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Buy-Sell Agreements and Their Role in Business Succession Planning

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Introduction

The death, disability or retirement of a controlling owner in a family-controlled business can wreak havoc on the entity that the owner may have spent a lifetime building from scratch. If not adequately planned for, such events can lead to the forced sale of the business out of family hands to an unrelated third party.

Business succession planning for family business owners can be especially challenging because it overlaps several legal and non-legal disciplines. Good planning requires mastery of sophisticated estate planning techniques, as well as an understanding of corporate, partnership and limited liability company law and income tax issues relating to each. That, however, may be just the tip of the iceberg. The relationship among the children, the relationship between the children and the business owner's spouse (particularly in the case of a second marriage), the willingness of the business owner to designate a single successor as the new "leader" (even if there is an equal division of ownership among the children in economic terms), and the business owner's ability to come to grips with the fact that one day the business will continue without him are just a few of the dynamics affecting the atmosphere in which the business succession plan must be formulated.

The significance of business succession planning cannot be overstated, both at a macro level and at a micro level. More than 90 percent of all U.S. businesses are family businesses. These, in turn, account for approximately 97 percent of the nation's employers.[1] Despite the significance that they occupy in the U.S.

economy, it is estimated that only 30 percent of family businesses pass to the second generation, only 12 percent pass to the third generation, and only 3 percent reach the fourth generation.[2]

Buy-Sell Agreements in General

The foundational document for business succession planning is generally a buy-sell agreement.

A buy-sell agreement is an agreement between the owners of a business, or among the owners of the business and the entity, that provides for the mandatory purchase (or right of first refusal) of an owner's equity interest, either by the other owners or by the business itself (or some combination of the two), upon the occurrence of specified triggering events described in the agreement. Such triggering events can include the death, disability, retirement, withdrawal or termination of employment, bankruptcy and sometimes even the divorce of an owner. Buy-sell agreements may be adapted for use by all types of business entities, including C corporations, S corporations, partnerships and limited liability companies.

A buy-sell agreement does not have to be a standalone agreement. Indeed, in many cases, buy-sell provisions are contained in existing organizational documents. Depending upon the circumstances, these existing provisions may need to be amended or overridden by a standalone buy-sell agreement if the family's business succession plan is to be successful.

Reasons for Establishing a Buy-Sell Agreement

The primary objective of a buy-sell agreement is to provide for the stability and continuity of the family business in a time of transition through the use of ownership transfer restrictions and to establish a mechanism to determine the selling price of the owner's interest in the entity. Typically, the agreement prohibits the transfer of ownership to unrelated third parties by setting forth how and to whom shares or other equity interests may be transferred. The agreement also provides a mechanism for determining the sales price for the equity interests and how the purchase will be funded.

There can be other reasons for having a buy-sell agreement as well. For the founder of the business, who has built the business from scratch and feels that no one can run the business as well as he can, a buy-sell agreement allows him to maintain control of the business while at the same time providing for a smooth transition of control to the founder's chosen successors upon his death or disability. Structuring a buy-sell agreement provides a nonthreatening forum for the founder to consider which children should be managing the business in the future and which should not. Generally, the founder will only want those children who are active in the business to own a controlling interest in the business, but will want to treat all children equally from an economic standpoint. By implementing the founder's wishes, a properly structured buy-sell agreement can avoid disputes between children who are active and want to invest in the business and those who are not active and would rather have the business pay dividends. In addition, if the founder becomes disabled or retires, a buy-sell agreement can provide the founder with the security that his cash flow will not disappear because the agreement can provide for the company and/or the other owners to purchase his ownership interest at a predetermined price (including at a price established by an independent appraisal), either in a lump sum or installments, typically at preferential capital gains tax rates.

For those children who are active in the business, a properly structured buy-sell agreement will allow them to purchase the founder's shares over time on terms that have been negotiated at arm's length and will not cripple their ability to operate the business effectively, and that may have been at least partially paid for using life insurance. The agreement also provides a mechanism for not having to go into business with siblings (and spouses of siblings) that are not active in the business.

For the entity, a buy-sell agreement can help keep the business in the family and ensure the smooth transition to the next generation. The agreement can also void transfers that would otherwise result in the termination of the entity's S corporation status.

For the estate of the founder, a buy-sell agreement can (i) provide a market for an illiquid asset; (ii) provide liquidity to pay any estate taxes; (iii) provide for a surviving spouse; and (iv) under certain circumstances fix the value of the ownership interest for federal estate tax purposes.

Structuring the Terms of the Buy-Sell Agreement

The following questions should be considered in structuring the terms of the buy-sell agreement:

- Is the business a C corporation, S corporation, limited liability company or partnership (including a limited partnership)?

- What is the optimal way to value this type of business: a fixed amount, a formula, an independent appraisal, or some other method?

- Are there non-family members who own equity interests and will family members be given preference?

- Are the owners young enough and healthy enough to qualify for life and/or disability insurance?

- Should the business or the other owners purchase the equity interests?

- Which family members should be allowed to become owners?

- What is the Working relationship among the owners?

- How will the terms of the buy-sell agreement impact provisions in the business's organizational documents?

- Are there restrictions under loan agreements on the use of the entity's assets to redeem equity interests?

- Other than insurance, what sources of liquidity are available to fund the purchase of the ownership interests?

- Which of the many triggering events (such as death, disability or retirement) will be included in the agreement?

- Which triggering events will require a mandatory purchase by the business and/or the other owners, as opposed to a right of first refusal?

Types of Buy-Sell Agreements

There are three general types of buy-sell agreements: a cross-purchase agreement, a redemption agreement, and a hybrid agreement.

In a cross-purchase agreement, the remaining owners are required to buy, or are given a right of first refusal over, the ownership interests of the deceased or withdrawing owner.

In a redemption agreement, the business itself is required to, or is given the option to, buy the ownership interests of the deceased or withdrawing owner.

In a hybrid agreement, the business typically has the first opportunity to purchase the ownership interests of the deceased or withdrawing owner, with any ownership interests not purchased by the business required to be purchased by, or optioned to, the other owners. In addition, if the agreement so provides, this sequence can be reversed between the business and the other owners. Importantly, in the case of a C corporation, the corporation should have the initial obligation to purchase the shares under a hybrid agreement if such purchase obligation is also to be imposed upon the shareholders. Otherwise, if the corporation purchases shares that the other shareholders are obligated to purchase pursuant to the agreement, the shareholders will be deemed to be receiving dividends taxable as ordinary income to the extent that the corporation has earnings and profits.[3]

Choosing the Right Type of Buy-Sell Agreement

In choosing among the three broad categories of buy-sell agreements (cross-purchase, redemption or hybrid) the key decision to be made is who should be the purchaser. Will it be the remaining owners (cross-purchase), the entity (redemption), or a combination of the two (hybrid)?

It is also essential to consider how the purchase will be funded, and the extent to which life insurance will play a role. If life insurance will be used and there are multiple owners, a cross-purchase agreement may be cumbersome. The reason for this is that (unless a partnership or a trust is used to own the insurance policy) a typical cross-purchase agreement requires each owner to own a policy on the life of every other owner. For example, if there were five shareholders of a corporation, there would need to be twenty life insurance policies because each of the five shareholders would need to own separate polices on the lives of the other four shareholders. Six shareholders would therefore require thirty policies (6 x (6-1) = 30), unless the shareholders formed a partnership or limited liability company, or established a trust, to own the life insurance policies. The use of a partnership, a limited liability company or a trust can also avoid the "transfer-for-value problem" for income tax purposes.[4]

With a redemption agreement, there would only need to be a single life insurance policy on the life of each owner because the business is the only purchaser. But there are caveats: among other things, if the business is a C corporation and a redemption agreement is used, the corporate alternative minimum tax may apply, which would render taxable 75 percent of the otherwise non-taxable life insurance proceeds. Another factor in determining which type of buy-sell agreement to choose includes who has the ability to pay for the purchase of the ownership interests (the corporation or the owners).

The nature of the entity can result in different income tax consequences depending on the type of buy-sell agreement chosen. If the family business is a C corporation, the attribution rules under section 318 of the Internal Revenue Code ("I.R.C. or Code") (which attributes shares owned by certain family members, estates, trusts and businesses to other family members) may result in the redemption not qualifying for capital gains treatment under I.R.C. section 302(b) and therefore being treated as a dividend for income tax purposes. In contrast, a cross-purchase agreement will always produce a capital gains transaction, and assuming that the deceased owner's shares have been stepped up to their fair market value upon death pursuant to I.R.C. section 1014, there may be little or no gain. Moreover, if the business is an S corporation or a partnership (including a limited liability company that is taxed as a partnership for federal income tax purposes), a redemption agreement would not result in ordinary income to the outgoing business owner or to his estate.

Ethical Considerations

In many cases, it will be essential that the adviser clarify to the owners that the adviser is not representing any of the individual owners and that each of them should seek independent counsel in connection with the buy-sell agreement. As a practical matter, in many instances the owners will not seek independent advice. However, where the adviser has a longstanding relationship with one or more of the owners, but not all of them, it is essential that the other owners be advised to seek independent counsel. Not only will this protect the adviser from a later charge of violating ethical requirements, but it will also increase the likelihood that the agreement will be upheld by a court in the event that there is a dispute among the parties relating to the negotiation of the agreement.

Setting the Purchase Price

One of the most important functions of a buy-sell agreement can be to set the purchase price for an otherwise illiquid asset. There are several ways in which this can be done. One common way to set the price is by the periodic agreement of the owners. The main concern with this approach, however, is that the owners may fail to meet regularly and therefore the price will not reflect current values.

A second approach is to set the purchase price by a formula that takes into account such factors as book value and multiples of earnings. It is a good practice to use a valuation expert if a formula clause is employed.

Another method to set the price is to require that it be determined by an independent appraisal of value as of the date of the triggering event, which gives the owners the assurance that the purchase price will reflect the conditions existing at the time that the interest is to be purchased. The agreement can provide the method by which the appraiser is selected, and can also provide that if the selling owner disputes the first appraisal, he may commission a second appraisal (typically at his own expense). If the appraisals are within a specified percentage range of one another, then the purchase price may be the average of the two. Otherwise, the two appraisers may be instructed to pick a third appraiser, whose expense is split evenly and whose appraisal becomes binding on the parties.

Mandatory or Optional Purchase

A decision should be made as to whether the purchase or sale will be mandatory, or whether the entity or remaining owners will only have an option or right of first refusal.

In most cases, the withdrawing owners or the deceased owner's estate should be obligated to sell if one of the goals of the buy-sell agreement is to limit owners to persons active in the business.

The withdrawing owner, or the deceased owner's estate, would likely prefer that the entity or the remaining owners be obligated to purchase the interest for the following reasons:

- Absent an obligation to purchase, the entity or the remaining owners may decide that there is no practical reason to purchase the interest of the withdrawing owner or the deceased owner's estate if the interest is a minority (i.e., non-controlling) one.

- It is unlikely that the withdrawing owner or deceased owner's estate will find a ready market for a minority interest in a closely held business.

- A minority owner in a closely held business may potentially derive little or no current economic benefit as a result of owning the interest because he cannot compel the business to make him an employee, officer, managing partner or director of the business.

- A minority owner may have no voice in the affairs of the business and may not be entitled to be compensated, unless he is rendering agreed-upon services to the entity.

- A closely held C corporation is unlikely to pay substantial dividends, because the dividends are not deductible for tax purposes, while reasonable compensation is deductible.

- In an S corporation, partnership, or LLC, the owners of the majority interest, or the general partners or member-managers, will have control over the distribution of profits to the owners, unless otherwise agreed, and absent an agreement, there will be no distributions to pay taxes on the owners' share of the profits.

Restrictions, "Drag-Along," "Tag-Along" and Other Rights

The buy-sell agreement usually should contain restrictions on owners' voluntary transfers of interests in the business. Transfers may be permitted to an owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions. In contrast, transfers to third parties may be permitted after first offering the interest to the entity or the other owners, either at the price determined under the agreement or at the lower of the price determined under the agreement and the price offered by a third party.

The agreement may also contain "drag-along rights," which provide that if a certain percentage of the equity interests are being sold to a third party, the selling equity owners have a right to require the remaining equity owners to join in the sale at the same price and on the same terms that apply to the selling equity owners.

In addition, the agreement may contain "tag-along rights," which provide that if the equity owners of more than a certain percentage of the equity interest have agreed to sell their equity interests to a third party, the other equity owners have the right to join in the sale at the same price and on the same terms that apply to the selling equity owners. If, however, other equity owners are not permitted to join in the sale, they would then have the right to purchase the equity interest of the selling equity owners at a purchase price equal to the lower of the price determined under the agreement and that offered by the third party on the terms described in the agreement or contained in the offer by the third party, whichever are more favorable to the other equity owners.

Furthermore, the agreement may provide for an adjustment in the purchase price if either a certain percentage of the equity interests or a certain percentage of the assets of the entity are sold within a certain period of time. The adjustment would allow the equity owners who have recently sold their interests either to the entity or to the other equity owners the advantage of the increased value of the entity, as determined by the subsequent sale.

Funding the Buy-Sell Agreement

Proper funding of a buy-sell agreement is crucial to its success. The primary funding methods are (i) life insurance, (ii) an installment note, and (iii) a sinking fund. These funding methods can be combined.

Life insurance is an extremely common and effective funding mechanism. Whether owned by the business in a redemption agreement or by the other owners (or a partnership, limited liability company or trust that they establish) in a cross-purchase agreement, it provides the purchasers with the ability to guarantee that a certain amount of money will be there at the death of the owner provided that the premiums are paid. Some form of permanent insurance (such as whole life, universal life or variable life) is generally employed rather than term insurance, which gets more expensive as the insured ages and may not be able to be renewed beyond a certain age (usually between 60 and 70 years of age).

There are downsides in certain circumstances to using life insurance to fund a buy-sell agreement. As mentioned earlier, if a cross-purchase agreement is chosen and there are more than two owners, each owner will need to purchase a life insurance policy for every other owner (unless a partnership, limited liability company or trust were established to own the life insurance).[5] In addition, although life insurance proceeds are typically income tax-free, if a C corporation uses life insurance to fund a redemption agreement, 75 percent of the life insurance proceeds will be subject to the corporate alternative minimum tax if the corporation has gross receipts in excess of $7.5 million. Further, where life insurance is used to fund a corporate redemption agreement, there is a significant risk that the insurance proceeds will be included in the valuation of the business for estate tax purposes.[6]

Life insurance, however, has its limitations. As the business owner ages, premiums may become prohibitively expensive. In addition, some business owners will have health issues that render them uninsurable. Moreover, life insurance does not provide for handling lifetime transfers under a buy-sell agreement, such as disability or retirement. In the case of disability as a triggering event, disability insurance could be purchased to satisfy the obligation. In the case of retirement, it is possible, however, that the cash value of the life insurance could be used to satisfy a portion of the payout.

A second common funding method is to fund the purchase using an installment note. This will potentially enable the purchase to be funded out of the cash flow of the entity or the remaining owners. In addition, the installment sale may qualify for capital gains deferral under Code section 453. An installment note can be used either in lieu of, or in conjunction with, life insurance funding. Structuring the installment note is like structuring any other kind of promissory note. The parties must choose a term and an interest rate. A commercially reasonable interest rate based on what lending institutions would charge can be chosen or the interest rate can be tied to the "applicable federal rate" under Code section 1274(d). In the family business context, the applicable federal rate should be the floor for the interest rate so that the Internal Revenue Service ("IRS") will not recharacterize a portion of the loan as a taxable gift. In many cases, the buy-sell agreement will require the purchaser to pledge the purchased ownership interest as collateral until the loan is completely repaid.

A third (and the least common) way to fund the buy-sell agreement is through the creation by the business entity of a sinking fund accumulated over time for the purpose of funding the buyout. Any shortfall in meeting the purchase obligations could potentially be funded through loans. The obligation to purchase could, however, put the entity at a disadvantage in negotiating with banks or other financing sources. Banks may be reluctant to make loans to a business for payment to a withdrawing owner or the estate of a deceased owner unless the loan is well-collateralized or guaranteed by persons with significant net worth.

Coordinating the Buy-Sell Agreement with the Estate Plan

It is absolutely essential that the terms of the buy-sell agreement be coordinated with the rest of the business owner's estate plan. It could be disastrous if the terms of the owner's will and the buy-sell agreement contradict each other. Important issues to consider include (i) determining the fiduciaries (for example, the necessity of an independent trustee), (ii) how the estate tax should be apportioned and who will pay any additional estate tax if the IRS or the courts determine that the buy-sell agreement price is too low, and (iii) how the terms of the buy-sell agreement will impact the ability of the estate to take advantage of certain post-mortem estate planning opportunities, such as the ability to qualify for the election to defer estate taxes under Code section 6166.

Fixing Estate Tax Values

The value of an asset for federal estate tax purposes is its fair market value at the time 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."[7]

The IRS, for decades now, has expressed concern in the family business context that the price set forth in the buy-sell agreement may not accurately reflect fair market value because using an artificially low valuation would benefit the family by minimizing the amount of any estate tax. A complex body of law has developed in this area.

It can be very difficult to use a value in a family business buy-sell agreement other than fair market value and have it respected by the IRS. Significantly, although the value set forth in the agreement is not binding on the IRS, it will be contractually binding on the parties to the agreement, which can cause potentially disastrous results. If the deceased owner's interest in the business that is subject to the buy-sell agreement passes to the deceased owner's surviving spouse under his estate planning documents, this can potentially accelerate estate tax to the first spouse's death even though the estate plan has been drafted with formula provisions that are intended to defer all estate taxes until the death of the surviving spouse. This horrific result of accelerating substantial estate taxes to the first spouse's death can occur because estate tax inclusion resulting from buy-sell agreements can create "phantom assets" that are included in the gross estate of the first spouse to die; but because they are not "real assets," they are unable to pass to the surviving spouse to qualify for the federal estate tax marital deduction. This mismatch between gross estate values and marital deduction values could produce substantial estate taxes upon the "first death," in sharp contrast to the client's likely expectation that the marital deduction would shield the husband and wife from federal and state estate taxes until the death of the surviving spouse.

Prior to 1958, the courts generally would respect the price set forth in a buy-sell agreement for establishing estate tax values. As long as the agreement was binding on the owners both during life and at death and was legally enforceable, the agreement price would be respected even if it was significantly lower than actual fair market value.

In 1958, the IRS issued regulations under I.R.C. § 2031 that were intended to curb perceived valuation abuses. Treasury Regulation § 20.2031-1(b) defines *fair market value* as the price that a willing buyer would pay a willing seller for the property, both with reasonable knowledge of the relevant facts and neither being under a compulsion to buy or to sell. According to Treasury Regulation § 20.2031-2(h), the price set forth in the agreement will be disregarded in determining value for estate tax purposes unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and is 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.

The regulations under section 2031 were elaborated upon by the courts to establish a four-part test to determine whether the agreement price would be respected for estate tax purposes. The four requirements are as follows:

- The agreement sets a fixed price for the shares or one that is determinable by an ascertainable formula.

- The agreement is binding both during the deceased owner's lifetime as well as at his death. This requirement is satisfied as long as the deceased shareholder's estate is required to sell, even though the other parties are not required to purchase the shares but instead have only a right of first refusal.

- The agreement prohibits lifetime transfers at a price higher than the agreement price. Gratuitous transfers during life are permissible provided that the donees become subject to the restrictions of the buy-sell agreement.

- The arrangement is a bona fide business arrangement and is not a device to pass the business interests to the natural objects of the decedent's bounty for less than adequate consideration.

Historically, courts considered the fourth requirement to be satisfied as long as the price set forth in the agreement reflected actual fair market value at the time that the agreement was entered into, not at the date of the shareholder's death. This was the case even if the price under the buy-sell agreement was substantially lower than the fair market value.[8]

This four-part test was the *sole* standard for determining whether a buy-sell agreement would be respected for estate tax purposes prior to the enactment of section 2703 in 1990.

The Impact of Code Section 2703

On October 8, 1990, Congress enacted Code section 2703 to curb perceived valuation abuses in the area of buy-sell agreements. Code section 2703 applies to all buy-sell agreements entered into after October 8, 1990, as well as to those agreements that were entered into prior to October 8, 1990 but substantially modified after that date. Code section 2703 expands on the four-part test already in existence by breaking the fourth part of the test into two requirements and then adding a new third requirement.

Under Code section 2703(a), the estate tax value of property shall be determined without regard to (i) any option, agreement or other right to acquire or use the property at a price that is less than the property's fair market value (without regard to such option, restriction or right), and (ii) any restriction on the right to sell or use such property. This means that the general rule under Code section 2703 is that the restrictions on price in a buy-sell agreement or similar provision of any other document will be disregarded in determining the estate tax value of the property.

Code section 2703(b) provides that such option, agreement, right or restriction will *not* be disregarded for estate tax valuation purposes if the following three requirements are met:

- The option, restriction or agreement is a bona fide business arrangement.

- The option, restriction or agreement is not a device to transfer such property to members of the decedent's family (expanded to the "natural objects of the transferor's bounty" in the corresponding regulations) for less than full and adequate consideration in money or money's worth.

- The terms of the option, restriction or agreement are comparable to similar arrangements entered into by persons in an arm's length transaction.

The first two requirements basically divide the fourth requirement of the test that preceded the enactment of Code section 2703 into two parts, both of which must be satisfied. Not only must the option, restriction or agreement be part of a "bona fide business arrangement," but such option, restriction or agreement must also not be merely a "device" to transfer such property to the natural objects of the deceased owner's bounty for less than full and adequate consideration.
Importantly, the courts have recently held that these two requirements generally will not be satisfied where the entity does not conduct an active trade or business, but instead holds a portfolio of marketable securities or undeveloped real property.[9]

The third requirement under Code section 2703(b) (the comparability requirement) was without precedent under prior law and effectively eliminates the ability of buy-sell agreements to fix values for estate tax purposes for a family business where the values are substantially lower than true fair market values. Code section 2703(b) requires that in order to be binding for estate tax purposes, the terms of the option, restriction or agreement must be "comparable to similar arrangements entered into by persons in an arms' length transaction." Treasury Regulation § 25.2703(1)(b)(4) provides that a right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain negotiated among unrelated parties in the same business dealing with each other at arm's length. In determining whether a right or restriction meets the "fair bargain" requirement, the regulations require consideration of such factors as (i) the expected term of the agreement, (ii) the current fair market value of the property, (iii) anticipated changes in value during the term of the arrangement, and (iv) the adequacy of any consideration given in exchange for the rights granted.

The application of the comparability requirement can be particularly challenging for estate planners when preparing buy-sell agreements, as demonstrated by the case law that has addressed this issue.

In *Estate of Blount v. Commissioner*,[10] the court considered a buy-sell agreement that involved the purchase and sale of stock in a construction company. In preparing its estate tax return, the estate relied on the terms of a modified buy-sell agreement between the company and its shareholders to establish the value of the company at $4 million. The IRS, however, argued that the modified buy-sell agreement should be disregarded for estate tax valuation purposes because, among other things, it failed to satisfy all of the three safe harbor requirements under I.R.C. § 2703(b), including the comparability requirement of I.R.C. § 2703(b)(3). The Tax Court agreed with the government, observing that "section 2703(b)(3) requires a taxpayer to demonstrate that the terms of an agreement providing for the acquisition or sale of property for less than fair market value are similar to those found in similar agreements entered into by unrelated parties at arm's length in similar businesses." The court wanted to see as documentary evidence examples of "real-world agreements" containing comparable terms to the buy-sell agreement at issue in that case. The estate, however, failed to meet this burden; and, therefore, the court disregarded the buy-sell agreement for estate tax purposes.

In *Estate of Smith v. United States*,[11] a limited partnership agreement for a limited partnership (the sole asset of which was 100 percent of the common stock of an operating company) contained a right of first refusal (a "ROFR"). The ROFR allowed the partnership and/or partners to purchase another partner's interest before it could be sold to a third party. Among other things, the terms allowed promissory notes payable over a period of up to fifteen years bearing interest at the long-term applicable federal rate. Both the taxpayer and the government agreed that the use of an extended payout provision in the event that the ROFR were exercised would have a depressing effect on the value of the limited partnership interest to be purchased. The government also argued, however, that the extended payout provision should be disregarded under I.R.C. § 2703.

The court considered whether the ROFR satisfied all of the requirements of the safe harbor under I.R.C. § 2703(b) on the government's motion for partial summary judgment. Although the court found that the provision was a bona fide business arrangement, the record lacked sufficient evidence to allow the court to determine whether the provision was a device to transfer property for less than full and adequate consideration. As for the third safe harbor requirement of comparability, the court reviewed affidavits of two attorneys that the taxpayer submitted, which stated that extended payout provisions similar to the one in the Smith partnership agreement were common in agreements among unrelated parties. However, the court held that in order to satisfy the comparability requirement of I.R.C. § 2703(b)(3), the taxpayer was required to show that, when the agreement was made, it was "one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arms' length."[12] Ultimately, the court concluded that the opinions of testifying attorneys were "conclusory in nature"[13] and insufficient to satisfy the comparability requirement.[14]

In light of the foregoing case law, it would seem that the preferred way to proceed from a tax perspective is to base the purchase price in the agreement on one or more appraisals at the owner's death by independent valuation experts using valuation standards that would satisfy the comparability requirements of Code section 2703(b). This approach presents the greatest likelihood of being respected by the IRS for estate tax valuation purposes. If the estate planner and/or the family are concerned that the IRS will not respect the appraisals, the buy-sell agreement can include an adjustment clause that would apply if the IRS valuation was different from the appraisal valuation, which would adjust the purchase price under the buy-sell agreement to reflect the valuation as finally determined for federal estate tax purposes.[15]

Three additional points regarding Code section 2703(b) should be noted:

First, the regulations provide an exception to the requirements of Code section 2703(b) if more than 50 percent of the value of the property subject to the agreement is owned directly or indirectly by individuals who are not members of the transferor's family.[16] Consequently, in such a case, the agreement would have to satisfy only the first three requirements under the case and regulatory law that preceded the enactment of section 2703.

Second, Code section 2703 does not apply to agreements that were in place prior to October 8, 1990, unless the agreement was substantially modified after that date. In this connection, 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 time of the rights of any party with respect to property that is subject to the right or restriction is considered a substantial modification. In addition, if the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. Further, the addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless: (i) the addition is mandatory under the terms of the right or restriction, or (ii) the added family member is assigned to a generation (determined under the generation-skipping transfer tax rules of I.R.C. § 2651) no lower than the lowest generation occupied by individuals already party to the right or restriction.[17]

Third, Code section 2703 is to be applied *in addition to and in conjunction with* (and not in lieu of) the traditional four-part test for determining whether a buy-sell agreement will be respected for estate tax purposes.

Conclusion

Buy-sell agreements are a foundational document in many business succession plans for family businesses. A properly structured buy-sell agreement can ensure that the business passes to the intended beneficiaries and thereby reduce the likelihood of family disputes. In addition, the agreement can provide a market for otherwise illiquid assets as well as a source of funds to pay any estate taxes that may be due upon a business owner's death. Where transfer taxes present an issue, however, great care must be exercised to heed the rules governing buy-sell agreements under both Code section 2703 and the accompanying common law.

[1] Charles D. Fox, IV, PUTTING THE HORSE BEFORE THE CART: NON-TAX ISSUES IN BUSINESS SUCCESSION PLANNING 8-2 (44th Heckerling Univ. of Miami Inst. on Estate Planning 2010).

[2] *Id.* at 8-3.

[3] *See* Rev. Rul. 69-608, 1969-2 C.B. 42.

[4] Generally, life insurance proceeds are not subject to income tax unless the policy has been transferred to another person for valuable consideration. *See* I.R.C. § 101(a)(1). Such a transfer would subject the proceeds payable on the death of the insured to income tax to the extent that they exceeded the purchase price and post-transfer premiums paid by the transferee. The transfer-for-value rule, however, does not apply to a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. *See* I.R.C. § 101(a)(2).

In the case of a corporate cross-purchase agreement, when one of the shareholders dies, the policies that he owns on the lives of the other shareholders cannot be sold by his estate to any remaining shareholder without triggering the transfer-for-value rule, unless one of the exceptions apply. Use of a partnership will constitute one such exception; thus, a partnership among the shareholders that holds the life insurance policies will avoid the transfer-for-value problem.

[5] In contrast, the entity will usually own the life insurance policies in the case of a redemption agreement or a hybrid agreement.

[6] In *Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005), the U.S. Court of Appeals for the Eleventh Circuit, applying dubious reasoning, overturned a Tax Court finding that insurance proceeds should be included in the valuation of the business. According to the Eleventh Circuit, the insurance proceeds should be excluded from the decedent's gross estate for estate tax purposes because they were offset by the corresponding obligation of the corporation to pay the amounts to the decedent's estate pursuant to the buy-sell agreement.

[7] Treas. Reg. § 20.2031-1(b).

[8] *See Randolph v. United States*, 93-1 T.C. ¶ 60,130 (S.D. Ind. 1993).

[9] *See* Holman v. Comm'r, 130 T.C. 170 (2008) (entity holding Dell common stock failed to constitute a bona fide business arrangement, or to meet the device test, for purposes of section 2703), *aff'd*, 105 AFTR 2d ¶ 2010-721 (8th Cir. 2010); Fisher v. United States, No. 1:08-cv-00908 (S.D. Ind. Sept. 1, 2010) (taxpayer failed to establish a bona fide business arrangement for purposes of section 2703 where the entity's principal asset was a parcel of undeveloped real property).

[10] T.C.M. 2004-116, *aff'd in part, rev'd on other grounds*, 428 F.3d 1338 (11th Cir. 2005).

[11] 94 A.F.T.R.2d 5283 (2004)*, rehearing on other issues*, 96 A.F.T.R.2d 6549 (W.D. Pa. 2005).

[12] *Id.* at 5283.

[13] *Id.* at 5283.

[14] *See* Francis X. Burns, Gabriel T. Ratliff & Julia R. Rowe, *Valuing Limited Partnership Interests – Public Documents Provide Objective Evidence of Comparability Under IRC Section 2703*, TR. & EST. (Oct. 2010 at 33) (noting that the section 2703(b) safe harbor requirements are coming under closer examination by the courts and the business valuation community, and suggesting that inquiry be made where appropriate of publicly available limited partnership agreements as a source of real-world comparables).

[15] *See Petter v. Comm'r*, T.C.M. *2009-820* (2009).

[16] *See* Treas. Reg. § 25.2703-1(b)(3).

[17] *See* Treas. Reg. § 25.2703-1(c)(1); Treas. Reg. §

25.2703-1(d), ex. 2. The following are not considered substantial modifications: (i) a modification required by the terms of a right or restriction, (ii) a discretionary modification of the agreement containing the right or restriction if the modification does not change the right or restriction, (iii) a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, and (iv) a modification that results in an option price that more closely approximates fair market value. *See* Treas. Reg. § 25.2703-1(c)(2).

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