject to alternative minimum tax for C Corporations.

4. Economic Effect of Premium Payments: where young and old shareholders or shareholders with disparate interests are parties to the buy-sell agreement, the burden of life insurance premiums is not spread evenly.

5. Cross purchase: use a combination of insurance and long term notes or have the older insured fund part of the premium as a "loan" to be added to the purchase price.

6. Redemption: the additional premium can be treated as a "loan" which is added to the purchase price.
D. Ownership Problems

1. **Transfer for Value Issues**: Existing personally-owned or corporate-owned policies may not be used to fund a shareholders' cross purchase arrangement because of the "transfer for value" problem.

2. I.R.C. Section 101(a)(2) provides that if a policy or any interest in a policy is transferred for a 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:
   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. With this in mind, it may be advisable to form a partnership just to hold the insurance, with the shareholders of the corporation as the partners.
   c. if the policy transfer does not result in a change of the tax basis of the individual assets transferred.

3. A trusteed cross purchase arrangement may generate a transfer for value problem upon the death of a shareholder because of a transfer of beneficial interests in the remaining policies to the surviving shareholders. This can be avoided to the extent the shareholders are also partners in the same partnership.

E. Funding The Insurance For A Cross Purchase Arrangement

1. **Bonus Arrangement**: the employer may fund the amount of the premium or the amount of the premium plus the tax due on the bonus to the employee (double bonus) and deducts the payment as compensation.

2. **Split dollar insurance** is an arrangement between an employer and employee under which there is a sharing of premium outlays, cash values and death benefits.

F. Use Of Special Policies

1. Joint life second to die policy.

2. Joint life first to die policy.
a. Should be purchased subject to an executed buy-sell agreement to avoid a potential transfer for value problem.

b. There exists a question as to whether the incidents of ownership held by the decedent at death will result in the insurance proceeds being included in the decedent's estate use of a trust for the benefit of the shareholders can solve this problem.

G. Non-Insurance Funding Through Company Profits

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. From a tax perspective, this is typically not the most advantageous way to make these payments for the Company, since the payments are being made with after-tax dollars and are not deductible.

These types of provisions can vary widely, including time of payment, conditions precedent to payment, and other conditions which are particular to the business itself. As will be discussed later in these materials, these provisions should be designed to comply with Section 6166 of the Internal Revenue Code in order to allow a deceased owner’s estate to defer the payment of estate taxes as a result of inclusion of the interest.

Caution—where the buy-sell provides that payments will be made out of future profits of the Company, the Seller incurs significant risk of default. Accordingly, it is imperative that the buy-sell agreement contain some provision for security for payment to the Seller. This can include provisions for a security interest in the stock being transferred; personal guarantees by the other owners; a lien on company assets; and other commercially reasonable security arrangements.

VI. TAX CONSIDERATIONS

A. INCOME TAX ISSUES

How the buy/sell transaction will be taxed for income tax purposes varies depending on many factors. As a general rule, the transaction will either be characterized as a distribution, a dividend, or a sale or exchange. Perhaps the most important factor in this determination involves the type of entity involved.

1. C Corporations

Where the buy-sell transaction involves stock in a C corporation, the transaction will either be treated as a dividend or as a sale or exchange of a capital asset. In this context, it
is 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 thus has received a stepped up tax basis.

a. Entity Purchase:

The general redemption rules in IRC Section 302 apply to redemptions in determining whether or not 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 IRC Section 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. Section 302(b)(1).
- The distribution is substantially disproportionate with respect to the shareholder. Section 302(b)(2).
- The distribution completely terminates the shareholder’s interest in the corporation. Section 302(b)(3).
- The distribution is in partial liquidation of a non-corporate shareholder. Section 302(b)(4).
- The distribution is made after the shareholder’s death for the purpose of paying estate taxes and other administration expenses. Section 303.

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

1. 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.” *Davis v. United States*, 397 U.S. 301 (1970). 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. See, PLR 2005520067; Rev. Rul. 75-502. 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. Reg. § 1.302-2(b). Case law and IRS rulings since the *Davis* case have fleshed out this exception, by 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. See, Zaritsky, *Structuring Buy Sell Agreements*: 
Analysis with Forms, Warren, Gorham & Lamont, 2nd Ed., § 2.02[2][b] (2002 and 2009 Cum. Supp), for a good listing of cases and rulings. The private letter rulings and cases are widely inconsistent in this area, making it a dangerous exception upon which to rely without clear precedent.

2. **Substantially Disproportionate Redemption:**

The second exemption 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:

a. The Shareholder owns less than 80% of the total voting stock of the corporation that he or she had owned before the redemption after the redemption is complete;

b. The shareholder owns less than 80% of the percentage of total value of the common stock that he or she had owned before the redemption;

c. The shareholder owns less than 50% of the total combined voting power of the shares; and

d. The redemption is not part of a series of planned redemption.

The regulation on this particular exception contains an excellent example showing the rule’s application. See Reg. § 1.302-3 (b). There are also numerous private letter rulings and revenue rulings which provide additional guidance on its application. See e.g. PLR 9514020, PLR 200125010; Rev. Rul. 75-447; Rev. Rul. 76-385. All of these examples show that the IRS will apply the mathematical tests very strictly, with very little room for argument by the taxpayer where the thresholds are not met. Where the stock redeemed is not voting stock, then the regulations state that this exception is not applicable. Reg. § 1.302-3(a).

3. **Complete Termination of Shareholder Interest.**

The general rule 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. IRC Section 302(b)(3). Like with other exceptions, the family attribution rules found in IRC Section 318 can be a major factor, and can disqualify the transaction from meeting the exception. However, unlike for other exceptions to the dividend treatment rules, the family attribution rules can be waived for the complete
Liquidation exception. IRC Section 302(c)(2). For this waiver to be effective, the following elements need to be met:

a. Immediately after the distribution, the shareholder has no interest in the corporation other than as a creditor;

b. The shareholder does not acquire any interest other than stock required by bequest or inheritance within ten 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;

c. The shareholder has not transferred any stock or received any stock in ten 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

d. The shareholder elects to waive the attribution rules.

Section 302(c)(2)(A) and (B). 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. See Reg. § 1.302-4(a)(1) and (2).

The letter rulings and cases addressing this particular exception pertain mainly to the waiver of family attribution rules. See, e.g., Lisle v. Comm., TC Memo 1976-140 (1976) and PLR’s 99426041 and 200750001 for good examples. 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. Lisle, TC Memo 1976-140. However, where the shareholder elects to waive the family attribution rules, he cannot serve in any capacity in the corporation. See, e.g., Rev. Rul. 70-104; Rev. Rul.56-566. 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. See FSA 2002030121. While 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. See, e.g., Hurst v. Comm., 124 T.C. No. 2 (2005) (holding that 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).
Because waiver of the family attribution rules is available for this particular exception, it is perhaps one of the most widely noted and used exceptions to avoid dividend treatment of redemption distributions for buy-sell agreements.

4. **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 Section 302(e), with the following:

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

(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 trader business. Section 302(e)(3).

5. **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 the general rule, 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). IRC § 303(a). This can be a very important exception in the context of small family-owned businesses with high values but low liquidity. Furthermore, for an estate to qualify for this rule, the value of the stock has to constitute at least 35% of a decedent’s adjusted gross estate. IRC § 303(b)(2). 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 (§ 303(a)). 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 mean no income taxes due to the step-up in basis).

**NOTE: Taxability of Corporation on Distribution.**

Typically, under any of these scenarios, the corporation would incur no taxes on the distribution and redemption. IRC § 162(k). However, practitioners should note IRC § 311 does apply to these buy-sell transactions, which can lead to a tax on a corporation where it distributes appreciated property in exchange for the stock.

Note also, that 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. IRC § 312. As a practical matter under Section 301, 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.

**b. Cross Purchase.**

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. For stock that is received from a decedent, there will typically be little or no tax consequences, 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 tax payer 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. There are other exceptions as well that would apply, but they are rare, and typically 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 installment sales, which will be addressed infra.
2. S Corporations

Redemptions of S Corp stock bring up the same major issues as with an entity purchase of a C Corporation stock, in that the first question to determine is whether or not 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.

a. Entity Purchase

The same rules for C corporations apply to S corporation redemptions by an entity, and in that same analysis this must be undertaken. 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 simple, because there will be no accumulated E&P. IRC § 1371(c)(1). 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. IRC § 1368(b).

For non-pure S corporations, the analysis requires a review of the accumulated adjustments account. Section 1368 of the Code 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:

1. 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. IRC § 1368(c)(1).

2. All amounts in excess of AAA will be taxed as a dividend, up to the total amount of the corporation’s E&P. IRC § 1368(c)(2);

3. 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. IRC § 1368(c)(3).

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.
b. Cross Purchase Agreement

Cross purchase agreements for S corporations are treated essentially the same as with a C Corp sale, in that they will be given sale or exchange treatment. One important difference is that the basis of the shareholders after the redemption will be increased to reflect the purchase price of the stock purchase. This is important to the remaining shareholders, since S corporation shareholders can deduct net corporate losses up to their adjusted bases in their stock. See IRC § 1366(d)(1). 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 Section 1368(c).

One other consideration for cross purchases of S Corp stock is whether the corporation will elect to “close the books” for the corporation, where the shareholder completely terminates his or her interest in the corporation. IRC § 1377(a)(2). Note that the corporation must agree to such a proposal, and thus it may be wise to put a provision in the buy-sell agreement requiring the corporation 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.

c. One Class of Stock Requirement.

Perhaps the most unique issue involved with either 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. Reg. § 1.1361-1(1)(2)(iii)(A). 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(1)(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 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.” Under Reg. § 1.1361-1(1)(2)(iii)(C), a determination of book value will be respected where (1) the book value is

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determined in accordance with Generally Accepted Accounting Principles (including permitted optional adjustments); or (2) the book value is used for any substantial nontax purpose.

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. See, e.g., PLR 200914019; PLR 9803008. 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.

d.  **Closing the Books – Section 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. IRC § 1377(a)(2). 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 prior to the date of the transaction. Reg. § 1.1377-1(b)(3). 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.

3. **Partnership Interests**

The treatment of sales proceeds generated for the sale of partnership interests is much different than the sale of a corporate stock, mainly due to some special rules that are required to be considered for partnership interests. Although these materials will not go in depth to the partnership rules, the following represents a brief summary of how such a sale will be treated for both an entity purchase as well as a cross-purchase.

a.  **Entity Purchase:**

Redemptions of partnership interests are governed under Section 736 of the code. However, the rule 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 and 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. Payments considered received as a payment for goodwill are treated as distributive share of partnership profits, rather than as capital gain, or they are treated as a guaranteed payment. IRC § 736(a)

Under Section 751, the amount attributable to unrealized receivables or inventory will be taxed as ordinary income, with the remainder being taxed as capital gain to the extent it exceeds the partner’s basis in the interest. This is the commonly referenced “Hot Assets” rule for partnership distributions, and is a major difference between corporate redemptions and partnership redemptions. For inventory in redemption transactions, the Section 751 hot asset rule applies, but only if the inventory 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.”

For general partners and service partnerships, it is important to address the allocation to be made under Section 736 for the redemption payment. The selling partners will typically want the payments to be considered as Section 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 sells proceeds under Section 736(b) as for payments 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. See Reg. § 1.736-1B.

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

Even where Section 736(b) applies, the practitioner must refer to Section 751(b) to the extent that the distribution is received for unrealized receivables or substantially appreciated inventory, which can result in recharacterization of at least a portion of the purchase price as ordinary income. All other amounts in that situation would be treated as a capital gain under Section 731 of the Code.

b. 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 Section 731. However, the “hot asset” rules of Section 751 apply to partnership cross purchases, 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. See IRC 751(a). 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 Section 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.

Note also that for cross purchases, existing Section 754 elections can come into play to determine the adjustments (either up or down) of the partnership’s basis in its assets, and the purchasing partner’s respective bases in their interests in the partnership.

c. 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.

IRC § 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 IRC § 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 IRC § 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 Section 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.

B. ESTATE TAX ISSUES

The main issues for buy/sell agreements in the area of estate and gift tax is found in the issue of valuation, specifically over whether the IRS will recognize the values established by the buy/sell agreement as a fair statement of the value of the business interest. As noted earlier, many business owners utilize buy/sell agreements to fix the value of the
business interests at what they deem to be an acceptable level, even though the amount agreed upon may be lower than fair market value. In a family context, many business owners utilize buy/sell agreements and other restrictions to essentially “freeze” the value of the business interests for purposes for estate taxes.

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

1. Pre-1990 agreements:

How the IRS treated buy/sale agreements prior to 1990 is primarily determined by case law. There is a brief regulation on this issue found in Reg. § 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.

Reg. § 2031-2(h). From this brief regulation, courts have devised a four part test to determine whether or not the IRS will accept the purchase price dictated the buy/sale agreement. 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/sale 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/sale agreement;

4. The buy/sale agreement is not a device to transfer the business interests to the natural objects of the decedent’s bounty for inadequate consideration.

See *Wilson v. Bowers*, 57 F.2d 682 (2nd Cir. 1932); *Lomb v. Sugden*, 82 F.2d 166 (2nd Cir. 1936).

By far, the last requirement, which is called the “device test”, is by far the most subjective, and is subject to many conflicting rulings by the IRS and the courts. Furthermore, the device test is typically applied to intrafamily transfers, since transfers among non-related business owners would seem to fall outside the rule. Factors which come into play for this test include such facts as the health of the owners; failure to honor the agreement in prior instances; and other factors which indicate that the proposed price in the agreement is merely intended to effectuate a transfer to the decedent’s family and avoid taxation. The 2001 case of *Estate of True v. Comm.*, TC Memo 2001-167 (2001) provides an excellent example of the application of this test in an intrafamily scenario.

Note that the IRS will apply the rule to unrelated business owners where it deems it appropriate, especially where the value fixed for the business interest is significantly less than fair market value. See, e.g., *Estate of Carpenter*, TC Memo 1992-653 (1992). However, courts are less likely to find that the test is met in such circumstances, since 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. *Id.*

2. **Post 1990 Buy/Sell Agreements**

IRS § 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 Section 2703 are 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 that test into two parts. The change on that test is that now 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 presented by the taxpayer. Some prior cases had indicated that where the taxpayer proved that the agreement was a bona fide business arrangement, then that fact could be used to argue that the device test was met, but any conflict on that issue, at least as it pertains to related party transactions covered by Section 2703, is now resolved.

The final requirement in Section 2703 is new, and perhaps constitutes the biggest proof problem for any buy/sell agreements in this area, as you must show 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. 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.

Case law interpreting this provision typically relies upon expert testimony to establish that the buy/sale agreement is comparable to other agreements in the market. See e.g. Estate of Blount vs. Commissioner, 2004-116 (2004); Estate of Smith v. United States, T.C. Memo 2004-116. A review of the cases and private letter rulings in this area shows that on this particular element the inquiry is fact intensive, and accordingly both the examples in the regulations and the case law should be reviewed in determining whether the requirement can be met.

For good examples of the application of Section 2703 to particular circumstances, see Holman v. Commissioner, 94 AFTR 2d 2004-5627 (D.C. Pa., 2004) and Estate of Amlie v. Commissioner, 130 T.C. 170 (2008) aff’d, 105 AFTR 2d 2010-721 (8th Cir. April 7, 2010).

3. Safe Harbor Exception for 2703 for Unrelated Parties

Importantly under the regulations, specifically Reg. § 25.2703-(1)(b)(3), the IRS will presume the buy/sell agreement meets the three statutory exceptions to Section 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 who have buy/sell agreements, the first issue that should be reviewed is whether or not Section 2703 even applies, due to this exception.

4. **Effect on marital deduction.**

Under IRC Section 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 Private Letter Ruling 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 Court held that this right effectively converted the spouse’s interest in the stock into a “terminable interest” under Section 2056(b)(1), and thus the marital deduction was denied for the trust.

Case law on this issue seems to confirm the IRS’s position on this Private Letter Ruling. See, *e.g.*, *Renaldi v. U.S.*, 97-2 USTC 60,281 (Fed. Cl. 1997), aff’d, 178 F.3d 1308 (Fed. Cir. 1997). 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.

5. **Effect on Annual Exclusion.**

To qualify for the annual exclusion under IRC Section 2503(b), a gift must constitute a “present interest.” The impact of restrictions on the sale of stock in closely held businesses has been subject to numerous cases, and the Courts clearly review the restrictions on sale in making that determination. For example, in the oft-cited case of *Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003), the Court addressed whether the annual exclusion could apply to the gift of certain interests in a family-owned LLC. The interest transfer was subject to numerous restrictions, including a requirement to offer to settle the interest to the LLC and a requirement of manager consent for any third party sales. The donor in this case 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 accordingly the annual exclusion did not apply. The Court applied the “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.

The gifting of stock or membership interests in closely held businesses is a widely utilized tactic by practitioners for transferring interests in a business to
family members, while preserving the donor’s applicable exclusion amount through use of the annual exclusion to exempt the gift from gift tax coverage. Where those interests are subject to numerous restrictions, including buy-sell provisions commonly used in many operating agreements, practitioners should exercise caution in advising clients on this point, and should carefully structure the transaction to avoid an adverse ruling such as in the Hackl case.

6. **Estate Tax Deferral Issues for Buy-Sell Agreements.**

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 IRC Section 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, and then ten 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 Section 303 to assure sale or exchange treatment to the seller of the stock.

The trap for the unwary under this rule is found in Section 6166(g), which provides the rule that deferral is not available where the estate sells fifty percent or more of the decedent’s business interests during the deferral period. Redemptions under Section 303 are specifically excluded from this rule. IRC Section 6166(g)(1)(B). However, that rule only covers redemption agreements that don’t 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 fifty percent of the interest of the decedent, the deferral provisions of Section 6166 are not available.

Revenue Ruling 86-54 provides a detailed explanation of the relationship between Section 303 and Section 6166. In that revenue ruling, the IRS affirms the “series redemption” approach under Section 303 in order to take advantage of the deferral under Section 6166, stating that each redemption during the ten-year period will be treated separately. 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. See PLR 9202020 (affirming such an approach).

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