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THE USE OF SHAREHOLDERS AGREEMENTS IN ESTATE PLANNING

by

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The primary estate planning goals of a shareholder in a closely-held corporation are normally no different than those of any other individual. In broad terms, those goals are (i) to distribute the individual's assets, upon his death, to the recipients chosen by him, (ii) to minimize the transfer taxes imposed on the distribution and (iii) to insure that sufficient funds are available to pay those taxes. A properly-drafted shareholders agreement can fulfill an important role in reaching each one of these objectives.

DEFINITION

The term "shareholders agreement" is one of a number of phrases (such as, for example, a "buy-sell" agreement) commonly used to describe a contractual arrangement among participants in a business venture, governing the disposition of their business interests during their lifetimes and upon their deaths. Broadly defined in this manner, it can be seen that the phrase can also apply to partnerships and partners (in which event it is usually part of the partnership agreement itself), and, in fact, while some of the aspects of this article relate only to corporations, many points pertain to partnerships as well.

THE ROLE OF THE SHAREHOLDERS AGREEMENT

Focusing on the three primary estate planning goals described above, the role of the shareholders agreement can be summarized as follows.

Distribution of Assets

It can be seen that, in absence of another arrangement, the shares of a closely-held corporation which are owned by a shareholder at his death would pass under the decedent's will, or according to the intestacy laws, frequently to a spouse or child. This, of course, may be a desired result, but, more often than not, it is not. For one thing, if the spouse or child is not to be active in the business, there will frequently be an inherent tension between the surviving active shareholders and the decedent's successors, stemming from such unavoidable conflicts as the need of the successors for a cash return on their shares, presumably in the form of dividends, contrasted with an active shareholder's general desire to avoid dividends (which of course are not deductible to the corporation) and to maximize compensation

instead. Or, as another example of a problem which can be created by the distribution of shares under a shareholder's will, it is frequently desirable from an estate planning standpoint to distribute a portion of the decedent's assets to a trust or trusts; if, however, the corporation had elected to be taxed under Subchapter S, a distribution of stock to a trust would terminate the election under Sections 1371(a)(2) and 1372(e)(3). While these problems may be absent in many business and family situations, it is apparent that any shareholder in a closely-held business should give serious thought to whether his shares would be a desirable asset in his estate. If the conclusion is that they would not be, an appropriate solution to the problem might be a shareholders agreement, providing for a mandatory purchase of the decedent's interest, at his death, by the surviving shareholders, by a third party (e.g. a key non-shareholder employee) or by the corporation itself.

Minimization of Transfer Taxes

Another primary estate planning goal mentioned above was the minimization of estate and inheritance taxes. This, of course, involves many techniques, such as the establishment of an inter vivos gift program, the proper use of the marital deduction in the will, the proper use of generation-skipping trusts and the like. But this goal of tax minimization is especially difficult where a large portion of the client's estate consists of assets in a closely-held business. For one thing, it is frequently of vital importance to the client to maintain control over the business during his lifetime, a factor which often mitigates against an active program of inter vivos gifts or charitable donations. The overall solutions to this problem (such as, for example, recapitalizing into voting and non-voting stock and gifting the latter) are beyond the scope of this article, but it should be pointed out that a shareholders agreement will frequently be desirable as an adjunct to these solutions. More pertinent to the discussion here is the problem caused by the notorious difficulty of valuing closely-held stock for tax purposes. It is not uncommon for a well thought out and carefully executed estate plan to be virtually devastated when the Internal Revenue Service, after auditing the estate tax return, increases the value of closely-held stock contained in the estate to an amount far in excess of the value anticipated by the estate planner. In this connection, a shareholders agreement can play a vital role, since, if that agreement is carefully drafted, the price established in the agreement for the buy-out of the decedent's interest should in many cases constitute the ceiling valuation for tax purposes, even if the buy-out is not in fact implemented and even if the shares in question would, other than for the agreement, have an undesirably higher value. See, e.g., *Wilson v. Bowers* 57 F. 2d 682 (2d Cir. 1932). Two caveats should, however, be mentioned. First, the IRS takes the position that the

existence of a buy-sell agreement, albeit a binding one, should not carry substantial weight in a family situation. To take an example, if A and B are 50 percent shareholders in a corporation, and if B is A's son and only heir, an agreement binding B to purchase A's stock upon A's death at a specified price should have little effect on valuing the stock in A's estate. The Service position on this issue is set forth in Regs. 20.2031-2(h), stating in relevant part that the buy-out 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.”

And even aside from this “bona fide business arrangement” requirement, it is clear that the agreement, in order to “fix” the estate tax value, must govern inter vivos as well as testamentary dispositions (see, e.g., *Estate of Minnie Caplan*, T.C. Memo. 1974-39) and it is also reasonably clear that the buy-out provisions must be more than a mere option to buy in the surviving shareholders or the corporation. And, it is possible that an ostensibly binding buy-out obligation on the part of the corporation will be construed to be a mere option, inadequate to “fix” estate tax values, if it is obvious that there are and will be no funds available to fund the purchase. On the other hand, a “put” option in the estate, binding the corporation or surviving shareholders to purchase the stock if the estate elects to sell it, probably *will* be adequate to establish the value of the stock, at least if the buyer has reasonably adequate resources. At any rate, if all these requirements can be met, it can be seen that the shareholders agreement can fulfill a vitally important role in eliminating the uncertainties of valuation.

Assurance of Liquidity

The third of the major estate tax planning goals listed above was the provision of adequate liquid funds to meet death tax obligations. The special problem posed by this goal to a client with a large block of closely-held stock is obvious, since there are few assets as difficult to convert into cash as closely-held business interests. It is of course possible that there are other funds available to meet these requirements, such as life insurance proceeds, and it is also true that there are statutory provisions intended to alleviate the problem, such as Section 6166, allowing the estate tax to be paid in installments over a period as long as ten years, where a large portion of the estate's value consists of a closely-held business. Not infrequently, however, these other solutions are inadequate, and it becomes necessary to convert the decedent's business interest to cash. If there are no pre-death

contractual arrangements, this conversion can be a difficult one, since the seller normally is in a difficult position with little bargaining power. The advantage of a shareholders agreement in this circumstance is clear, since it can either bind the corporation or the surviving shareholders to buy the decedent's interest (using life insurance proceeds or other resources) or, at the very least, it can give the estate a binding "put" to sell the stock if it wishes to do so.

STRUCTURING THE SHAREHOLDERS AGREEMENT

Having seen, then, that a shareholders agreement can fulfill at least three vital estate planning roles, it is desirable to list, in relatively summary form, the important decisions which must be faced in drafting the agreement.

Manner of Funding

Probably the best place to start in determining the structure of the agreement is to determine the source of the funds needed for the purchase price. There are three basic alternatives here, namely the use of life insurance, the use of corporate funds and the use of other funds owned by the shareholders. The choice among these alternatives will be made on the basis of various business and economic factors, including the cost of insurance, the private resources of the shareholders and the ability of the corporation to generate profits in excess of its operating and expansion needs. Where life insurance is not used, it is frequently desirable to provide that a buy-out can be made on installments; if this is done, provision should be made for interest and, perhaps, for security and guarantees on the unpaid balance.

Redemption v. Cross-purchase

Following the decision on funding, it must be determined whether the agreement should be of a "redemption" type (in which the corporation buys the stock) or a "cross purchase" type (in which the surviving shareholders buy the stock) or some combination of the two. As is usually the case in regard to business planning decisions, there is no conclusive answer to this question, since one type of arrangement might be better in one situation and another type in another.

One factor which must be considered is the relationship of the shareholders. As discussed in more detail below, Section 302 may turn a redemption (normally tax-free at death) into a dividend (ordinary income) if the redeemed shareholder has certain family or other interrelationships with the surviving shareholders. Thus, it is essential for the estate planner to project the likely order of deaths (which is obviously a chancy proposition) and determine whether the Section

302 problem would arise. This problem can be avoided entirely by a cross-purchase agreement, which can never result in a dividend.

Another very important factor in choosing between a redemption or cross-purchase is the source of funds to be used in completing the purchase. If that source is to be the earnings of the business, it is frequently better to use a redemption since that will allow the use of money which has only been taxed once (to the corporation). While the same single-tax advantage will arise if the needed funds can be paid out by the corporation to the buying shareholders in a tax-deductible form, such as compensation, this will frequently be difficult because of the statutory requirement that compensation must be "reasonable" in amount in order to be deductible; it thus will very possibly be necessary to provide the funds to the buyers through non-deductible dividends, meaning that the buying shareholders will be using dollars which have already been taxed twice. On the other hand, if it is clear that the surviving shareholders could properly receive additional compensation, and if they are in a lower bracket than the corporation, it might well be desirable to increase the compensation and thereby subject the funds to a single tax in a lower bracket. As another factor, it should be remembered that the use of corporate earnings to fund a redemption can very possibly create accumulated earnings tax problems under Section 531, a problem which will be discussed in more detail below.

At any rate, if the funds are to be provided not by company earnings but by life insurance, other considerations arise. One very important factor then becomes the number of shareholders since, in a cross-purchase arrangement, each shareholder must own a policy on the life of every other shareholder; where, for example, there are 25 shareholders, a cross-purchase arrangement would require 600 policies, while a redemption plan would necessitate only 25 policies. Also to be considered is the relative age and insurability of the parties; where, for example, one shareholder is substantially younger than the others, the younger shareholder would, in an insurance funded cross-purchase agreement, have to pay substantially larger insurance premiums. Another factor which must be considered when life insurance is utilized is how the policies are to be handled after the death of one of the participants. For example, assume a three man corporation made up of A, B and C, with a cross-purchase agreement. If A dies, his estate will own policies on the life of B (which C presumably would like to obtain for himself, in order to fund his future obligations) and on the life of C (which B would like to obtain). If, however, B and C purchase the policies from A's estate, this will be considered a "transfer for a valuable consideration" within the meaning of Section 101 (a)(2); then, when B or C dies, the proceeds received by the survivor will be income taxable to him (except for the amount he paid for the policy plus subsequent premiums). Again, these considerations will

have no relevance in a redemption agreement. Still another factor when insurance is to be used is that the ownership of the policies by the Corporation will mean that the policies are available for business use, such as collateral for loans, although, on the other hand, they are then subject to the risks of the business and the claims of creditors. Finally, where a redemption plan funded by insurance is envisioned, thought must be given to the effect of the insurance proceeds on the value of the Corporation's stock. Assume a corporation worth \$100,000 with two shareholders, A (owning 90%) and B (owning 10%). If the corporation buys a \$90,000 policy on A's life, its worth at his death will increase to \$190,000 of which, as a 90 percent shareholder, A's estate should get \$171,000. But this would leave only \$19,000 in the corporation, which is unfair to B. What is needed here is an insurance policy which will leave B with a \$100,000 corporation, but that would require a \$900,000 policy on A's life (so that, at A's death, the corporation would be worth \$1,000,000, of which the \$900,000 in insurance proceeds would be paid out to A). In short, where stockholdings are very disproportionate, a redemption-type insurance funded plan may be unfeasible.

One other factor to be kept in mind in deciding upon the redemption or cross-purchase approach is whether it is likely that the corporation will be liquidated or sold by the surviving shareholders. In a redemption agreement, the basis of the survivors' shares remains unchanged, while, in a cross-purchase agreement, the survivors will obtain a basis in the shares acquired from the deceased equal to the price paid for those shares. This increased basis could reduce the overall capital gain upon a subsequent liquidation or sale.

The factors enumerated in the preceding paragraphs will rarely lead to a clear-cut conclusion. It is, however, the obligation of the professional advisor to explore each one of these factors, applying it to the facts at hand, and reaching an overall conclusion on the basis of a careful balancing of all the pros and cons.

Determination of Purchase Price

The next most important decision which must be made in drafting a shareholders agreement is the method to be used in determining the purchase price to be paid for the shares. (Thought should also be given at the same time to the *date* of that determination; obviously a date-of-death valuation may be unworkable, since a death is likely to occur in the middle of a month, at which point a value determination may not be feasible. Even a month-end date may necessitate expensive accounting services if it does not coincide with the closing of a regular accounting period and it may be acceptable in some businesses to use figures as of the most recently ended fiscal year.)

While one very common method of valuation is the use of "book value," it is in the author's opinion a fairly unusual situation in which

this method, standing by itself, will yield a fair result. For one thing, many types of physical assets (such as real estate) will usually have an actual value in excess of "book." And some types of intangible assets (such as good will or patents) may not appear on the balance sheets at all. Further, the method of accounting will have a substantial effect on valuation; for example, a cash basis taxpayer will frequently not show any liability for taxes payable on income already earned. It may be possible to avoid these problems to some extent by providing for specified adjustments (e.g. "the assets shall be valued at book value, except for the corporate real estate, which shall be valued pursuant to an appraisal completed by X Appraisal Company") but it may be best to discard the "book" approach altogether. If "book" is to be used, at any rate, obvious adjustments should be provided for, possible ambiguities (e.g. good will and life insurance on the decedent's life) should be clarified and mechanics provided for determination (e.g. "book value shall be as determined, in accordance with the rules specified herein, by John Jones, CPA").

A possible alternative to the "book value" approach is to use a formula, such as by capitalizing average earnings for a specified period before death. For example, there might first be determined the average earnings of the company over a specified number of years prior to death, which average (perhaps weighted to give more importance to the most recent years) would then be multiplied by a specified factor typical to companies of that size and industry. (Perhaps this earnings value could then be averaged with the company's book value.) A formula approach presents extremely difficult drafting problems (for example, some method should be found for extracting "extraordinary" gains or losses in computing average earnings), but it can be the best method of valuing many types of companies.

A third method of valuation is to use an outside appraisal. If this alternative is chosen, the mechanics of the appraisal should be carefully drafted (including, for example, the source of fees for the appraisers) and instructions to the appraiser should be included (such as the relevance of good will, and the method of valuing inventories).

A fourth alternative for valuation is to use a value established in advance by the parties. Thus, the original agreement could provide for a specified price, and mechanics could be established for periodic revaluations. While practitioners frequently find that clients forget about the periodic valuations, appropriate use of "ticklers" by the company's professional advisors could avoid this problem. Even so, however, it is important to include a "safety valve" if the revaluations are neglected since, otherwise, the parties could be saddled at death with a grossly unrealistic value set many years earlier; one such "safety valve" is a provision switching to a book, formula or appraisal value if the agreed value has not been formally reviewed for a specified period prior to death.

The final vital point to be decided upon is whether the buy-out restrictions are to be mandatory or optional. One possibility is to give the estate a "put," i.e. enabling the decedent's successors to decide whether to keep the shares or sell them to the surviving shareholders or corporation. This approach is obviously of primary benefit to the potential sellers. A second possibility is to give the company or the surviving shareholders an option, giving to it or them the choice of whether to acquire the stock. As noted above, such an option will *not* "fix" the value of the decedent's stock for estate tax purposes. Finally, the purchase and sale can be made binding on both sides. It can be seen that this will be the most equitable result in most situations.

Once the major decisions outlined above are made, the other elements of the contract should more or less fall into place. Some of these other elements are the restrictions to be imposed on inter vivos transfers (which must be drawn carefully to avoid state corporate law restrictions on absolute unalienability); the presence or absence of restrictions on transfers to family trusts, etc.; the applicability of restrictions on transfers to other shareholders (under some state laws, a shareholders agreement will not bar a transfer to an existing shareholder unless the agreement expressly so provides); the possibility for a required or optional buy-out on the *disability* of an employee-shareholder (which provision must take into account the disability provisions and definitions, if any, in the life insurance policies which are intended to fund the buy-out); and the mechanics of the purchase (provisions should be included for the giving of written notices, method of payment, closing dates for purchase, etc.). It can be seen, obviously, that the properly drafted shareholders agreement will be a document of substantial length. Indeed, it can well be concluded that the frequent practice of merely including a paragraph or two on the subject in the corporate charter or by-laws is a totally inadequate method of handling the problem. While it may well be desirable to include in those documents a reference to the agreement (and corporate law requires that such a reference be contained on the stock certificates themselves), any such references should be backed up by a complete and carefully drafted agreement, signed by all the parties.

INCOME TAX ASPECTS OF AGREEMENT

Payment of Premiums

Life insurance premiums paid on insurance used to fund a shareholders agreement will not be deductible, whether paid by the corporation (as under a redemption-type plan) or by the shareholders (e.g. as under a cross-purchase plan). Section 264(a)(1). On the other hand, it is clear that premiums paid by the corporation in a

redemption-type agreement will not be dividend income to the shareholders. See Rev. Rul. 59-184, 159-1 C.B. 65. If the corporation pays premiums on a cross-purchase agreement, however, it is likely that the payments will be dividends.

Accumulated Earnings Problem

Under a redemption-type agreement, the corporation is, of course, utilizing its funds to purchase stock held by the decedent. As noted above, the primary purpose of the redemption is frequently to provide funds for the estate. The question arises, thus, as to whether the accumulation of corporate funds for this purpose (either by building up cash value in an insurance policy to be used to fund the obligation, or by accumulating liquid funds generally) can constitute an accumulation of corporate funds beyond the reasonable needs of the business, subjecting it to the penalty tax of Section 531. The critical question here is whether the primary goal served is that of the corporation or its shareholders, and there have been cases holding both ways on this question. See *Pelton Steel Casting Co.*, 28 T.C. 153 (1957), aff'd, 251 F.2d 278 (7th Cir. 1958) and *Mountain State Steel Foundries, Inc.* 18 T.C.M. 306 (1959), rev'd, 284 F.2d 737 (4th Cir. 1960). In a planning context, it might well be helpful to include in the corporate minutes appropriate evidence of the importance of the agreement to such business factors as the continued stability of the enterprise. One possibly helpful provision is Section 537(b), which specifically includes as a "reasonable need of the business" any funds accumulated to fund a redemption under Section 303 (see below), but only in respect to the year of death or thereafter.

Stock Redemption

In a redemption-type agreement, corporate funds are being paid out to a shareholder. Assuming that the corporation has current or accumulated earnings and profits, the distribution of funds will be a dividend unless it qualifies under one of the exceptions to the dividend rules. (The effect of being treated as a dividend is especially harsh in the context of a buy-out of a shareholder's interest at death; the basis of the purchased stock will have been "stepped-up" at death to its estate tax value, meaning that a purchase of the stock at a fair price will frequently result in no tax at all, while a dividend will be taxed to the recipient in full, and of course at ordinary income rates.) The exceptions which are sometimes available are (i) the "partial liquidation" under Section 346 (which will not be discussed here, since it is rarely available to a continuing business) (ii) the "Section 302" redemption and (iii) the "Section 303" redemption.

Turning first to Section 302, it is provided in effect that a distribution will not be treated as a dividend if it meets one of the criteria speci-

fied therein. One of these criteria, mentioned in Section 302(b)(1), is that the redemption must not be "essentially equivalent to a dividend"; since *Davis v. United States*, 397 U.S. 301 (1970), the availability of Section 302(b)(1) has been severely limited. More important, then, are the criteria specified in Section 302(b)(2) (which applies if, after the redemption, the redeemed shareholder's interest is substantially disproportionate, as defined, to his ownership prior to the redemption) and Section 302(b)(3) (which applies if the redemption completely terminates the shareholder's interest). The major problem in satisfying these rules arises where the various shareholders are related to each other since, in determining whether a deceased shareholder's interest will be disproportionately reduced or terminated, the Code applies very wide-ranging "attribution" rules, under which stock owned by others will be deemed to be owned by the person or entity whose interest is being redeemed. A complete study of these attribution rules (and the possibility for waiving them under some circumstances) is beyond the scope of this article, but an example would be helpful to illustrate the problem. Assume that there are three equal shareholders, A, B and C. B is A's son. A dies and, under his will, his shares are to go to W, A's wife (and B's mother). B's shares, under the attribution rules, are considered to be owned by W and W's constructively owned shares will be considered to be owned by the estate, of which W is a beneficiary. Accordingly, a redemption from the estate will not qualify under Section 302, and the amount paid for A's stock will be treated as a dividend to the estate. While proper planning may avoid this problem, it can be seen that, without such planning, a mandatory buy-out contract could be disastrous. It is clear, then, that any redemption-type agreement must be drafted with the potential Section 302 ramifications in mind.

A partial solution to the Section 302 problem is sometimes provided by Section 303. Under that Section, a redemption will avoid dividend treatment if the redeemed shares' value constitutes a large part of the decedent's estate (specifically, more than 35 percent of the gross estate or 50 percent of the taxable estate). An important limitation is that Section 303 only applies to the extent of the taxes (state and federal) imposed on the estate, plus deductible funeral and administrative expenses. There is no requirement that a Section 303 redemption must be made pursuant to a pre-death agreement nor that any such agreement specifically refer or limit itself to Section 303. Accordingly, the availability of Section 303 is just another planning factor for a professional advisor to take into account in structuring the shareholders agreement.

One other possible redemption tax trap should be mentioned. If the shareholders agreement provides for a cross-purchase, a corporate redemption would be considered as the use of corporate funds to meet what was really a personal obligation of the surviving shareholders,

resulting in a dividend. See *United States v. Wall*, 164 F.2d 462 (4th Cir. 1947). An easy way to avoid this problem in drafting is to give the one or the other (i.e. the corporation or the surviving shareholders) only a first option to buy, with a binding obligation to arise in the other upon the first optionee's failure to exercise its or his rights.

ESTATE TAX ASPECTS OF AGREEMENT

One most important factor relating to the estate tax effect of a shareholders agreement has been discussed, namely the relevance of the purchase price specified in the agreement to the estate tax value of the shares to be acquired. Because of some significant recent developments, one other area should be discussed.

Assume that a controlling shareholder is subject to an agreement, binding his corporation to buy his shares upon his death. Assume further that the agreement is funded by a life insurance policy on his death, owned by the corporation, and that the purchase price for his stock will reflect the insurance proceeds. On the shareholder's death, the shares will be included in his estate at a value which reflects the insurance proceeds. The question arises, however, as to whether the insurance policy will be directly includible in his estate, on the grounds that, as controlling shareholder of the corporation which owned the policy, the retained "incidents of ownership" over the policy are sufficient to bring it into his estate under Section 2042. It is probably clear under the case law that the policy could not be included twice, directly and indirectly (i.e. as an asset of the company), but it would be bad enough if the insurance was to be included only once, but directly. For one thing, the removal of the insurance from the value of the company so as to include it directly under Section 2042 could well reduce the company's value in the estate below the percentages required for a Section 303 redemption (see above) or for installment payment of taxes under Section 6166. For another thing, such a direct inclusion of the insurance would obviously be at a dollar-for-dollar value while, as an asset of the corporation, the policy proceeds would be subject to the same valuation discounts applicable to all the corporate assets. At any rate, after some controversy, the IRS has now promulgated Reg. § 20.2042-1(c)(6), providing generally that, where the proceeds are payable to the corporation, they will not be included directly in the estate (even in the case of a sole shareholder), but will enter into the estate only as an asset of the corporation.

