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Buy-Sell Agreements for the Family Owned Business: Practical Considerations and Planning Opportunities

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BUY-SELL AGREEMENTS FOR THE FAMILY OWNED BUSINESS: PRACTICAL CONSIDERATIONS AND PLANNING OPPORTUNITIES

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I. Introduction.

A. In general. In planning for a closely held business and its owners, it is always important to integrate the needs and capabilities of the business with the personal, business and estate plans of each of the owners, especially with regard to an estate's need for liquidity and the owners' desires as to the future control and ownership of the businesses. The so-called "Buy-Sell Agreement" is a frequently utilized mechanism for dealing with the variety of business and estate planning issues involved in owning a closely held business and in accomplishing the desired objectives of the owners. In addition to providing for the purchase and sale of business interests as the name implies, the buy-sell agreement will often cover a number of business arrangements between the owners.

A "Buy-Sell Agreement" is typically a single document, however, the "buy-sell" provisions may be contained in the articles of incorporation, partnership agreement, bylaws, and employment agreements. Used in its broadest sense, a "Buy-Sell Agreement" represents the total of all agreements between the owners of closely held businesses regarding the control of the business, the identities of the shareholders, the transfer of ownership, and a variety of other business and financial matters.
In structuring a buy-sell agreement it is important that the estate planning objectives of the business owners be implemented only after carefully evaluating the impact of the agreement on the business itself. Care must be given not only to achieving the estate planning goals of the business owners but, also, to satisfying the operational needs and capabilities of the business and the income needs of the owners during their lifetimes.

Although buy-sell agreements are beneficial in planning for all forms of closely held business ventures, this outline will deal with the issues in the context of a closely held corporation except where a partnership is specifically referenced. Further, the outline will primarily emphasize the use of the buy-sell agreement in a family owned business, although most of the factors and considerations involved are equally applicable to any closely held business, whether or not family owned.

B. **Overview of Matters to Consider.** Some of the traditional reasons for using buy-sell agreements are: (1) establish certainty in the continuity of ownership of the business; (2) provide a market for the otherwise illiquid closely held shares; (3) establish a funding source and mechanism for the purchase, establish certainty as to the value of the shares for estate tax purposes; and (4) provide restrictions regarding current ownership and operational matters, i.e., voting control, protection of the S corporation status, payment of dividends and the like.

The buy-sell agreement must be recognized as an enforceable contract under state law. Under the laws of most states shareholders and partners are given broad latitude in determining, by agreement, matters of governance of the corporation or partnership and matters involving restrictions on ownership and transferability of business interests.

In evaluating the desirability and need to adopt a buy-sell agreement, it is important for the advisor and the owners to realize that the "present" may be
the last real opportunity to establish a unanimously agreeable understanding as to future ownership and control of the business. At a later time, once changes in the health, financial circumstances or personal relationships have occurred, it may be difficult, if not impossible, to reach satisfactory agreements due to the divergent interests among the owners.

Prior to structuring the agreement, the advisor must first investigate and evaluate the needs and capabilities of the business and the personal needs, capabilities and desires of all of the people involved, which includes the owners and other affected parties, i.e., wives, children, key employees, etc. In many cases, the long time advisor of the principal owner (often the lawyer or accountant) will know all of the people and most of the circumstances involved so that he or she can quickly understand the goals, capabilities and needs of the business and its shareholders.

Since the enactment of the Omnibus Budget Reconciliation Act of 1990 ("OBRA '90") which repealed §2036(c), retroactively to the date of its adoption, December 17, 1987, and replaced that section with Chapter 14, buy-sell agreements among family members have been within the scope of §2703, effective for buy-sell agreements made after October 8, 1990. Generally, §2703 permits a buy-sell agreement to establish the value of the business interest for gift, estate and generation-skipping tax purposes if certain conditions are met.

C. Types of Matters Covered by Agreement. Most buy-sell agreements will contain binding shareholder understandings as to the following matters.

1. Retention of Control. The agreement will restrict both lifetime and death transfers to assure retention of control within the desired ownership group.
2. **Creation of Market and Funding Mechanism.** Ownership interests in closely held businesses are typically highly illiquid. By requiring a purchase upon the occurrence of a specified event, i.e., the shareholder's death, disability, retirement or termination of employment, the buy-sell agreement will create a "market" for the interest. In addition, the agreement should contain provisions pertaining to how the funds will be accumulated or otherwise provided for to pay the purchase price.

3. **Establish Purchase price and estate tax value.** Subject to the application of §2703, a buy-sell agreement, by requiring the estate of a deceased shareholder to sell its stock at a stated or determinable price (and meeting certain other requirements), can establish the estate tax value of the interest to be purchased at death.

4. **Guidelines for business operations and voting.** The buy-sell agreement will often establish operating guidelines for the business by containing provisions for protecting a corporation's Subchapter S election, creating voting agreements to protect minority or majority interests, establishing limits on compensation for business owners active in the business, and protecting the business from creditors of insolvent owners.

II. **Establishment of Estate Tax Value.**

A. **In general.** In addition to providing a "market" for closely held shares at a stated or determinable price, a buy-sell agreement can serve the purpose of establishing the value of a deceased shareholder's stock for gift, estate, and generation-skipping tax purposes. The importance of this issue cannot be over emphasized, since if the agreement provides for a purchase price which is below the fair market value determined for estate tax purposes at date of death, there could be an unplanned for and highly detrimental impact on the estate, i.e., the estate
could face an estate tax obligation attributable to the stock purchased in excess of the proceeds received under the buy-sell agreement.

The current rules governing whether or not a buy-sell agreement will establish the value of a shareholder's stock for Gift, Estate and Generation-skipping tax purposes are contained in §2031 as modified by §2703, enacted by the Omnibus Budget and Reconciliation Act of 1990 (OBRA '90), effective for agreements entered into (or substantially modified) after October 8, 1990. Section 2703 clarifies that the "bona fide business arrangement" and the "device" tests contained in existing law must be independently met and added an additional requirement that the agreement must be "comparable to similar arm's length arrangements." The section did not disturb the other requirements of prior law which continue in effect.

B. **Chapter 14 - Special Valuation Rules.**

1. **In general.** Prior to December 17, 1987, there was considerable flexibility in the laws governing the transfer of ownership in a family business. Much of this flexibility was eliminated or severely restricted by the passage of §2036(c) in 1987. Following three years of strenuous effort by many individuals and small business organizations, §2036(c) was repealed, retroactive to its date of enactment, with a new Chapter 14 of the Code being substituted in its place, effective for transfers after October 8, 1990. OBRA '90 §11601(a) and §11602(a). Chapter 14 operates to determine the value of a gift of an equity interest in a business by valuing any interest retained by the donor and subtracting that value from the total value of the business. This so-called "subtraction" method is intended to produce a realistic valuation at the time of the gift. Chapter 14 contains four sections: §2701, dealing with corporations and partnerships; §2702, dealing with trusts and joint purchases; §2703, dealing with buy-sell agreements; and §2704, dealing with certain lapsing rights and restrictions.
2. **Section 2703.** Section 2703(a) provides that the value of gifted property is determined without regard to any option, agreement (e.g., a buy-sell agreement) or other right to acquire or use property at less than fair market value unless the following requirements of §2703(b) are met: (1) The agreement is a bona fide business arrangement; (2) the agreement is not a device to transfer property to a member of decedent's family for less than full and adequate consideration; (3) the terms of the agreement are comparable to similar arrangements entered into by persons in arms-length transactions. §2703(b). The requirements of §2703 are not limited to agreements among family members; however, if the agreement is among non-family members, the "device" requirement in (2) above should be automatically satisfied.

3. **Legislative history.** The Senate Finance Committee explanation to Chapter 14 states that the first two requirements under §2703(b) are similar to tests in previous Treasury regulations §20.2031-2(b) "except that the bill clarifies that the 'business relationship' and the 'device' requirements are independent tests. The mere showing that the agreement is a 'bona fide business arrangement' would not give the agreement estate tax effect if other facts indicate the agreement is a 'device' to transfer property to members of the decedent's family for less than full and adequate consideration." Senate Finance Committee Report, S. Rep. 1001, 101st Cong. 2nd Sess. (1990) at 67-68.

The requirement of §2703(b)(3) that the terms of the agreement must be comparable to similar arrangements entered into by persons in an arm's length transaction, places the burden on the taxpayer to show the agreement was "one that could have been obtained in an arm's length bargain." Senate Finance Committee Report, S. Rep. 1001, 101st Cong. 2nd Sess. (1990) at 68. Factors to be considered include the terms of the agreement, the present value of the property, the expected value at the time of exercise and the consideration to be paid. The
Conference Committee Report states that "...general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard...." Conference Report, H.R. 101-964, 101st Cong., 2nd Sess. (1990) at 1137. On this point, the Senate Finance Committee stated that meeting the requirement involves consideration of several factors and "...requires a demonstration of the general practice of unrelated parties. Expert testimony would be evidence of such practice." Senate Finance Committee Report, S. Rep. 1001, 101st Cong. 2nd Sess. (1990) at 68. See Prop. Reg. §25.2703-1(b)(4).

The Senate Finance Committee also stated that §2703 adopted the rationale of St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982), where the court held that even where the agreement was supported by valid business considerations, e.g., assuring continuity of management, exclusion of hostile shareholders, etc., it did not eliminate the need to inquire into whether the agreement represented a "device" to pass the value of the business to the decedent's testamentary beneficiaries for less than adequate consideration. The court interpreted Rev. Rul. 59-60 disjunctively, i.e., the value determined under the agreement will be disregarded if it is either not a "bona fide business arrangement" or is a "device" to benefit the objects of one's bounty. Both tests must be met independently. See Reg. §25.2703-1(b)(2). Final regulations were adopted on January 28, 1992. T.D. 8395.

4. Treatment of existing agreements. Buy-sell agreements are "grandfathered" under §2703 unless they are "substantially modified" after October 8, 1990. It is suggested that a change in the valuation formula for determining the option or purchase price would jeopardize the grandfathered status of the agreement; whereas, a change in one of the factors used in the valuation formula (e.g., a change in the P.E. multiple) would probably not be a "substantial
modification," nor would the addition of new parties if required by the agreement. See Prop. Reg. §25.2703-1(c).

5. **Current law requirements (including §2703).** As the law now stands, there are six (6) basic requirements which will determine whether or not a buy-sell agreement will establish the value of a deceased owner's stock interest for gift and estate tax purposes: (1) the stock must be subject to an obligation or option to purchase that is a binding obligation against the estate of a deceased shareholder; (2) the valuation method must establish the purchase price with certainty; (3) the stock cannot be subject to lifetime transfers that could defeat the option or obligation to purchase; (4) the agreement to purchase must represent a "bona fide business arrangement"; (5) the agreement must not be a "device" to transfer the shares to the natural objects of the decedent's bounty at a lower than market value; and (6) the agreement (its terms, purchase price, restrictions, etc.) must be comparable to similar arrangements between persons in an arm's length transaction. For a discussion of the requirements for establishing estate tax value prior to adoption of §2703, see Harris, "Buy-Sell Agreements for the Family Business: Selected Problems and New Concerns," 24th Southern Federal Tax Institute (1989) at ¶II at pp. J3-8; and paragraph II.C., infra.

6. **Practical considerations.** Since, under §2703(b)(3), the burden is on the taxpayer to show that third parties would have entered into the agreement in question, it is advisable to have an independent appraiser determine the value of the business; and, recognizing that each business is unique, the valuation method used in the agreement to determine the purchase price should clearly reflect the facts and circumstances of the particular business. The need to determine an appropriate valuation method strongly suggests the advisability of obtaining the judgment of an experienced professional.
C. **Review of Other Requirements.** Since §2703 serves only to clarify and add to the previously existing requirements for establishing value for estate tax purposes, it is necessary to review the rules established by the case law, IRS Regulations and Rulings under §2031 as to when an agreement to purchase a shareholder's stock will establish the value of the stock for estate tax purposes. See Rev. Rul. 59-60, Sec. 8, 1959-1 C.B. 237.

Prior to October 8, 1990, effective date of §2703, there were only four basic requirements which governed when a buy-sell agreement would establish the value of a deceased owner's stock interest for estate tax purposes: (1) the stock must be subject to an obligation or option to purchase that is a binding obligation against the estate of a deceased shareholder; (2) the valuation method (or fixed value) must establish the purchase price with certainty; (3) the shares cannot be subject to lifetime transfers that could defeat the option or obligation to purchase; (4) the option or obligation to purchase must represent a "bona fide business relationship" and not be a "device" to transfer the shares to the natural objects of the decedent's bounty at less than full and adequate consideration. A discussion of these four requirements follows.

1. **Estate's obligation to sell.** To establish a value for estate tax purposes, the estate must be obligated to sell; however, there is no requirement for the purchaser to buy. Therefore, an option held by the corporation or surviving shareholders is sufficient as long as the estate is obligated to sell if the option is exercised. It could be argued by the estate that the shares were worth even less than the option price if the option holder elected not to exercise the option. However, from the estate's standpoint, an option rather than an obligation could result in liquidity problems for the estate since, even though the agreement may have set the value for estate tax purposes, no cash would be generated for the estate unless a sale actually occurs. For this reason, buy-sell agreements typically
provide that the purchaser is obligated to purchase upon the death of a shareholder. Even where funding the purchase is a problem, thus making it necessary to pay a portion of the purchase price in installments, an obligation (rather than an option) is, nevertheless, provided for because of the estate's need for liquidity.

2. Methods for establishing the purchase price. The purchase price of shares must be established with certainty by the valuation method contained in the buy-sell agreement. Establishing the value and an appropriate method of valuation for a closely-held business can be one of the most difficult issues involved in designing the buy-sell agreement. Notwithstanding the appropriateness of valuation method selected, unforeseen conditions in the future (when the value of the business is actually determined under the agreement, i.e., upon a shareholder's death, disability, etc.) will almost always result in some benefit or detriment to the various parties to the agreement. Therefore, in establishing an appropriate valuation method, the goal is to keep this unintended benefit or detriment as small as possible.

The advisor should emphasize the importance of determining a realistic value of the business and establishing an appropriate valuation method to be used in the agreement. The advisor should strongly suggest that an evaluation of the business be made by an independent party (accountant, attorney, or appraisal company) prior to the finalization of the agreement. See Rev. Rul. 59-60, supra, which can be used as a guide for valuing many closely held businesses. The use of an appropriate valuation method to reach an accurate measure of fair market value is especially necessary in light of the added restrictions of §2703. Further, an appropriate valuation method will provide a target for funding the purchaser's obligation and liquidity planning by the seller and his estate.

In establishing a method for valuing the business, all of the accepted factors for valuing business interests must be considered, with the added
difficulty that the valuation method selected must take into account that it will likely be applied years, if not decades, after it is agreed upon. There are several general methods of valuation typically used in buy-sell agreements, each method having variations, described as follows.

a. **Fixed value.** An unchanging "fixed value," with no provision for adjustment, is no longer used since it is inherently not perceived as fair by the parties and would probably not meet the tests under §2703(b) and the IRS regulations. Reg. §25.2703-1(b).

b. **Appraisal value.** A buy-sell agreement can avoid the troublesome issue of valuation by providing for independent appraisers to value the business when death or other "trigger" events occur. However, the appraisal method is rarely used in valuing an operating business since business appraisals take considerable time, are expensive, and give no guidance for purposes of funding the obligation and general planning. Certain types of businesses may, however, be good candidates for using the appraisal method as the fairest way to satisfy all the owners. These include real estate and public securities holding companies where going concern value, goodwill and similar operating factors do not exist. In these cases, the appraisal is really an appraisal of fixed assets rather than a business appraisal. If the appraisal method is used, a so-called "triple appraisal" method is often adopted (where the purchaser and estate each appoint an appraiser who in turn selects a third). This approach, however, can result in unexpected delay, litigation and added expense. The appraisal method, in essence, defers the decision as to value until date of the triggering event, thus leaving the owners and their advisors with present uncertainty when funding decisions are being made. See Exhibit "A" for an example of the appraisal method of valuation used in a buy-sell agreement for a real estate partnership.
c. **Formula method of value.** If the objective is to establish a realistic fair market value based on factors which would be considered by a outside purchaser, then some type of formula method of valuation will likely be used. Perhaps the most common formula method is the use of "book value" which can be easily determined from the company's financial statements. Although "book value" is easily determined, it can result in a significant deviation from fair market value unless adjusted for such matters as: (1) the company's accounting method, (2) differences between book value and fair market value of improved real estate, equipment and other tangible assets, (3) adjustments to accounts receivable to reflect collectability, and (4) adequacy of various reserve accounts.

Another formula method often used is one based on "earnings" where earnings are capitalized to arrive at a proper value. Many closely held business are not susceptible to an unadjusted earnings formula where most of the company's earnings are distributed to shareholder-employees as compensation and other benefits; however, adjustments to earnings can be made to take these expenses into account. A difficult determination in the "earnings" approach is the selection of an appropriate "earnings multiple" (or capitalization rate); and even if the earnings multiple is appropriate at the time of the agreement, a change in the business or in the economic environment can significantly affect the capitalization rate from the viewpoint of an outside purchaser.

Often a formula method based on both asset values and earnings is employed in setting the value of a closely held business. To establish that the agreement is "bona fide business arrangement" and that it is not serving as a "device" to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration, it is prudent to prepare a written valuation report at the time the agreement is made which demonstrates the current appropriateness of the valuation method used. For examples of formula valuation methods,
see Exhibit "B-1" pertaining to a construction and real estate development company; and Exhibit "B-2" pertaining to a management consulting company.

d. **Agreed value.** A frequently used method of valuation is the "agreed" value, which requires periodic adjustments by all of the parties, coupled with a back-up valuation (either formula or appraisal valuation) to take effect if an adjustment to value has not been made within a certain period of time (usually within 18 months or less) prior to the "triggering" event. This method allows the parties to periodically update the value based on changing circumstances. It is important that a back-up value be provided since owners will often find it difficult in the future to unanimously agree on adjustments to value (or to even discuss value again after the agreement is signed), especially where there are significant disparities in age or in degrees of participation in the business which can result in disagreements as to business and financial objectives. In addition to serving as an alternative value, the existence of an "automatic back up" value often facilitates the shareholders reaching an agreement (which they might not otherwise do) within the required time. An automatic back-up provision could state that, "if the parties have not agreed to a value as herein provided for within 18 months prior to the death of any shareholder, a formula (based on book value, average earnings, etc.) will automatically be used to establish a value for purposes of the agreement." See Exhibit "C" for an example of an "agreed value" with a "back-up adjustment" for a medical corporation.

3. **Lifetime transfers.** To be effective in establishing a value for estate tax purposes, the buy-sell agreement must provide that the corporation or other shareholders are obligated or have the option to purchase the shares of a shareholder who desires to sell during lifetime, at the same price and on the terms as provided for upon the death of a shareholder. If only a right of "first refusal" is provided, it will not be effective in establishing the estate tax value since the
price during the lifetime of the shareholder could exceed the purchase price at
death. See Reg. §20.2031-2(h). Further, the right of "first refusal" is not
generally satisfactory because it permits a premium price to be offered by a third
party which could force the remaining shareholders to either meet the price or suffer
the consequences of a new and potentially hostile owner. From the selling
shareholder's viewpoint (especially a minority shareholder), both the right of first
refusal and the option may be unattractive because of their failure to guarantee a
"market" for the shares.

a. Practical considerations. A right of first refusal or
an option at a fixed or determinable price during lifetime frequently operates to
depress the value of the stock and may have such a "chilling" effect on a prospective
purchaser as to prevent any offers from being made. In addition, a right of first
refusal or an option will typically slow the process for closing of a stock purchase
even if the other shareholders permit the transfer or do not exercise their option.

b. Adoption of agreement by new purchaser. A right
of first refusal or an option will often be coupled with a provision stating that any
outside purchaser is required to adopt the buy-sell agreement or that the stock
transferred to an outside party will automatically be subject to the terms and condi-
tions of the agreement. Either of these provisions will effectively restrict the
subsequent transfer of the shares and protect the remaining owners. See Exhibit
"D" for option granted to a corporation and its shareholders to purchase during
lifetime.

4. "Bona fide business arrangement" test. Prior to the
adoption of §2703, for the value established under a buy-sell agreement to be
binding for estate tax purposes, the agreement must have been a "bona fide business
arrangement." The long-established position of the Service was that "It is always
necessary to consider the relationship of the parties, the relative number of shares
held by the decedent, and other material facts to determine whether the agreement represents a **bona fide business arrangement** or 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." Rev. Rul. 59-60, 1959-1 C.B. 237, at 244 (emphasis added).

The Service did not specify in Rev. Rul. 59-60 "when" the agreement must meet the "**bona fide business arrangement**" test nor did the regulations elaborate on this point. However, the test was leniently applied in litigated cases which held that if the agreement were reasonable at the time it was signed, subsequent changes in the value of the business would not impair the ability of the agreement to determine the estate tax value. This result was achieved even though agreements among family members were often voluntarily adjusted from time to time to meet the family's economic and personal circumstances. For example, assume the following: (1) a closely held corporation owned by father and son enters into a stock redemption agreement to purchase the shares of a deceased shareholder; (2) the agreement meets all of the mechanical tests, i.e., binding obligation or option effective against the estate, stated valuation method and restrictions on lifetime transfers at that value; (3) the father's will bequeaths to his son all of his shares in the corporation not redeemed under the agreement. In these circumstances, there was often an identity of interests between father and son regarding the valuation method used in the agreement in order to minimize the purchase price and the estate tax liability. Clearly, a value determined at arm's length by unrelated parties might reach a different result. Despite opportunities for such manipulation, the courts prior to the adoption of §2703 generally accepted agreements that were supported by adequate consideration at the time executed and which achieve a valid business purpose, e.g., assuring continuity of management, exclusion of hostile shareholders, etc. **Estate of Seltzer**, T.C. Memo 1985-519(e); **Estate of Bishop**, 69 T.C.
32 (1977). However, in St. Louis Bank v. United States, 674 F.2d 1207 (8th Cir. 1982), the court held that even where the agreement was supported by valid business considerations, it did not eliminate the need to separately inquire as to whether the agreement represented a "device" to pass the value of the business to the decedent's testamentary beneficiaries for less than adequate consideration. The court interpreted Rev. Rul. 59-60 disjunctively, i.e., the value determined under the agreement would be disregarded if either the agreement was not a "bona fide business arrangement" or was a "device" to benefit the objects of one's bounty. Both tests must be independently met. The facts in St. Louis County Bank were unusual and the case did not give rise to a large number of new cases in the area; nevertheless, it did stand for the proposition that an agreed formula valuation which was subject to manipulation by lifetime decisions within the control of family members could create a situation where a "facts and circumstances test" would be applied in reviewing, and perhaps overturning the valuation agreed to by the parties. This same analysis could also apply where the buy-sell agreement was frequently amended to meet changing estate planning needs. The principle established in the St. Louis County Bank case (codified in §2703(b)) did not apply where there are unrelated parties to the agreement.

III. Drafting Corporate Buy-Sell Agreements. Although the need to establish a binding estate tax value will strongly influence the drafting of most buy-sell agreements, the agreement must also reflect the overall needs and financial capabilities of the business as well as the lifetime and estate planning needs of the owners.

A. Selecting type of agreement. An important decision at the outset is to determine the type of agreement to be used, i.e., who will be the purchaser -- the corporation in a "redemption" type agreement, the other shareholders in a
"cross-purchase" type agreement, or a combination of the two types? The determination should be made only after evaluating various factors.

1. **Life insurance considerations.** Since many buy-sell agreements are partially or fully funded with life insurance on the lives of the shareholders, the availability of the insurance, the number of policies needed and the source and amount of funds needed to pay the insurance premiums are all important factors in determining the type of agreement to be utilized.

   a. **Amount of insurance.** Unless it is desirable (and affordable) for a shareholder's interest to be purchased without any out-of-pocket expenditure of funds by the other shareholders or the corporation, it is typically not necessary to fully fund the purchase price with insurance. However, if the shareholders (as potential sellers) want to insure that the entire purchase price can be paid in cash (to minimize the credit risk to a deceased shareholder's estate), then full funding of the obligation with insurance may be necessary. Typically, the amount of the insurance funding will be determined primarily by the financial ability of the corporation or shareholder to pay the premiums, influenced by the degree of credit risk which the shareholders (as potential sellers) are willing to assume and the desire by the shareholders (as potential purchasers) to avoid paying any out-of-pocket funds at the time of the purchase.

   b. **Multiple policies.** In a cross-purchase agreement, unless a or partnership can be utilized, each shareholder must hold a policy on the life of every other shareholder, e.g., if there were three shareholders, there would need to be 6 separate policies; if 4 shareholders -- 12 separate policies; if 6 shareholders -- 30 policies). Therefore, the existence of more than 3 or 4 shareholders can make the use of a cross-purchase agreement difficult, if not unworkable. A single policy on each shareholder will suffice in a redemption agreement. A possible solution to the multiple policy problem in cross-purchase...
arrangements (if no partnership exists) may be found in the use of a "buy-out insurance trust" which owns the policies. See discussion in Section X.D., infra.

c. **Ownership.** In a redemption agreement, the policies are owned by the corporation which permit the corporation to borrow against the cash surrender value if needed. The cross-purchase agreement, if no trust or partnership is used, leaves the payment of premiums and borrowing on the policy in the control of the individual shareholders. Consideration should be given to the fact that creditors of the owners of the insurance may assert claims against the cash surrender value of the policies. Depending on the relative creditworthiness of the parties, this factor alone could determine which form of agreement is most desirable.

d. **Proportionality.** Where the shareholder interests are not equal, e.g., a 10% and a 90% shareholder, the minority shareholder would, in a cross-purchase arrangement, be required to fund the much higher value of the majority owner's interest. In fairness, the minority owner should fully pay for his purchase of the majority owner's shares; however, the minority owner may not be financially able to do so or there may be other factors which suggest he should not have to do so. If the same disparity in ownership (10% and 90%) exists under a redemption agreement, the majority owner is, in essence, paying for the buy-out of his own shares since he would otherwise be entitled to (or be benefitted by) 90% of the funds used to satisfy the agreement. In other words, where a redemption agreement is used and the corporation purchases and pays for the stock (through payment of insurance premiums or from its other assets), the shareholders are (from an economic standpoint) bearing this cost in proportion to their relative stock interests.

2. **Tax considerations.** The cross-purchase agreement will result in "sale or exchange" treatment to the selling shareholder, however, since the sale is most often triggered by the shareholder's death, there will typically be no
gain or loss. To achieve capital gain treatment under a redemption agreement, the corporation's purchase would have to meet the rules of §302 or §303. This may be a problem in a family-owned corporation because of the attribution rules of §318.

a. **Basis.** In a cross-purchase agreement, the purchaser's basis in the stock acquired will be equal to his cost while in a redemption by a C corporation the surviving shareholders will have no increase in basis. In a redemption by an S corporation the amount of increase in basis to the remaining shareholders will depend on the time of year when the "triggering" event occurs and other factors. See discussion of "basis" considerations where an S corporation is involved, infra, at Section X.

b. **Alternative minimum tax.** In a C corporation with relatively little taxable profits (which is the case for most professional and other personal service corporations), the risk that the life insurance proceeds will result in a significant additional tax under the "alternative minimum tax" (AMT) rules suggests that a cross-purchase arrangement be utilized notwithstanding other factors. See discussion of the effect of the AMT on corporate owned life insurance, infra, at Section IX.

c. **Accumulated earnings.** In a redemption agreement, the corporation risks exposure to the tax on unreasonable accumulation of earnings which could be imposed on the accumulations necessary to fund the agreement, especially where the corporation is accumulating funds to purchase a majority shareholder's interest. §531, et seq.; see IRS §531 Audit Guidelines at §637(3)(a) and (f); see Callahan, Estate and Personal Financing Planning ¶23:11; and see Lewis, 35-7th T.M., Accumulated Earnings Tax (1988) at A-32, et seq.

3. **Other factors.** Other factors which may influence the type of buy-sell agreement to be utilized include credit arrangements, the insurability of individual shareholders and the refusal of a shareholder to participate. In addition,
the relative tax rates of the corporation and the various shareholders can be significant. For additional factors, see discussion of special concerns for S corporation buy-out agreements, infra, at Section VIII. A factor which should always be considered is the likelihood that the buy-out may occur during the lifetime of a shareholder rather than at death.

IV. **Business and Personal Factors.**

A. **In general.** In addition to meeting the requirements necessary to establish the value of the stock for estate tax purposes, the buy-sell agreement will often contain restrictions on the transfer of stock, voting rights, and the operations of the business. The advisor must obtain as much information as possible to effectively integrate a workable and realistic business structure for achieving both the estate planning and personal needs of the shareholders and the operational needs of the corporation.

B. **Restrictions on lifetime transfers.** The type of restrictions on lifetime transfers of shares will be influenced by several factors.

1. **Transfer with consent.** The agreement can either absolutely prohibit the transfer by a shareholder during lifetime; or permit transfers only with the consent of a certain percentage of the shareholders.

2. **Permitted transfer to a limited class.** The agreement will often permit a gift of shares to family members or to a specified limited class, subject to the restrictions in the agreement. However, even though limited, these permitted transfers can jeopardize the effectiveness of the valuation being accepted for estate tax purposes, since systematically planned transfers by an older transferor to a younger transferee could result in a practical avoidance of the buy-sell restrictions (and therefore a "device") even though the shares remain subject to the shareholders agreement. §2703(b)(2); and see Ltr. Rul. 8710004.
3. **Encumbrances.** The agreement may provide that the shares cannot be encumbered to secure the personal debts of a shareholder. Frequently, however, such encumbrances are permitted subject to the creditor coming under the same restrictions as the shareholder in the event of a foreclosure. Thus, foreclosure by a creditor would trigger the requirement to sell under the agreement. See Exhibit "E" for a provision permitting gifts of shares to family members and the pledge of shares for loans.

C. **"Trigger" events.** Advisors should carefully analyze the various events which call for shareholders to sell and the corporation or shareholders to purchase. The selection of these "trigger" events will be influenced by a number of factors which involve tax, personal and economic considerations.

1. **Death.** The agreement will typically provide that upon the death of a shareholder, there will be an obligation for the deceased shareholder's estate to sell and the remaining shareholders or the corporation to have an obligation or option to purchase. See Exhibit "F" for a paragraph requiring the sale and purchase of a deceased shareholder's stock.

2. **Disability.** Where a disabled shareholder is also an employee of the business (which is often the case), it is important to the business (and to the disabled shareholder) that "disability" be one of the triggering events. Upon disability, the disabled shareholder's stock will be purchased under the agreement and cash will be paid to the disabled shareholder. This also results in the elimination of a non-contributing shareholder who often will have the same needs and desires as the family of a deceased shareholder, i.e., the need for payment of dividends, etc., which typically are contrary to the needs of the corporation and the desires of the remaining shareholder-employees.

   a. **Definition of "disability."** The corporation can purchase disability buy-out insurance on an employee-shareholder to aid in funding
its obligation. In doing so, it is important that the definition of "disability" in the agreement be the same as the definition of "disability" in the insurance policy used to fund the obligation. It is equally important that the definition of "disability" meets the personal needs of the shareholders. In addition, the employee may be personally covered by disability insurance to replace his or her lost compensation from the business. For a full discussion of disability insurance, see Reif, "Severance and Disability Arrangements," Ali-Aba Course of Study, Qualified Plans, P.C.'s and Welfare Benefits (1989), 627 at 731-750; and Callahan, Estate and Personal and Financial Planning, Chapter 2. See Exhibit "G" for a provision requiring purchase of a disabled shareholder's stock.

3. **Termination of employment.** Upon termination of employment, even if not disabled, a non-working shareholder may desire that significant dividends be paid by the corporation -- a desire likely to be in conflict with the needs of the business and the desires of the other shareholders whose income is primarily in the form of compensation, directors' fees, etc. More likely, the terminated employee will likely be anxious to have his stock purchased, especially if he is a minority shareholder and is not a family member. Typically, the initial purchase of stock by a key employee is coupled with a buy-sell agreement containing a mandatory buy-back provision upon termination of employment at a formula price. This gives the minority shareholder both the incentive to enhance the value of the corporation while employed and the protection of knowing that his investment will be liquidated upon his termination of employment.

   a. **Voluntary transfers.** Shareholder agreements typically provide for the corporation and the remaining shareholders to have an option (not an obligation) to purchase the shares in the event a shareholder wishes to transfer his shares. The agreement should clearly specify whether the option can be exercised to purchase all or only a part of the shares of the selling shareholder.
Typically, the requirement is that all (and not less than all) of the shares must be purchased in order to protect the selling shareholder. However, this requirement can result in the corporation or remaining shareholders being forced to come up with significant resources to fund the purchase at a time when it is not convenient or possible. A compromise is often reached to permit installment payments for a portion of the purchase price.

4. **Involuntary transfers.** It is generally desirable for the agreement to include an option (not an obligation) to repurchase shares if the shares become subject to an involuntary transfer, i.e., a transfer to a trustee in bankruptcy or a guardian upon a shareholder's incompetency. The option to purchase may be important since the fiduciary (trustee in bankruptcy or guardian) may take positions inconsistent with the general goals of the business, i.e., seeking to force payment of dividends, unwilling to provide funds for capital needs, and the like. It is also desirable for the agreement to provide for an option to purchase in the event the shares are subject to an involuntary transfer in connection with a marital dissolution. Special care should be taken in drafting such an option which will be effective in a divorce proceeding where the court orders the transfer of a shareholder's stock to a spouse. Issues as to the enforceability of such a provision are likely to be raised, with both corporation and shareholders becoming embroiled in the marital proceeding, especially if the non-shareholder spouse feels the purchase price under the buy-sell agreement is inadequate.

D. **Option vs. obligation.** In each circumstance which triggers a purchase under the agreement, consideration must be given to whether or not the purchaser should be obligated or merely have an option to purchase. The objectives of the decedent or withdrawing shareholder are almost always best served by a mandatory purchase if adequate funding is available. To establish the value for estate tax purposes, the agreement need only provide that the estate of the deceased
shareholder is obligated to sell, with no requirement that the corporation or remaining shareholders are obligated to purchase. Typically, however, to accommodate the estate's liquidity needs, the agreement should provide for a mandatory purchase on death. Similar considerations make a mandatory purchase desirable (if funding is available) in the case of disability. It is rare that a mandatory purchase would be provided in the event of a voluntary or involuntary lifetime transfer (except where a non-family minority shareholder terminates employment) since in either event, such a fixed obligation would represent a contingent liability unacceptable to the corporation or the shareholders.

E. Voting restrictions. In addition to purchase obligations and restrictions on the transfer of shares, the buy-sell agreement can effectively deal with the voting rights of the owners. The advisor, while determining the facts necessary to prepare the buy-sell agreement should review the voting patterns and any existing agreements among the shareholders which could affect the buy-out arrangements. Such agreements could involve a voting trust to assure consolidation of voting power in a single shareholder or agreements on issues pertaining to the corporation's "S" election, i.e., payment of a minimum level of dividends. Any voting agreements or restrictions should be reviewed to make sure they are enforceable under state law and are consistent with the buy-sell agreement. For a comprehensive discussion of voting agreements and other general business provisions to be considered in drafting buy-sell agreements, see Zaritsky, Forgotten Provisions in Buy-Sell Agreements, 19 U. Miami Trust and Estate Planning 6 (1985).

V. Partnership Buy-Sell Agreement. Most of the considerations in analyzing and preparing a corporate buy-sell agreement are equally applicable in the partnership context. Often the buy-sell provisions are contained in the partnership agreement itself; however, if there is a separate agreement, the partnership agreement should be carefully analyzed to determine that its provisions are not in
conflict with the desired effect of the buy-sell agreement. While practical considerations in drafting partnership buy-sell agreements are largely the same as those involved in a C corporation, some significant differences should be noted.

A. Cross-purchase vs. partnership purchase. The capital gain concerns involved in a corporate redemption agreement are not involved in a partnership. The sale of a partnership interest to the other partners is treated under §§731 and 751 which provide that proceeds received by the selling partner are considered to be from the sale of a capital asset except to the extent of ordinary income treatment under §751. If, however, the partnership (rather than the other partners) purchases the selling partner's interest, the transaction can be structured to permit deductible payments by the partnership which will be received by the partner as ordinary income. The payments to the withdrawing partner would be considered as "guaranteed payments" of a portion of the partners' distributive share under §736(a). However, if not specifically designated as "guaranteed payments," the payment would be considered in exchange for the partners' partnership interest. §736(b).

With the current relatively small difference in tax rates on capital gains and ordinary income (28% versus 31%-34%), it may be beneficial to structure the transaction so that payments for a retiring partner's interest that exceed the partner's basis will be guaranteed payments deductible by the partnership under §736(a), with the balance being paid in exchange for the partnership interest. This split method of payment, i.e., the amount paid up to the selling partner's basis being a capital transaction under subsection 736(b) with the remaining payments being "guaranteed payments" deductible by the partnership under §736(a), can be beneficial. If payments for "goodwill" are called for in the partnership agreement, they will be treated as being made in exchange for the partnership interest under §736(b) and, therefore, not deductible.
B. **Insurance.** The "transfer for value" problems in partnership buy-sell agreements are substantially less than in the case of a corporation since §101(a) provides an exception to the "transfer for value" rules for transfers of life insurance between partners. Therefore, the cross-purchase form of buy-sell agreement can in some instances be more easily utilized in a partnership buy-sell arrangement.

C. **Section 754.** To avoid uncertainty and future conflict, the permitted election under §754 should be considered at the time of preparing the buy-sell agreement so it can prescribe a method for determining which events will trigger and which partner (or partners) can compel the election. For a discussion of issues involved in using the §754 election, see Levison, *The Partnership Basis Election Analyzed*, 14 Estate Plan 138 (May, 1982).

VI. **Funding the Purchase Agreement.**

A. **In general.** One of the most important determinations to be made in planning for a buy-sell agreement is the source of funding for the obligations created by the agreement. The issue of funding must take into account both the needs of the shareholders and their estates as potential "sellers" as well as the financial and cash flow capabilities of the shareholders and the corporation as "purchasers." Methods of funding must typically be determined both currently (to begin the process of accumulation or payment of life insurance premiums) and in the future at the time of the triggering event (i.e., death, disability, etc.) Although life insurance will often solve the funding problem for purchasing a deceased shareholder's stock, and disability insurance may be available to fund the stock purchase in the event of a permanent disability, insurance proceeds (except to the extent of cash values) are not available in lifetime purchase situations, i.e., upon retirement, termination of employment, or at the time of a voluntary or involuntary transfer. In addition, the needed life or disability insurance may either be
unavailable or unaffordable because of the age or poor health of the shareholder or because of limited financial capabilities of the corporation. The determinations of (1) whether or not to obligate or have an option, (2) the events which will trigger a sale and purchase, and (3) the extent to which the liquidity needs of the potential seller should be provided for -- all must be evaluated in light of the funding capabilities of the parties. Where life insurance is not available or not affordable, there may not be a reasonable alternative (due to lack of funding) which will satisfy all of the needs of both the buying and the selling parties. However, in some situations, non-insurance methods of funding and installment methods of payment can adequately meet many of the major needs of the parties.

B. **Installment sales.** The purchasers can be given the right to pay part or all of the purchase price in installments by giving a promissory note, the rate of interest and the length of time for payment depending on the comparative needs and abilities of the parties. If possible, the promissory note should provide for a competitive rate of interest to encourage early payoff and avoid attribution of interest under §483. The agreement should contain the specific requirements as to the security for the note and any restrictions to be placed on the operation of the business while the note remains unpaid. See Exhibit "H" for provisions which permit an installment sale, which require security for the indebtedness and impose restrictions on corporate activity. Since the deferral of payment permits the purchaser to fund the purchase price out of future earnings, the ability of the business to handle these purchases must be carefully evaluated. Although the installment sale may not satisfy the liquidity problems of an estate, it is often the only solution where insurance is not available. Nevertheless, before finalizing the terms of the installment sale, it should be recognized that the estate is not only at risk in meeting its cash flow needs (taxes and other expenses) but is also subjected to a credit risk measured by the purchaser's ability to pay, a risk ultimately borne by the deceased.
shareholder's family. Similar considerations must be evaluated in the case of disability, loss of employment and other events where the purchaser is permitted to pay the purchase price in installments.

C. Funding delayed until "trigger" event. The buy-sell agreement can provide that the full purchase price will be paid in cash on the date of purchase even though there is no plan for funding through insurance or other sources. By doing this, the parties anticipate that the corporation (or other shareholders) will be able to arrange to borrow or otherwise obtain the needed funds to satisfy the cash obligation when the time arises (presently not determinable) in the future. In drafting such a provision, adequate time between the "trigger" event and the closing of the transaction should be provided to allow time for the sale of assets to raise cash or to complete the necessary dealings with lenders. Generally, the difficulties and risks imposed on the corporation (or shareholders) to raise the necessary funds (by selling assets or borrowing) at an unspecified time in the future (when the availability of credit cannot be estimated) makes this approach less than satisfactory in most cases. However, in some situations, this approach can satisfy the cash needs of the selling shareholder and help resolve a difficult problem. More often a combination of a mandatory cash payment and an installment sale will result in a balancing of interests between sellers and purchasers.

D. Accumulation of funds. If no insurance or outside funding is available, the corporation can seek to accumulate funds internally in advance of the anticipated obligation. However, since the obligation can occur at any time, this method cannot insure the corporation will have the necessary funds in time to meet its obligations. From a tax standpoint, the self-funding accumulation may cause an "unreasonable accumulation of surplus" problem, especially where the funding is to purchase the interests of a majority shareholder. Typically, the self-funding accumulation of liquid funds against a contingent purchase obligation is acceptable.
only as a supplement to other alternatives since self-funding does little during the early years of the agreement (when the accumulation is small) to be of significant help.

E. Shareholders as purchasers. Where the corporation is not capable of funding the purchase, a cross-purchase agreement can shift the burden to the individual owners who may be more financially capable of handling the obligation. In most cases, however, this merely shifts and does not resolve the problem. The shareholder's liability under a cross-purchase agreement can be unlimited or it can be limited to the value of the assets pledged as security for the shareholder's note if an installment purchase is permitted. Typically, shareholders do not want to obligate their personal estates for stock purchase obligations especially where the amount of the purchase price (although determinable in the future) is unknown at the time the agreement is entered into. This concern also influences whether an option or a required purchase will be utilized in the agreement.

F. Hybrid funding. The buy-sell agreement will often provide that cash will be paid at closing to the extent of the insurance proceeds (or up to a specified percentage of the purchase price if no insurance is available) with the balance payable over a term of years evidenced by a secured promissory note. The provisions for the cash and deferred payments could, for example, call for a "down payment of the greater of 25 percent of the purchase price or the net proceeds from life insurance, with the balance, if any, being deferred over a five-year term." See Exhibit "I" for a provision requiring payment in cash to the extent of life insurance with installment payments of the balance; and Exhibit "J" for a provision which specifies the security for an installment note and other corporate restrictions.

VII. Role of Advisor - Possible Conflict. In evaluating the need for and the design of a buy-sell agreement, the advisor will typically be representing owners with competing interests. Even if each party has an equal chance of being either a
buyer or a seller at the time of the entering the agreement, there are often circumstances where either the corporation or certain shareholders have such a high degree of competing interests that it becomes difficult for the advisor to represent all parties effectively. Where such is the case, the attorney should (as soon as possible) explain the potential conflicts and suggest the opportunity for separate counsel to be involved. See American Bar Association, Model Code of Professional Responsibility, E.C. 5-16, which states as follows:

"EC 5-16 In those instances in which a lawyer is justified in representing two or more clients having different interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent. If there are present other circumstances that might cause any of the multiple clients to question the undivided loyalty of the lawyer, he should also advise all of the clients of those circumstances."

In attempting to strike a balance between competing interests, the planner must be sensitive to any conflict among the parties and must evaluate the issues for all parties at the time of planning the agreement. If after discussions with the shareholders the attorney determines that he can effectively represent all parties, it is desirable that a written consent and acknowledgement be obtained from all the shareholders (1) acknowledging that the potential conflicts were revealed and discussed and that separate counsel was recommended and (2) consenting to the single representation. See Exhibit "K" for an engagement letter used by Myron E. Sildon of Kansas City, Missouri, in dealing with this issue.

VIII. Special Concerns of S Corporations.

A. In general. The same reasons and purposes for having a buy-sell agreement apply equally to all types of entities, both S and C corporations and partnerships. However, due to the statutory requirements an S corporation must satisfy (at the time of election and during each year of operation), a buy-sell
agreement becomes even more important for the S corporation. In addition to carrying out the traditional purposes, the buy-sell agreement must deal with the unique problems of S corporations, i.e., preventing an inadvertent termination of the S election, payment of dividends, and providing for certain shareholder elections on termination of a shareholder's interest in the corporation.

With many closely held corporations electing S status in recent years (especially since 1986), the special provisions in buy-sell agreements for S corporations are applicable to a very large number, if not a majority, of all closely held corporations.

B. S corporation requirements. The statutory requirements for S corporations affecting buy-sell agreements are:

1. The S corporation can have only one class of stock. §1361(b)(1)(D) as modified by §1361(c)(4).
2. The S corporation cannot have more than 35 shareholders. §1361(b)(1)(A).
3. The shareholders of an S corporation can only be individuals (who are United States citizens or resident aliens), estates and certain trusts. §1361(b)(1)(B) and (C).

Both a decedent's estate and a bankrupt's estate of a shareholder are permitted shareholders of an S corporation and count as only one shareholder during the existence of the estate, regardless of the number of beneficiaries. However, upon distribution of the estate (i.e., the designated beneficiaries of a decedent or the creditors of a bankrupt), the transferees will each count as a shareholder, thus, creating a potential for violating the shareholder requirements for maintaining S status. The buy-sell agreement should cover these circumstances by providing purchase rights in the corporation or other shareholders, although it is not certain under the bankruptcy laws that it is possible to bind the trustee of a bankrupt's
estate. See Bankruptcy Code §365(a) and (c) and Countrymen, "Executory Contracts in Bankruptcy," 57 Minn. L.Rev. 439, 460 (1973). The trustee cannot, however, accept the benefits and reject the burdens of the agreement, In Re Nitech Paper Corp., 43 Br. 492 (D.C. N.Y. 1984). See Exhibit "L" for special provisions to protect the S status of the Corporation.

C. Trusts as shareholders. Voting trusts are allowed as owners of S corporation stock and each holder of a voting trust certificate is counted in determining the 35 shareholder limitation. §1361(c)(2)(B)(iv). From an estate planning standpoint, only two types of trusts are permitted as shareholders of S corporations, a "grantor trust" and a "qualified subchapter S trust":

1. Grantor trusts. A "grantor trust" is an inter vivos trust where the grantor (or a beneficiary) of the trust is treated as the owner of the trust for income tax purposes by reason of having the power to vest corpus or income in himself. §1361(c)(2)(A)(i). See §671-677 treating the grantor as the owner and §678 where a non-grantor is considered the owner of the trust. Upon the death of the grantor, the trust is permitted to continue as a shareholder for two (2) years after the grantor's death if the entire trust corpus is includible in the grantor's estate for estate tax purposes. If the entire corpus is not so included in the grantor's estate, the trust continues as a permitted shareholder for only 60 days after the grantor's death. §1361(c)(2)(A)(ii). Therefore, it is advisable for the buy-sell agreement to provide that the trustee must, after the shareholder's death, transfer the stock to a beneficiary who is a permitted shareholder or sell the shares to the corporation or other shareholders. To prevent an inadvertent termination of the S election, the agreement should require the shareholders to notify the corporation of any stock transfers made to trusts so that it can be determined at that time whether or not the trusts are "grantor trusts"; and, if they are, whether the corpus of the trusts will be includible in the grantor's gross estate. This
information is necessary in order to determine whether a distribution of the stock from the trust would be required within 60 days or two (2) years following the shareholder's death. It is, therefore, also advisable for the buy-sell agreement to require that counsel for the corporation be appointed to make these determinations. This, of course, requires constant monitoring by the attorney and is a responsibility for which the attorney should be fully protected.

2. **Qualified subchapter S trust (QSST).** A trust will qualify as a QSST if it must distribute all of its current income to a sole beneficiary who is a United States citizen or resident alien, who signs a separate election for each S corporation owned by the trust, and who is the only person who can receive a corpus distribution during his or her lifetime. The income interest of the sole beneficiary must end on the earlier of the beneficiary's death or the trust's termination; and upon termination, the corpus of the trust must be included in that beneficiary's estate for estate tax purposes. §1361(d). Typical trusts which qualify as QSSTs are a QTIP marital deduction trust, a life income trust with the beneficiary having a testamentary general power of appointment, and a §2503(c) trust for minors if income is distributed (or required to be distributed) to the minor.

3. **Other trusts.** If the trust is not a grantor trust or a QSST, it can own S corporation stock for only 60 days after the date of transfer to the trust. Types of trusts precluded from owning S corporation stock are: (1) the typical "sprinkling" trust where the trustee determines annually the amount of income, if any, to be distributed among the various beneficiaries; and (2) a charitable remainder or other trust where the income of the trust could exceed the amount distributable to the beneficiary. It should be noted that a grantor retained income trust (GRIT) can also satisfy the S corporation rules as a grantor trust.

4. **Possible conflict of interest.** The need for continuous involvement by the counsel for the S corporation in matters pertaining to an
individual shareholder's personal planning can create a conflict of interest in the attorney's attempts to represent both the corporation and its shareholders. The S corporation presents more problems than C corporations in this regard because carrying out one shareholder's plans may adversely affect the S election and, therefore, the other shareholders. The buy-sell agreement can help reduce this conflict by providing that a shareholder must, on a confidential basis, disclose his or her personal estate and trust planning documents to the counsel for the S corporation so that an inadvertent termination of the S status of the corporation will not occur.

5. **Inadvertent terminations.** The Subchapter S Revision Act of 1982 deals with the inadvertent termination of the S election by granting the Commissioner broad relief powers to reinstate the S election. §1362(f). A number of private letter rulings illustrate the Service's liberal interpretation of this power and show, assuming prompt action, that relief will generally be granted. See Ltr. Ruls. 9204013; 9202024; 9036027; and 9004006. See Katzenstein "Strategies for Saving the S Election Upon the Death of an S Corporation Shareholder," Vol. 15, No. 4, Estate Planning, 210 (July/Aug. 1988).

D. **Handling problems unique to S corporations.** The many requirements for maintaining a corporation's S status suggest that the corporation and its shareholders utilize agreements and techniques which will help maintain the election as long as it is desirable.

1. **Expressions and prohibitions.** The agreement should contain statements, to which reference is made on the stock certificates, that the intent of the parties is to maintain the corporation's S status, if elected, and that the transfer of shares (except to permitted persons or trusts) are prohibited. Although the enforceability of an absolute prohibition against transfer may be questioned, it is beneficial to have the statement serve both as a reminder and a deterrent to the
shareholders and to support the argument for rescission of any transfer in violation of the agreement. An example of such an expression of intent and prohibition of transfer is:

"Whereas it is the intent of the parties to maintain the S election of the corporation and to prevent any inadvertent and unintended termination of the election until properly revoked by the parties;

"Therefore, notwithstanding anything in this agreement to the contrary, no shareholder shall transfer any stock of the Corporation to:

"(1) Any person which would make the total number of shareholders exceed thirty-five (35) or such other number permitted under I.R.C. §1361(b)(1)(A);

"(2) Any individual who is not a United States citizen or a resident alien of the United States; or

"(3) Any trust which is not a 'grantor trust' or Qualified Subchapter S Trust (QSST) that satisfies the requirements of I.R.C. §1361(c)(2) or (d)."

2. Prohibited corporate activities. Since the S corporation is a party to the agreement in a redemption or hybrid type of agreement and can be a consenting party to a cross-purchase agreement, the agreement should deal with corporate activities that could result in the termination of the S election. These provisions will include a prohibition against the corporation owning more than 80% of the stock of another corporation and, if the S corporation was previously a C corporation with earnings and profits, engaging in essentially passive types of activities. §§1361(b)(2) and 1362(d)(3).

E. One class of stock. The Subchapter S Revision Act of 1982 has interpreted the "One Class of Stock" requirement as permitting voting and non-voting stock as long as the shares have identical rights in the profits and assets of the corporation. §1361(b)(1)(D) as modified by §1361(c)(4). There have been a number of rulings by the Service on the issue of whether or not the buy-sell agreement itself creates a second class of stock. The first such ruling in 1984, Ltr.
Rul. 8506114, involved a buy-sell agreement with broad and varied restrictions; nevertheless, the Service ruled the agreement did not result in creating a second class of stock.

Although final Regulations were adopted on this issue in March of 1992, a summary of the initial and several early rulings will help to illustrate the types of provisions which can and cannot be utilized without violating the "second class of stock" rule. See Reg. §1.1361-1(l)(2).

1. **Letter Ruling 8506114.** The agreement in this ruling was designed primarily to cover key employees having a proprietary interest in an S corporation. The agreement restricted those shareholders' ability to transfer stock and any transfer made in violation of the agreement was stated to be void and without effect. The S corporation was given the right to purchase the employee's stock at book value if it were notified of a proposed transfer and if the corporation did not purchase the stock, it could be sold only to a person who executed the buy-sell agreement and who would be an eligible S corporation shareholder. The agreement also provided that the corporation was obligated to purchase the stock (or cause others to purchase) if a shareholder died, was adjudicated incompetent, insolvent or bankrupt, if there was an involuntary transfer, if the shareholder's employment was terminated, if the shareholder became disabled, or if there was a determination by the executive committee or the directors of the corporation that the shareholder should sell all or a portion of his stock. The agreement had specific provisions affecting the purchase of stock owned by the Corporation's largest two shareholders. The agreement also provided that shareholders could be required to make capital contributions or loans to the corporation on a pro rata basis; and, as to this provision, the ruling stated that since all shareholders were subject to this provision, the requirement did not create a different class of stock. The agreement also covered the corporate decision making process, granting the majority
shareholder a veto right in preventing any reduction in his proportionate interest in the corporation (indicating the shareholders did not have preemptive rights). Further, the founding shareholder was not subject to all of the transfer restrictions affecting the other shareholders. The agreement also contained a provision whereby the corporation had an option to purchase certain shareholders' stock at "fair market value" if the shareholder voted against or abstained from corporate actions requiring shareholder approval. The purchase price for the stock was subject to an automatic adjustment if certain events occurred within two years after the purchase. The agreement also required shareholders to return a certain portion of the funds distributed to them by the corporation to be managed by the corporation, the prime purpose being to require all shareholders to maintain sufficient funds which could be available for loans to the corporation should they be needed. The buy-sell agreement specifically allowed the corporation to retain a portion of its earnings.

The concern was that the various provisions, taken as a whole, created a second class (or more classes) of stock in light of the differences among the shareholders as to transfer restrictions, purchase obligations, price determinations, the difference in rights, i.e., the executive committee's right to require some but not all shareholders to sell their stock, the obligation of shareholders to vote their shares to effectuate decisions made by the executive committee, the special founder's rights possessed by only one of the shareholders, and the required reinvestment obligations.

Notwithstanding all the varied restrictions and rights, the Service determined there was not a second class of stock, thereby establishing the rule that variations in voting, transfer and price restrictions are not prohibited as long as the rights to dividends and assets of the corporation on liquidation are equal among all shares. This is the position of the Service even though the restrictions will, as a practical matter, result in the shares being worth more or less to various
shareholders. The only determinative factor is that a shareholder’s rights to the assets of the corporation (not the value of the shares) are on an equal basis among all shareholders.

Given the broad nature of the buy-sell agreement involved in this Ruling, it is unlikely that the standard buy-sell agreement would create a second class of stock as long as the rights to profits and distributions on liquidation are on an equal basis among the shareholders.

2. **Letter Ruling 8528049.** In April of 1985, the Service issued its second ruling on whether or not a buy-sell agreement created a second class of stock. In this ruling, the S corporation and the voting shareholders had a right of first refusal if a non-voting shareholder attempted to transfer his stock. The Service held that the voting and non-voting stock, both having the same rights as to dividend and distributions on liquidation was not a second class of stock and that the agreement itself did not create a second class of stock. The Service ignored the difference in treatment between the two types of stock as to the right of first refusal on lifetime transfers and the obligation of the non-voting shareholders to sell their stock if their employment with the corporation was terminated for any reason.

3. **Revenue Ruling 85-161, 1985-41 I.R.B. 22.** This ruling involved a restriction which prevented only one shareholder from selling his stock without obtaining the consent of the other two shareholders. If consent could not be obtained, the shareholder could only sell his stock to the corporation or the other shareholders at book value. Since all stockholders had identical rights in the profits and assets of the corporation, the Service ruled that the restriction did not affect the shareholder's interest in the corporate profits or assets so as to create a second class of stock. Thus, the Service again literally applied the "interest in profits and assets" rule established under §1361(b)(1)(D) and (c)(4) notwithstanding that one shareholder could never receive more than book value for his or her stock without
the other shareholders' consent. See Committee Report on P.L. 97-354. Therefore, even though the restrictions in the agreement may make a particular shareholder's stock worth less than the shares of other shareholders, the Service has stated that this alone will not be considered a difference in "interest in profits and assets." See Ltr. Rul. 8908069 which cites Rev. Rul. 85-161 in holding that a buy-sell agreement did not affect the shareholder's rights to profit and assets of the corporation and was, therefore, not a second class of stock.

4. Debt of S corporation. Prior to the S Corporation Revision Act in 1982, the Service often contended that loans to an S corporation made by shareholders on a pro-rata basis were really a second class of stock. The Revision Act specifically addressed this problem and enacted the so-called "Straight Debt" safe harbor provisions. §1361(c)(5). See Reg. §1.1361-1(l)(5).

a. "Straight debt." If a corporation issues a debt instrument to evidence a shareholder loan and it: (1) provides for an unconditional promise to pay a specified sum, (2) bears a specified interest rate and interest payment dates which are not contingent upon profits, corporate discretion or similar factors, (3) is not convertible into stock, and (4) the creditor is eligible to own S corporation stock, then even if the debt is issued on a pro-rata basis, the debt will not be considered a second class of stock. See Reg. §1.1361-1(l)(5)(iv). If the S corporation anticipates incurring losses and the shareholders anticipate lending funds to the corporation to create "basis" so they can deduct the losses on their individual returns, the following provision should be in the buy-sell agreement:

"Any debt owed to a shareholder of the corporation shall be evidenced by written instrument, shall be payable on demand or mature at the end of a specified time, shall bear a specific rate of interest and payment dates which are not contingent on any event or circumstance, will not be convertible into corporation stock, and will not be transferrable either during the shareholder's life or by his or her estate after death unless the transferee is a permitted shareholder of an S corporation."
b. **State laws.** At least one state, California, has imposed restrictions on so-called "promotional stock," i.e., stock issued without the transfer of tangible assets to the corporation. Under the California law, such promotional stock is restricted as to the payment of dividends and liquidating distributions; and this legislatively imposed restriction has been held to create a second class of stock. See California Corporation Code §25141 and 10 California Administrative Code §260.141; *Paige v. United States*, 78-2 U.S.T.C. ¶9702, 580 F.2d 960 (CA. 9) affirming 75-2 U.S.T.C ¶9587 (C.D. Cal.).

5. **Proposed and Final Regulations.** The Internal Revenue Service issued proposed regulations (the "first proposed regulations") regarding the single class of stock requirement on October 4, 1990. These regulations were severely criticized, and in response to the virtual unanimous negative reaction, the Service withdrew the first proposed regulations on August 13, 1991, replacing them with a revised version of the regulations regarding the single class of stock requirement ("Second Proposed Regulations"). 56 Fed. Reg. 38,391 (August 13, 1991). Following publication of the Second Proposed Regulations, additional comments and testimony were received, after which the regulations were revised and issued in final form on May 29, 1992. 57 Fed. Reg. 22,646 (May 29, 1992).

6. **General Rules.** The final regulations state that a corporation is generally considered to have only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Reg. §1361-1(1)(1). Differences in voting rights among shares of stock are disregarded in determining whether a corporation has more than one class of stock.

7. **Buy-Sell and redemption agreements.** The final regulations provide specific guidelines respecting the extent to which buy-sell and redemption agreements may violate the single class of stock requirement. The regulations state
specifically that buy-sell agreements among shareholders and redemption agreements are to be disregarded in determining whether an S corporation's outstanding shares of stock confer identical rights to distribution and liquidation proceeds unless (i) a principal purpose of such agreement is to circumvent the single class of stock requirement and (ii) the agreement establishes a purchase price that, at the time the agreement is entered into, is either significantly greater or less than the fair market value of the stock. Reg. §1.1361-1(l)(2)(iii)(A).

a. If an agreement provides for the purchase or redemption of stock at book value or at a price between fair market value and book value, such price is not considered to be significantly in excess of or below the fair market value of the stock.

b. A good faith determination of fair market value will be respected absent a showing that (i) the value is substantially in error and (ii) the determination of value was not performed with reasonable diligence.

c. A determination of book value will be respected if (i) the book value is determined in accordance with generally accepted accounting principles or (ii) the book value is used for any substantial non-tax purposes. Reg. §1.1361-1(l)(2)(iii)(C).

i. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability or termination of employment are disregarded in determining whether an S corporation's stock confers identical rights. Reg. §1.361-1(l)(2)(iii)(B).

F. Distribution of earnings. In valuing S corporations for buy-out purposes, there should be taken into account the fact that the shareholders will typically need to receive a portion of the corporation's income in order to have sufficient funds to pay the tax on the income attributable to them from the corporation. It should be noted that the top federal income individual tax rate of 31%
is still less than the top corporate rate of 34%; therefore, some S corporations can accumulate more of their earnings than they could as C corporations. In other words, many C corporations will "distribute" more of their profits to the U.S. Treasury (in taxes) than they would need to distribute to their shareholders (as S corporations) to cover the shareholders' individual taxes. To protect the shareholder's need for dividends, a required minimum level of dividend distribution by an S corporation should be provided for in the buy-sell agreement. See Exhibit "M" for provision regarding dividend distributions of income by an S corporation.

G. Election to "close the books." The corporation with approval of all its shareholders who own shares at any time during the corporation's taxable year can elect to treat income and losses for the year in which a shareholder transfers all of his stock as if the books of the corporation were "closed" on the date of sale. §1377(a)(2). If the election is made, the shareholders will be treated as if the corporation had two short taxable years within its full taxable year. If the election is not made, income or loss of the corporation is allocated on a pro rata, per share, per day basis for the entire year. §1377(a)(1)

1. Examples. The two options are illustrated as follows:

Facts: Widget, Inc., an S corporation on a calendar-year, has a loss of $100,000 for the six-month period January 1 through June 30, 1989, and breaks even during the next six months ending December 31, 1989, thus incurring a loss for the entire year of $100,000. On January 1, 1989, the stock of Widget, Inc. is owned equally by A and B. On July 1, A transfers all of his stock interest in Widget, Inc. to C.

Pro-rata rule of §1377(a)(1). The $100,000 loss for 1989 would be allocated equally to each day of the corporation's taxable year so that $50,000 of the loss would be allocated to the first half of the year. Since A owned 50% of the stock of the corporation during this period,
he would be allowed $25,000 of the loss on his individual tax return for
1989. B would be allocated $50,000 of the loss, and C would be
allocated $25,000 of the loss.

Two taxable-year rule of §1377(a)(2). The $100,000 loss for 1989 would
be allocated entirely to the short taxable year ending June 30, 1988.
Accordingly, A and B would each be entitled to $50,000 of the loss.
Since Widget, Inc.'s short taxable year, July 1 through December 31,
1988, is a break-even year, A and C would be attributed with no income
or loss from the corporation for this period.

2. Agreement to "close the books." It is often desirable for
the buy-sell agreement to provide that shareholders must consent to the election to
"close the books" and to specifically state who will bear the accounting and other
costs required to make the necessary computations during the year of sale. In
addition, if the parties agree to protect the interest of a terminating shareholder,
the buy-out agreement should provide for the distribution of the entire year's income
(or an amount equal to the taxes); otherwise, the general corporation laws will apply
so that the corporation's Board of Directors may or may not declare dividends in its
discretion. See Exhibit "N" for provision requiring shareholders to elect to "close
the books" if any shareholder requests.

IX. Alternative Minimum Tax and Life Insurance.

A. In general. The law contains a corporate alternative minimum tax
(AMT) for the stated purpose of eliminating situations where corporations have paid
little or no tax in years in which they reported substantial earnings (and paid
substantial dividends) to their shareholders. See General Explanation of Tax Reform

B. The AMT formula. The tax base for calculating AMT is the
corporation's "alternative minimum taxable income" (AMTI) which is its regular
taxable income increased (or decreased) by various adjustments and reduced by an exemption of $40,000. The AMTI is then subject to a tax at a 20% rate and the amount of tax so calculated (the "tentative minimum tax" (TMT)) is the applicable tax if it exceeds the corporation's regular income tax for that year. In arriving at AMTI, a corporation's taxable income is recalculated based on "adjustments" and "preferences." "Adjustments" can either increase or decrease taxable income, whereas a "preference" will only increase taxable income. In addition, a "book income adjustment" (changed for years after 1989 to an "adjusted current earnings" or ACE adjustment) was provided to ensure that all corporations with substantial incomes (from a financial standpoint) will pay some tax.

1. **The "book income" adjustment.** For years through 1989, an adjustment was made to the corporation's tax base (AMTI) which has the result of increasing AMTI by one-half of the amount by which the "adjusted net book income" exceeds AMTI; this difference was then added to the AMTI so that, in effect, the corporation's tax base was calculated twice (once without and then again with the "book income" adjustment). §56(f)(1).

2. **The "earnings" adjustment.** For taxable years since 1989, corporations use an "earnings" adjustment instead of a "book income" adjustment. Beginning in 1990, the AMTI was increased by 75% of the amount by which current ACE adjustment exceeds AMTI. §56(g)(1); Reg. §1.56(g)-1(c)(6).

3. **Accounting for life insurance.** The generally accepted accounting method for corporate owned, cash value life insurance is expressed in Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, which requires that the annual increase in the cash surrender value of the policy be charged to an asset account and the annual premium charged to expense. The net result is that the premium is offset by the increase in cash value which typically results in a net expense during the early years of a policy (premiums higher than
cash value increases) and non-taxable income in later years when the annual increase in cash value exceeds the premium.

C. Alternative minimum tax and life insurance. Both the "book income" and ACE adjustments impact on two aspects of corporate owned life insurance -- (1) the annual increase the cash value of the policy and (2) the death benefit.

1. Cash value. The annual increase in cash value (inside build-up) will generally not result in AMT unless the net annual increase (cash value increase less premium paid) exceeds $54,000 in 1990 and later years. Therefore, the increase in cash surrender value is not likely to result in AMT for the majority of corporate taxpayers except where a large, high cash value policy is involved. §56(g)(4)(B)(ii). Regarding increases in cash value, the Conference Committee Report to TRA-86 stated that the "inside build-up," minus a portion of the premium attributable to the mortality charge, is includible in earnings and profits. Conference Report No. 99-841 at II-278.

2. Death benefit. The death benefit from life insurance is nontaxable income to the corporation and increases the "book income" and ACE adjustment after the corporation has recovered its basis in the contract. Therefore, since 50% of the insurance proceeds would be an adjustment to AMTI prior to 1990, the AMT cost of those proceeds would not exceed 10% of the face value of the policy. The change in 1990 resulted in life insurance death benefit proceeds being taxed at a maximum rate of 15% (i.e., 20% x 75% = 15%). Regarding death benefits, Rev. Rul. 54-230, 1954-1 C.B. 114, held that the excess of life insurance proceeds in excess of the aggregate premiums paid was includible in "earnings and profits." Although "earnings and profits" is not defined in the Code, the fact that insurance proceeds increase corporate resources available to shareholders makes it likely that the holding of this ruling will be followed in the AMT calculation.
D. Planning suggestions.

1. Since the effective rate (depending on several factors) can be as high as 15%, one option is to purchase more insurance to cover the tax.

2. In establishing a new buy-sell agreement, the use of a cross-purchase agreement (which avoids AMT) may be advisable if other factors are also favorable.

3. Since the AMT does not apply to S corporations, the elimination of AMT exposure is an incentive for the corporation to make an S election.

For a good discussion of the alternative minimum tax on life insurance proceeds payable to a C corporation, see Wolf and Kupferberg, "What is the best form of structuring corporation buy-out agreements now?" 16 Estate Planning 2 (Jan./Feb. 1989).

X. Restructuring Agreement After Election of S Status.

A. In general. Since the enactment of TRA-86, many corporations have elected S status because of lower individual tax rates, avoidance of the corporate alternative minimum tax, avoidance of the corporate tax on built-in gains, avoidance of unreasonable compensation issues and for a variety of other reasons. Many of these corporations, while operating as a C corporation, entered into a stock redemption type of buy-sell agreement that provided for the corporation to purchase the stock of a shareholder upon his death. The obligations created by many of these agreements were funded by life insurance on the lives of the shareholders, with the corporation being the owner and beneficiary.

Prior to TRA-86, it was generally desirable to use stock redemption agreements, especially since C corporations were typically in lower income tax brackets than the top marginal brackets of their shareholders. The only significant drawback of the stock redemption agreement was the fact that the
surviving shareholders would not receive a step up in the basis of their stock upon the purchase by the corporation.

B. **Continuation of redemption agreement.** If the stock redemption agreement continues after the corporation changes from "C" to "S" status, the stock basis of the surviving shareholders will be affected by the date on which the deceased shareholder's death occurs and whether or not there has been an interim "closing of the books" pursuant to §1377(a)(2), i.e., the shareholders being treated as if the corporation had two short taxable years in the taxable year in which a shareholder dies. See examples at pp. 44 and 45, supra. If the deceased shareholder of an accrual basis S corporation dies in the beginning of the year and no election is made so that the corporation's income for its full taxable year (including life insurance proceeds) is allocated to each shareholder on a prorata, per-day basis, the surviving shareholders will have a higher basis in their stock than would be the case if there had been an election to "close the books." Although life insurance proceeds are tax exempt, a shareholder's basis is increased by an item of income such as tax-exempt income. §§1367(a)(1)(A) and 1366(a)(1)(A). If the S corporation is an accrual method taxpayer where there has been an election to "close the books," a shareholder's death will cause the insurance proceeds to be accrued immediately, resulting in the total proceeds being included in the corporation's short year ending on the shareholder's death. Thus, in a two shareholder corporation, one-half of the insurance proceeds would be allocated to each shareholder for the short year. If the purpose is to increase the basis of a surviving shareholder to the highest possible level, it would be preferable not to "close the books" where there is an accrual method S corporation.

If the S corporation is on the cash basis, it would be desirable to "close the books" so that the collection of the death proceeds of the insurance will occur in the short taxable year in which the corporation has only the surviving shareholders
to whom the income (and the basis increase) will be allocated. This would not be detrimental to the deceased shareholder's estate since any basis increase resulting from the insurance proceeds would be wasted if allocated to the estate because of the step up in basis provisions of §1014. See Green, "Tailoring Buy-Sell Agreements to Solve the Unique Problems of S Corporations," 63 TAXES 978 (December 1985) at 995, fn. 78.

To preclude the estate of a deceased shareholder from being taxed with a portion of an S corporation's taxable income during the year without receiving any benefit (the estate will receive only the fixed buy-out price under the agreement), the buy-sell agreement should provide that upon the death of a shareholder his stock ownership in the corporation shall be deemed to be immediately terminated, notwithstanding the fact that his stock will not actually be redeemed from his estate until some time after his death. If this is not desirable, the agreement can still protect the deceased shareholder's estate by providing that the deceased shareholder's estate will receive a distribution from the corporation (either as part of the purchase price or as a dividend distribution) equal to all or a part of the income allocated to the deceased shareholder's estate. It is important that the "one class of stock" rule of 1361(b)(1)(D) be carefully examined before drafting any such provision. See generally Gorfinkle, "Should Redemption Agreements Be Changed When S Corporation Status is Elected?" 69 J. of Tax. 220 (October 1988); and Mittelman, "S Corporation Buy-Sell Agreements After the Tax Reform Act of 1986," J. of Am. Soc. of CLU and ChFD (May 1988) at 36. See also Gray and Bravenec, "Buy-Sell Agreements of S Corporation Stock Affected by Corporation's Special Tax Status," 63 J. of Tax. 202 (October 1985).

C. Cross-purchase agreement. If a cross-purchase agreement exists, the surviving shareholders will have a basis in stock purchased from a deceased shareholder's estate equal to the amount paid for the stock plus the
surviving shareholders' portion of the corporation's income during the year of death. See example in Gorfinkle, "Should Redemption Agreement Be Changed When S Corporation Status is Elected?" 69 J. of Tax. (October 1988) at 223. The cross-purchase agreement funded entirely by life insurance will, in most cases, result in the surviving stockholder's basis in the purchased stock being substantially higher than it would be under a stock redemption agreement. If the buy out is fully or almost fully funded by life insurance, the basis increase of the surviving stockholder under a stock redemption agreement will approach the basis increase under a cross-purchase agreement only if a deceased shareholder were to die very early in the taxable year and the election to "close the books" is not made where there is an accrual basis S corporation involved or the election is made if the corporation were on the cash basis. Thus, the stock redemption agreement creates uncertainty as to the surviving shareholder's basis, depending on the date of the death of the deceased shareholder and whether or not the election to "close the books" is made, whereas the cross-purchase agreement guarantees a basis equal to the purchase price.

D. Changing from "redemption" to "cross-purchase." If the decision is made to terminate an existing stock redemption agreement and create a new cross-purchase agreement, the "transfer for value" rule of §101(a)(2) will be an obstacle. Unless the shareholders of the corporation are also partners in an existing partnership, a transfer of the insurance policies from the corporation to each shareholder on the other shareholder's life will be a "transfer for value." If the shareholders are all insurable and the life insurance policies are relatively new or term policies, it may be advisable for the corporation to cash in the policies and for the shareholders to take out new policies on each other. However, in many cases this is not practical because of relatively old high cash value policies (which would
result in a much higher premium for new policies) or because a shareholder is not currently insurable.

1. Shareholders as "partners." If the shareholders of a closely held corporation are also partners in an existing enterprises, i.e., a real estate partnership which leases personal or real property to the corporation, the transfer of the policies to the non-insured shareholders will meet the "partner of the insured" exception of §101(a)(2)(B). If no such partnership exists, the shareholders may form an equipment leasing partnership to lease equipment to the corporation. So long as the partnership is a valid partnership under state law and engages in a business activity, it will be recognized. See Moline Properties, 311 U.S. 436 (1943).

2. Buy-out life insurance trust. If the corporation has more than two shareholders, the cross-purchase agreement (even if newly created) will only temporarily solve the transfer for value problem since after the first death of a shareholder the remaining shareholders would need to purchase the policies on the other shareholders' lives from the deceased shareholder's estate. It may be possible to avoid this transfer for value problem and solve many of the administrative problems involved in maintaining a large number of insurance policies (4 shareholders would require 12 policies; 5 shareholders would require 20 policies) by creating a "buy-out life insurance trust" to hold the policies. The trust, established in conjunction with a cross-purchase agreement, would own a single policy on each shareholder who would be a beneficiary of the trust. Upon a shareholder's death, the insurance proceeds would be collected by the trustee and distributed to each of the surviving shareholders to use in purchasing the shares from the deceased shareholder's estate in accordance with terms of the cross-purchase agreement. See Exhibit "O" for a buy-out life insurance trust used in conjunction with a cross-purchase agreement prepared by Ronald D. West of Washington, D.C.
If a cross-purchase agreement is not fully funded, the unfunded portion of the obligation will continue to be a personal liability of each surviving shareholder which to many shareholders will be objectionable. On the other hand, the cross-purchase arrangement, whether or not utilizing the buy-out life insurance trust, does protect the insurance proceeds from the claims of creditors of the corporation.

E. **Termination of S status.** Eventually, it may become desirable to terminate the corporation's S election. However, under a cross-purchase agreement which is not fully funded and where the surviving shareholders are personally obligated to make installment payments, the termination of the election could cause a problem if the shareholders need to rely on distribution of funds from the corporation. Although increased salaries may be an answer in some cases, the need for distributions from the corporation could exceed what is "reasonable compensation" under §162. This same problem could result in the event the purchase price at death exceeds the insurance available so that the shareholders would have a large continuing installment obligation to pay.

F. **Review of existing agreements.** All existing stock redemption agreements of former C corporations which have elected S status, especially those funded with life insurance, should be reviewed to determine whether it is practical to restructure them as cross-purchase agreements. If possible the change to a cross-purchase agreement could be of great benefit to the surviving stockholders. If more than two shareholders are involved, the "transfer for value" problem is a deterrent unless there is an existing partnership among the shareholders. A buy-out life insurance trust can eliminate "transfer for value" problems after the first death of a shareholder but does not help in avoiding the problem when policies are transferred from the corporation to the shareholders.
Within 30 days after the date of termination of employment, the Selling Partner shall select and appoint one appraiser and shall give written notice of such selection or appointment to the Partnership. Within 15 days after the receipt of the written notice of the selection or appointment of said appraiser, the Partnership shall select and appoint an appraiser and shall give written notice of such selection or appointment to the Selling Partner. It shall then be the duty of said two appraisers to determine the fair market value of the interest of the Selling Partner in the Partnership as of the aforesaid date. Said two appraisers shall meet within 10 days after the appointment of the second appraiser, and if within 15 days after the appointment of the second appraiser, the said two appraiser are unable to agree upon the fair market value of the Selling Partner's Partnership interest, said two appraisers shall appoint a third appraiser within 5 days after their failure to agree upon the fair market value of such interest and said third appraiser shall determine the fair market value of said Selling Partner's Partnership interest within 15 days after his appointment.

The appraised value of said Selling Partner's Partnership interest as determined by the first two appraiser appointed, assuming they shall be able to agree, shall be the decision of the appraisers, and said decision shall be binding upon the Selling Partner and the Partnership. In the event said two appraisers are unable to agree, the appraisal by the third appraiser shall be binding upon the Selling Partner and the Partnership. After reaching a decision concerning the valuation of said Partnership interest, the appraisers or appraiser, as the case may be, shall give written notice thereof to the Selling Partner and the Partnership.

The Selling Partner and the Partnership each shall pay all fees and charges of the appraiser of its own selection, and one-half of those of any third appraiser whose services might be needed as above provided.
EXHIBIT "B-1"
FORMULA METHOD (BASED ON ASSET VALUE AND EARNINGS)
OF VALUATING FOR CONSTRUCTION AND
REAL ESTATE DEVELOPMENT COMPANY

FIFTH

The purchase price for each share of Company's common stock shall be determined from the earnings and assets of Company as shown on its regularly prepared financial statements and its books and records in the following manner:

(a) Determine the value of Company based on "Earnings" as follows:

(i) Determine the net earnings (or loss) of Company as shown on the financial statements of Company for each of the most recent five (5) full fiscal years of Company and weight said earnings on a 5-4-3-2-1 scale, using the weight of "5" for the most recent full fiscal year, a weight of "4" for the next prior year, a weight of "3" for the next prior year, a weight of "2" for the next prior year, with the earliest fiscal year used in the computation being given a weight of "1."

(ii) Divide the total of the weighted earnings of Company, as computed in (i) above, by fifteen (the total of weighting factors) to determine the "Average Annual Earnings" of Company.

(iii) Multiply the "Average Annual Earnings" by five (5) to determine the value of Company based on Earnings.

(b) Determine the value of Company based on its "Assets" by determining the value of the assets of Company as of the end of the month immediately prior to the date of a Shareholder's death or as of the end of the fiscal year of Company immediately prior to the date of the Senior Managing Shareholder's notification of Company of his election to sell part or all of his stock, or as of the end of the fiscal year of Company immediately prior to the date of Company's exercise of its option to purchase the stock of a Junior Managing Shareholder following the Junior Managing Shareholder's termination of employment for reasons other than death, or as of the end of the fiscal year of Company immediately prior to the date on which Company's option to purchase the stock of a Junior Managing Shareholder lapses (due to Company's failure to exercise its option), in the following manner:

(i) Determine the "Book Value" of the current assets;
(ii) Determine the fair market value of the fixed assets, which shall be the greater of the depreciated "book value" of each fixed asset or the value of each fixed asset approved by the insurance carrier insuring the fixed assets; and

(iii) Add the amounts determined in subparagraphs (b)(i) and (ii) of this paragraph and subtract therefrom the total of all liabilities of Company to determine the value of Company based on "Assets."

(c) Add the values of Company based on "Earnings" and "Assets" as determined in subparagraphs (a) and (b) of this Paragraph Fifth and divide the sum by two to determine the "Value" of Company.

(d) The purchase price for each share of Company's Class "A" Voting Common Stock shall be determined in the following manner:

(i) Divide the Value of Company (as determined in subparagraph (c) of this Paragraph Fifth) by the number of "Equivalent Shares." The number of "Equivalent Shares" is determined by summing the number of Class "A" Voting Common Stock multiplied by 100% and the number of Class "B" Non-Voting Common Stock multiplied by 90%.

(ii) Multiply the final amount obtained in subparagraph (d)(i) of this Paragraph by seventy-five percent (75%) (which reflects a fifteen percent discount for lack of marketability of the stock and a ten percent (10%) discount for the "minority interest" status of each share to be purchased, if appropriate) to determine the purchase price for each share of Company's Class "A" Voting Common Stock.

(e) The purchase price for each share of Company's Class "B" Non-Voting Common Stock shall be ninety percent (90%) of the value of the Class "A" Voting Common Stock before the application of the "minority interest" discount (as determined in subparagraph (d) of this Paragraph Fifth). (This discount reflects the fact that this Class "B" Common Stock is worth less than the Class "A" Common Stock because of the Class "B" Common Stock's incapacity to vote.)

(f) The parties hereto intend to arrive at the true fair market value of Company's stock and intend the foregoing method of valuation to reflect the guidelines regarding valuation as set forth in Internal Revenue Service Ruling 59-60, 1959-1 C.B. 237.
(g) The purchase price for each share of Company's Class "A" Voting Common Stock and Class "B" Nonvoting Common Stock as determined under this Paragraph Fifth shall be conclusive and binding upon the Shareholders.
FORMULA METHOD (BASED ON HIGHER OF FIXED PRICE OR "BOOK VALUE")
OF VALUATION FOR MANAGEMENT CONSULTING COMPANY

Seventh.

The purchase price for Shareholder's common stock of the Company shall be Five Hundred Dollars ($500.00) per share or an amount per share equal to 10 times the net earnings per share after the payment of income taxes of the Company, as shown on the annual audited statement of the Company, prepared by the Company's regular independent auditors for the fiscal year of the Company immediately preceding the year in which the death of Shareholder occurs, or in which Shareholder gives written notice of his desire to sell his stock, whichever amount per share is greater; and said amount, as so determined, shall be conclusive and binding upon the parties unless and until a new purchase price is established, as hereinafter provided in Paragraph Eighth.
4. **Purchase Price.** As of the date hereof, the value of all of the issued and outstanding shares of Stock for the purpose of this Agreement shall be $250,000.00. The Shareholders and the Corporation agree to redetermine the value of all of the issued and outstanding shares of Stock on at least an annual basis and within seventy-five (75) days following the end of each fiscal year of the Corporation, and the value so agreed upon shall be entered on the Valuation Schedule attached hereto as Exhibit “A” and made a part hereof. The value of all the issued and outstanding shares of Stock shall be the value last entered on the Valuation Schedule unless more than twenty-four (24) months shall have elapsed since the effective date of the last determination of value, in which event the value of all the issued and outstanding shares of Stock last entered on the Valuation Schedule shall be (i) increased by an amount equal to the profits of the Corporation since the end of the fiscal year immediately preceding the date on which the last value was entered, or (ii) decreased by an amount equal to the losses of the corporation since the end of the fiscal year immediately preceding the date on which the last value was entered. The profits or losses of the Corporation shall be determined by the accountant regularly employed by the Corporation in accordance with accounting principles normally used by him in the preparation of the financial statements of the Corporation, and his determination shall be binding and conclusive upon the parties hereto, their personal representatives and successors and all other persons involved.
EXHIBIT "D"

OPTION IN CORPORATION AND SHAREHOLDERS
TO PURCHASE DURING LIFETIME

Third.

In the event Shareholder desires to sell all or any part of his common stock in Company during his lifetime, Shareholder shall notify the Company and the other shareholders in writing of his desire to sell. In such event, the Company shall have the option within a period of sixty (60) days after the receipt of such notice to purchase such stock at the price and upon the terms hereinafter provided in Paragraphs Seventh and Ninth. Upon the failure of the Company to exercise its option hereinafore given to purchase such stock within the time provided, such shares shall be offered for sale pro rata to the other shareholders of Company and such other shareholders shall have the right to purchase all (and not less than all) of such stock at any time within thirty (30) days after receipt of such offer at the price hereinafter provided in Paragraph Seventh, such price to be paid in cash. Upon the failure of the Company and such other shareholders to exercise the options hereinafore given to purchase such stock within the times provided, this agreement shall terminate as to such stock and Shareholder shall then have the full right and privilege of disposing of such stock in any manner or to whom he desires; and Shareholder may surrender to the Company, within ten (10) days after the expiration of the thirty (30) day period last above referred to, the certificates representing the shares offered for sale and not purchased under the terms hereof, and the Company shall issue to him in lieu thereof new certificates for an equal number of shares without the endorsement hereinafter set forth in Paragraph Sixth.
EXHIBIT "E"

PERMISSION TO GIFT SHARES TO FAMILY MEMBERS
AND PLEDGE SHARES AS SECURITY FOR LOANS

TENTH

Notwithstanding any other provision contained in this Agreement, the Senior Managing Shareholder shall have the right to transfer, by way of gift or as security for a loan, all or any part of his stock; provided, however, that any such transferred stock shall be subject to the terms of this Agreement, it being understood and agreed that the stock to be purchased under this Agreement shall include not only the stock owned by the Senior Managing Shareholder as of the date of this Agreement, but also any stock transferred by the Senior Managing Shareholder during the term of this Agreement; and any person, firm or corporation holding said stock shall be restricted in the sale of said stock in the same manner as a Junior Managing Shareholder.

A Junior Managing Shareholder shall have no right to pledge his stock in Company as security for a loan; but, a Junior Managing Shareholder shall have the right to transfer, by way of gift, all or any part of his stock; provided, however, that any such transferred stock shall be subject to the terms of this Agreement, it being understood and agreed that the stock to be purchased under this Agreement shall include not only the stock owned by the Junior Managing Shareholders as of the date of this Agreement, but also any stock transferred by a Junior Managing Shareholder during the terms of this Agreement; and any person, firm, or corporation holding said stock shall be restricted in the sale of said stock in the same manner as a Junior Managing Shareholder.
EXHIBIT "F"

OBLIGATION TO SELL AND OBLIGATION TO PURCHASE SHARES
UPON DEATH OF A SHAREHOLDER

FIRST

Upon the death of any Shareholder, the estate of the deceased Shareholder shall sell, and
Company shall purchase, all of the stock of Company owned by such Shareholder at the time of such
Shareholder's death. The amount of the purchase price and the terms of payment for the stock of
Company purchased pursuant to this paragraph shall be in accordance with the provisions as they are
hereinafter set forth in Paragraphs Sixth and Seventh.
EXHIBIT “G”

OBLIGATION TO PURCHASE STOCK ON DISABILITY OF SHAREHOLDER

(2) In the event a stockholder who is party to this agreement becomes totally and permanently disabled before reaching age 55, and remains so for a period of 12 months from the onset of such disability, then the Company shall purchase and the disabled stockholder shall sell, as of the end of such period, all of such disabled stockholder’s stock in the Company. “Disability” or “total and permanent disability” for purposes of this agreement shall be considered that disability of an insured stockholder which is described and determined by the insurer as “total and permanent disability” in the insurance policies on such insured stockholder listed in Article 4 below and/or Schedule “B” attached hereto. The purchase price shall be that which is established in Article 3 below, provided, however, that such purchase price shall not be paid in a lump sum but instead shall be paid in installments of $5,000.00 per month plus interest in an amount equal to 8 1/2% per year of the declining balance of such purchase price until the total purchase price shall have been paid in full. If a disabled stockholder ceases to be totally and permanently disabled at any time after such installment payments have commenced but prior to the time they have been completed, then such installments shall thereafter be paid at the rate of $2,500.00 per month until the balance of said purchase price and interest at the rate of 8 1/2% per year on the declining balance shall be paid in full. If the disabled stockholder shall die prior to the time that the purchase price has been paid in full, the balance of the purchase price plus any accrued interest then due shall be paid to shareholder’s estate in one lump sum.*

*Other alternatives can be provided; i.e., the parties could agree to stop the buy-out upon a disabled shareholder ceasing to be disabled; could agree to let the disabled partner buy back in again; could provide for the installment obligation of the Company to be evidenced by a promissory note (with or without security), or could provide that the disabled shareholder will remain a shareholder until the purchase price is paid in full.
Upon a Shareholder’s death, the purchase price of the stock owned by such Shareholder as determined under Paragraph Fourth, shall be paid in the following manner:

(a) Within 90 days after the appointment and qualification of a legal representative for the estate of such deceased Shareholder, Company shall deliver to the deceased Shareholder’s legal representative Company’s secured promissory note (the security for said promissory note and other restrictions being described in Paragraph Sixth), said promissory note to provide for payment of the amount of the purchase price in ten (10) equal annual installments of principal and interest, with the first of such installments being due and payable on the first annual anniversary of the date of the Shareholder’s death. Said promissory note shall provide for interest on the outstanding balance of principal due on said note at the greater of:

(a) the Applicable Federal Rate, if any, as determined under the appropriate sections of the Internal Revenue Code in effect on the date the promissory note is executed, or (b) the rate of 7 1/2% per annum.

Said promissory note shall permit Company to pay any part or all of any amounts due on said note in advance without penalty; shall provide that Company shall pay all costs of collection, including 15% of the unpaid balance of principal and interest as attorney’s fees if collected by law or through any attorney at law; and shall contain such other terms and provisions as are customarily found in commercially acceptable promissory notes.

(b) If any portion or all of the stock to be purchased by Company is subject to any pledge or encumbrance, Company may pay such amount, within the discretion of Company, to discharge any liability under such pledge or encumbrance, which amount when so paid shall be credited against the purchase price to be paid hereunder.

(c) If, at the time Company is required to make payment of the purchase price for the stock of a Shareholder, Company’s capital surplus is insufficient for such purpose, Company’s entire available surplus
shall be used to purchase as many shares of such stock as possible; and Company and its Shareholders, including any Shareholder's legal representative, shall promptly take all required action to reduce the stated capital of Company to the extent necessary to create the additional surplus required for the redemption of such unpurchased stock.

SIXTH

The debt evidenced by said promissory note provided for in Paragraph Fifth above shall be secured by the stock purchased from the deceased Shareholder, pursuant to Paragraph First; and the certificate or certificates representing said stock of the deceased Shareholder shall be held by Shareholder's legal representative until all principal and interest due under Company's said promissory note have been paid in full. In the event of default in the payment of any installment of principal or interest, or any part thereof, due on said promissory note, the deceased Shareholder's legal representative may, at his option, declare the principal sum then remaining unpaid, together with accrued interest thereon, due and payable at once, and shall have the power to sell, at public or private sale, with or without notice or advertisement, and without the order of any court, any and all of said shares of stock, and to convey fee simple title to said stock to the purchaser or purchasers at such sale or sales. Said deceased Shareholder's legal representative shall not be disqualified to be the purchaser upon such sale of said stock. The proceeds of such sale shall be applied first to the payment of all expenses of the sale and next to the payment of accrued interest and then to the principal due on said promissory note. If the net proceeds of such sale are not sufficient to satisfy said debt in full, Company shall, immediately upon demand, pay the deficiency in full. If the net proceeds from such sale are in excess of the amount needed to satisfy said debt in full, such excess amount shall be paid to Company.

As long as Company remains indebted on said promissory note provided for in Paragraph Fifth hereof, in any sum whatsoever, Company shall not, without the prior written approval of the holder of said promissory note, declare any dividends on its stock, cause or permit to be taken any action resulting in or seeking to accomplish any recapitalization, reorganization, merger or dissolution of Company or other change in the capital structure of Company; nor shall Company issue any additional shares of stock of Company during such period. In addition to the above restrictions, so long as Company remains indebted on said promissory note in any sum whatsoever, Company shall not, without the prior written approval of
the holder of said note, increase the salaries, bonuses, fringe benefits, or compensation of any kind for any of its officers or of any employee (whether or not an officer) who is a shareholder or a member of a shareholder's immediate family. At all times during the period in question, Company will, unless otherwise permitted in writing by the holder of said promissory note, maintain a ratio of its current assets to its current liabilities of at least one to one.

Should Company violate or be in default under any of the provisions of this Stock Purchase Agreement or any provision of the aforesaid promissory note, then, in addition to all other rights and remedies of the deceased Shareholder as herein provided for, as provided for in Company's said promissory note, and as may be additionally provided by law, a special meeting of the Board of Directors of Company shall be held within ten (10) days after the Shareholder's legal representative demands such meeting. At this special meeting of the Board of Directors, the legal representative of Shareholder's estate shall be entitled to appoint a majority of Directors of Company's Board of Directors; and the directors so appointed by the legal representative of the Shareholder's estate shall remain in office until the entire indebtedness due under said promissory note and the entire purchase price for said stock has been paid in full.
Ninth.

The terms of payment of the purchase price of any common stock purchased by the Company hereunder shall be as follows:

(a) If the common stock to be purchased by the Company is subject to any pledge or encumbrance, the Company shall devote the proceeds of any policies of insurance on Shareholder's life to the discharge of any liability under such pledge or encumbrance, which amounts when so applied shall be credited against the purchase price to be paid.

(b) In the event the purchase price of such common stock is equal to or greater than the proceeds received or receivable from such insurance policy or policies, the Company shall apply the balance of the proceeds of such life insurance (after applying so much of the proceeds to the discharge of any liability as provided for in subparagraph (a) above), to the purchase price of such stock by paying same to Shareholder or Shareholder's personal representative; and the Company shall have the right to pay the difference, if any, between the amount of the insurance proceeds and the purchase price either in cash from its surplus, or by giving to Shareholder or Shareholder's personal representative the Company's promissory note, payable in sixty (60) equal monthly installments, the first of said installments being due and payable on the ninetieth (90th) day after the date of Shareholder's death or the date of exercise of the Company's option, whichever date is applicable. Said note shall bear interest at the rate of Eight Per Cent (8%) per annum on any unpaid balance until paid and shall contain a provision allowing the Company to pay any part or all of the unpaid principal balance of said note in advance without penalty. Said promissory note shall also contain such other terms and provisions as are customarily contained in a commercially acceptable promissory note, including without limitation a provision stating that if the Company defaults in making payment of any installment of principal or interest, or any part thereof, then at the option of the holder of said note, the principal sum remaining unpaid with accrued interest shall at
once become due and payable, without notice, and said principal sum and accrued interest shall bear interest at the rate of Ten Per Cent (10%) per annum from such time until paid; and the Company shall pay all costs of collection including Fifteen Per Cent (15%) of the unpaid balance of principal and interest as attorneys' fees if collected by law or through an attorney at law.

(c) In the event the purchase price of such common stock is less than the proceeds received from such insurance policy or policies, the Company shall pay the full purchase price to Shareholder or shareholder's personal representative in cash and retain the balance of such proceeds as the property of the Company.

(d) If, at the time the Company is required to make payment of the purchase price for the common stock of Shareholder, the Company's surplus is insufficient for such purpose, the Company's entire available surplus shall be used to purchase as many shares of such common stock as possible and the Company and its shareholder including Shareholder or Shareholder's personal representative, shall promptly take all required action to reduce the stated capital of the Company to the extent necessary to create the additional surplus required for the redemption of such unpurchased common stock. If, at such time, the Company has a deficit, the insurance proceeds, if any, shall first be applied to eliminate the deficit.
EXHIBIT "J"

PURCHASED STOCK HELD AS SECURITY FOR CORPORATION'S INSTALLMENT NOTE AND RESTRICTIONS ON CORPORATE ACTIVITY

SEVENTH

In the event the purchase price for Company's stock is paid for by Company delivering its promissory note as provided for in Paragraph Sixth, the debt evidenced by said promissory note shall be secured by the stock purchased from such Shareholder and the certificate or certificates representing said stock shall be held by said Shareholder or the deceased Shareholder's legal representative until all principal and interest due under Company's said promissory note have been paid in full.

As long as Company remains indebted on its promissory note provided for in Paragraph Sixth, Company shall not, without the prior written approval of the holder of said promissory note, declare any dividends on its stock, cause or permit to be taken any action resulting in or seeking to accomplish any recapitalization, reorganization, merger or dissolution of Company or other change in the capital structure of Company, nor shall Company issue any additional shares of stock of Company during such period. In addition to the above restrictions, so long as Company remains indebted on said promissory note, Company shall not, without the prior written approval of the holder of said note, increase the salaries, bonuses, fringe benefits, or compensation of any kind for any of its officers or any employee (whether or not an officer) who is a shareholder or a member of a Shareholder's immediate family. At all times during the period in question, Company will maintain a ratio of its current assets to its current liabilities of at least two to one.

In the event of default in the payment of any installment of principal or interest, or any part thereof, due under said promissory note, a Shareholder or the deceased Shareholder's legal representative, as the case may be, may, at his option, declare the principal sum then remaining unpaid, together with accrued interest thereon, due and payable at once, and shall have the power to sell, at public or private sale, with or without notice or advertisement, and without the order of any court, any and all of said shares of stock, and to convey fee simple title to said stock to the purchaser or purchasers at such sale or sales. Said
Shareholder or deceased Shareholder’s legal representative, as the case may be, shall not be disqualified to be the purchaser at such sale of said stock. The proceeds of such sale shall be applied first to the payment of all expenses of the sale, next to the payment of accrued interest and then to the principal due on said promissory note. If the net proceeds of such sale are not sufficient to satisfy said debt in full, Company shall, immediately upon demand, pay the deficiency in full. If the net proceeds from such sale are in excess of the amount needed to satisfy said debt in full, such surplus amount shall be paid to Company.

Further, should Company violate or be in default under any of the provisions of this Stock Purchase Agreement or any provision of the aforesaid promissory note, then, in addition to all other rights and remedies of a Shareholder or the deceased Shareholder’s legal representative as herein provided for, as provided for in Company’s said promissory note, and as may be additionally provided by law, Shareholder or the deceased Shareholder’s legal representative, as the case may be, may demand a special meeting of the Board of Directors of Company, which shall be held within three (3) days after said demand. At this special meeting of the Board of Directors, the Shareholder or the Shareholder’s legal representative, shall be entitled to appoint a majority of Directors of Company’s Board of Directors; and the directors so appointed by the Shareholder or the Shareholder’s legal representative shall remain in office until the entire indebtedness due under said promissory note has been paid in full.
EXHIBIT "K"

ENGAGEMENT LETTER

For attorney representing all parties in preparing a Buy-Sell Agreement. The author is grateful to Myron E. Sildon of Kansas City, Missouri, for his permission to use his Engagement Letter as an Exhibit in this outline.

Dear Shareholder of Quicksilver, Inc.

You have asked us to perform certain services for you relating to your proposed Buy & Sell Agreement. We are pleased to do so; however, it is in your best interest, and our own ethical obligation to each of you requires, that you fully understand the considerations involved in "dual representation" of your corporation and its respective shareholder.s

The different shareholders can have differing, and sometimes conflicting, interests and objectives regarding their corporate planning. For example, they may have different views on how to value the corporate stock upon the death or retirement of a stockholder. There may be a conflict in whether the selling shareholder should be subject to a covenant not to compete. There may be a conflict in how an installment payout is secured. These are just a few general examples. Each situation is unique.

If you each had a separate lawyer, you would each have an "advocate" for your position and would receive totally independent advice. Information given to your own lawyer is confidential and cannot be obtained by your fellow shareholders without your consent.

That may not be the case here where we are advising the entire family, but the opportunity for conflict does exist. We cannot be advocates for one of you against the other. Information that any of you gives us relating to your thoughts and special needs cannot be kept from the other shareholders. If you ask us to continue to serve you jointly and the corporation, our effort will be to assist in developing a coordinated overall buy out plan and to encourage the resolution of differing interests in an equitable manner and in the best interests of your mutual business affairs. We will attempt to represent your corporation without a bias in favor of any of you.

After considering these factors, each of you must decide whether you wish us to continue to represent you jointly in connection with your corporation and related matters. If you do, please review the statement that follows, sign it as indicated, and return this letter to us. An extra copy is enclosed for your records. If at any time any of you wishes to have the advice of separate counsel, you are completely free to do so. We hope that the information provided will assist you in using our services effectively. Again, we appreciate the opportunity to be of service. We look forward to a long and successful professional relationship with each of you and your corporation.

Very truly yours,

SILDON & KROEKER, P.C.

By

Myron E. Sildon

We have each reviewed the foregoing letter. Each of us realizes that there are areas where our interests and objectives may differ and areas of potential or actual conflict of interest between us in
connection with our estate planning and related matters. We understand that each of us may retain separate, independent counsel in connection with these matters at any time. After careful consideration, each of us requests that you represent us and our corporation jointly in connection with our corporation succession planning and related matters. Each of us also understands and agrees that communications and information which you receive from any of us relating to these matters may be shared with the others.

P. A. QUICK

I. M. QUICK

U. R. QUICK

QUICKSILVER, INC.

By

P. A. Quick, President
PROVISIONS TO PROTECT S STATUS OF CORPORATION

SECTION 5 – S CORPORATION STATUS. Corporation is an S Corporation within the meaning §1361 of the Internal Revenue Code of 1986 ("IRC"). No Shareholder may transfer, and no person may acquire, the legal or beneficial ownership of any share of Corporation’s stock if such transfer or acquisition would cause Corporation’s S status to terminate. Specifically, no transfer may be made to, and no acquisition may be made by:

(a) Any person who would cause the corporation to have more than thirty-five (35) shareholders;
(b) Any nonresident alien; or
(c) Any person other than an individual, an estate, or a trust permitted by the Internal Revenue Code to be a shareholder of an S Corporation.

No transfer of stock to a trust shall be permitted unless the Corporation has reviewed the trust instrument and found it to be satisfactory for purposes of IRC §1361. Furthermore, no transfer to a qualified subchapter S trust shall be permitted unless the Corporation has received in advance reasonable assurance that the income beneficiary will elect properly under IRC §1361(c)(2). Finally, no transfer to a qualified subchapter S trust shall be permitted unless the trust instrument requires that the income beneficiary properly elect under IRC §1361(d)(2) with respect to the Corporation and not revoke such election and that any successive income beneficiary not refuse to consent to such election.
SECTION 9 - CORPORATE DISTRIBUTIONS. Each Shareholder agrees that Corporation will use its best efforts to make pro rata distributions of money with respect to its shares sufficient to pay the federal and state income taxes on the income that passes through from Corporation under IRC §1366, net of any tax benefits produced by losses, deductions and credits that pass through under IRC §1366. Corporation will use its best efforts to make such distributions either during its taxable year or during the three months after the end of its taxable year. For purposes of this section, a distribution shall be treated as made with respect to a particular corporate tax year if (1) it is made during the taxable year and not designated by Corporation as made with respect to another taxable year or (2) it specifically designated by Corporation as made with respect to that particular taxable year. The foregoing distribution requirement set forth in this section is subject, however, to the reasonably required needs of Corporation as determined by Corporation to maintain sufficient funds for working capital and business needs so as not to impair the ability of Corporation to continue its business operations.
SECTION 13 – YEAR OF TRANSFER – TERMINATION OF S STATUS.

(a) **Complete Termination of Shareholder's Interest.** If Shareholder's shares are transferred pursuant to this Agreement and such transfer results in the complete termination of Shareholder's interest in Corporation while Corporation is an S corporation and the effective date of such transfer occurs during the Corporation's taxable year, and if either the selling Shareholder requests or the purchasing shareholder or shareholders request, then all of the Shareholders agree to take appropriate action to make an effective election under Section 1377(a)(2) of the Internal Revenue Code to close the Corporation's books on the effective date of the transfer. For purposes of this election, Shareholders shall mean all persons who are or were shareholders in the Corporation at any time during the taxable year in which the transfer occurs.

(b) **Termination Of S Status.** In the event the Corporation's S status terminates during the course of a taxable year for any reason whatsoever, and if any Shareholder so requests, all of the Shareholders shall take appropriate action to make an effective election under Section 1366(e)(3) of the Internal Revenue Code to close the Corporation's books on the date immediately preceding the date on which the termination of S status occurs. For purposes of this election the term Shareholders as a result of the S termination shall mean all persons who are or were shareholder in the Corporation at any time during the S short year and all persons who are or were shareholders in the Corporation on the first day of the C short year.
EXHIBIT "O"

BUYOUT LIFE INSURANCE TRUST*

(USED IN CONJUNCTION WITH A CROSS-PURCHASE AGREEMENT).

*The author is grateful to Ronald D. West of Washington, D.C. for permission to use his trust document as an Exhibit to this outline.

INSURANCE TRUST AGREEMENT

THIS AGREEMENT, dated ___________, 198_, is between ________________, ________________, and ________________, (collectively "Grantors" or individually "Grantor"), ________________, a ___________ corporation ("Corporation") and ________________, ("Trustee"). The term "Grantor" or "Grantors" shall also include any additional shareholders of the Corporation required to purchase insurance pursuant to this Agreement.

In consideration of the agreements contained herein, the parties to this Agreement agree as follows:

ARTICLE I

This Agreement may be referred to as the ________________ SHAREHOLDERS' INSURANCE TRUST ("Trust").

ARTICLE II

The Trustee shall, out of the funds of the Trust, purchase life insurance policies on the lives of the Grantors in the amounts required by the Shareholders' Agreement of even date herewith between the Grantors and the Corporation ("Shareholders' Agreement"). Each such policy shall irrevocably designate the Trustee as beneficiary. The Trust property shall consist of these policies, and any other property as may be added by any or all of the Grantors or any other person. The Grantors shall have no power to alter, amend, revoke or terminate this Trust, other than upon the unanimous agreement of the Grantors, the Trustee and the Corporation pursuant to Article IX hereof. The Trustee agrees to hold all of this property under the terms and conditions of this Agreement.
ARTICLE III

During the term of this Trust, the Trustee shall utilize contributions by the Grantors to purchase, hold and maintain insurance on the lives of the Grantors in the amounts set forth in the Shareholders' Agreement.

Each Grantor shall make or cause to be made contributions to the Trust in an amount equal to such Grantor's Proportionate Share of the premiums required to purchase and maintain insurance coverage on the lives of all of the Grantors which is required to be maintained pursuant to the Shareholders' Agreement. For purpose of this Agreement, "Proportionate Share" shall mean a percentage equal to the proportion that the number of shares of the Corporation's issued and outstanding capital stock ("Stock") owned by the Grantor (or his estate) bears to the total issued and outstanding Stock of the Corporation owned by all of the Grantors as of the date on which any contribution, distribution or payment is to be made except that the Stock of a deceased Grantor shall not be taken into account for purposes of determining the Proportionate Share of a surviving Grantor in the insurance proceeds under a policy on the life of such deceased Grantor. In the event that any Grantor ("Defaulting Grantor") shall fail to make or cause to be made his Proportionate Share of such contributions prior to the date that is _____ (__) days prior to the date that premiums on such insurance are due, the Trustee or any other Grantor shall have the right to make such contributions and shall be promptly reimbursed therefor by the Defaulting Grantor, with interest from the date such contributions were made by the Trustee or other Grantor until the date of reimbursement, at the rate of _____ percent (___%) per annum. Such amount of premiums may be withheld by the Trustee from the proceeds payable upon the death of the defaulting Grantor. If such premiums are not paid, the Trustee shall allow the policy on the life of the defaulting Grantor to lapse. In such case, the defaulting Grantor shall not be credited with any insurance proceeds upon the death of any other Grantor. Each such policy shall provide that premium reminder notices and all other correspondence shall be sent to the Trustee who shall promptly deliver such notices and correspondence to the Grantors.
ARTICLE IV

Upon the death of any Grantor during the term of this Trust, the Trustee shall make claim as beneficiary under such life insurance policy insuring such Grantor and shall promptly notify the surviving Grantors and the personal representative of the estate of the deceased Grantor upon receipt of the proceeds of such policy. After reimbursement of any advances made by the Trustee or any Grantor pursuant to Article III above (if any), the remaining amount of such insurance proceeds shall be paid on behalf of the surviving Grantors to or on behalf of the estate of the deceased Grantor in full or partial satisfaction of (i) the obligations of the surviving Grantors to purchase the Stock of the deceased Grantor pursuant to the Shareholders' Agreement, and (ii) the obligation of the Corporation to make deferred compensation payments as set forth in the Shareholders' Agreement. If required by the Shareholders' Agreement, all or a portion of such proceeds shall be paid by the Trustee to one of the surviving Grantors as payment against any obligation of the deceased Grantor to such surviving Grantor to the extent set forth in the Shareholders' Agreement. Each surviving Grantor shall remain obligated, pursuant to the terms of the Shareholders' Agreement, to pay to the estate of the deceased Grantor the difference, if any, between the price specified to be paid by each such Grantor for the number of shares of Stock of the deceased Grantor required to be purchased by each such Grantor as set forth in the Shareholders' Agreement and the amount of such Grantor's Proportionate Share of the insurance proceeds.

ARTICLE V

In the event that the Trustee (or any successor Trustee) fails to serve or is unable to serve for any reason, then a majority of the Grantors shall appoint a successor Trustee. In the event of any substitution of the trusteeship hereunder, the successor Trustee or Trustees shall execute a document acknowledging and consenting to the terms of this Agreement and such Trustee or Trustees shall then receive all assets then comprising the trust property (including any life insurance policies on the life of any Grantor) together with all books and records relating thereto. Upon such receipt, the successor Trustee or Trustees shall be vested with all rights, powers and privileges relating to the trust property as if such successor were the original Trustee. No successor Trustee shall be liable for any act or omission of their predecessor nor shall they be obliged to inquire into the validity or propriety of any such act or omission; any such successor
shall be entitled to accept as conclusive any accounting and statement of assets furnished to them by their predecessor, and they shall be entitled to receipt only for those assets included in such statement.

ARTICLE VI

Except as otherwise provided herein, no beneficial interest under this Trust, whether income or principal, shall be subject to anticipation, assignment, pledge, sale or transfer if any manner, nor shall any beneficiary have the power to anticipate, encumber, or discharge such interest, nor shall such interest, while in the possession of the Trustee, be liable for or subject to the debts, contracts, obligations, liabilities or torts of any beneficiary.

ARTICLE VII

A. No Trustee shall be required to give any bond or other security for the faithful performance of his or her duties.

B. The validity, construction and administration of this Trust shall be determined by reference to the laws of the State of Maryland.

C. Each Trustee shall be entitled to receive the compensation that is customary for a trustee in the State of Maryland.

D. No Trustee shall be liable for any depreciation or loss, through error of judgment or otherwise, of any property at any time constituting the trust property or any part thereof, but shall be liable only for his or her acts or omissions of gross negligence or willful misconduct.

E. This Agreement shall be binding upon and inure to the benefit of the parties and their respective personal and legal representatives, successors and assigns.

ARTICLE VIII

The Trustee is authorized to retain as owner any policies of insurance on the life of any of the Grantors purchased by him at any time, and to purchase, from time to time, as is required in order to permit the Trust to hold sufficient insurance to satisfy the requirements of the Shareholders' Agreement, additional policies of insurance on the life of any of the Grantors. The Trustee shall pay out of the funds of the trust all costs, including premiums or other charges of maintaining these insurance policies in force, as an expense of administering the trust and, if it is deemed necessary or advisable, to exercise his power
to borrow money for that purpose. However, unless there shall be sufficient funds in the trust for this purpose, the Trustee shall be under no obligation to pay such costs or other charges with respect to any such policy of insurance.

The Trustee is authorized to exercise, in such manner as he shall deem will best serve the interests of the Grantors, any option, election, or other power that an absolute owner of any policy would have with respect to that policy. The Trustee shall have, regarding any policy of life insurance at any time held as part of the trust estate, the exclusive right, exercisable by him from time to time and in his sole and absolute discretion:

A. To apply for and obtain by conversion or otherwise one or more other policies of insurance on the life of the Grantors;
B. To permit the policy to lapse and thereafter to reinstate it;
C. To receive dividends thereon;
D. To take paid up insurance in a reduced face amount or to take extended insurance and to apply the policy reserves for the purpose;
E. To demand, collect, and receive from the insurer all proceeds thereof;
F. To permit the policy to lapse or to cancel, terminate, or surrender the policy and to demand, collect, and receive the cash surrender value or other proceeds that may thereupon become available;
G. To exercise all options, rights, privileges, and elections, including the right to elect modes of settlement and the privilege of conversion, exercisable thereunder or allowed by the insurer;
H. To sell, transfer, assign, pledge, or otherwise dispose of the policy;
I. To exchange the policy for another policy on the life of the Grantor in any amount less than the original face amount thereof and to collect the cash value remaining after the exchange;
J. To borrow upon the policy from the insurer or from any other person for any purpose, including the payment of premiums or other charges, and to pledge or hypothecate the policy for any loan;
K. To take any other action regarding the policy that the Trustee deems to be in the best interests of the trust estate and the Grantors thereof;
L. To do all other acts and things not inconsistent with the provisions of this instrument which it may deem necessary or desirable for the proper management of the Trust herein created, in the same manner and to the same extent as an individual might or could do with respect to his own property; and
M. To exercise all powers conferred in this Agreement without authorization or approval of any court, and such powers shall:
(a) be exercisable by the Trustee and by any successor or substitute in any jurisdiction whatsoever;

(b) be exercisable in respect of all assets held by his or under his control;

(c) remain exercisable as fiduciary powers of administration only, and without affecting the vesting or beneficial interest, until actual and final distribution of all of the assets of the Trust;

(d) be exercisable without any duty on any person dealing with the Trustee to inquire into its authority;

(e) be conclusive, when exercised, upon all persons interested in the Trust; and

(f) remain exercisable as fiduciary powers of administration only, without the vesting of any beneficial interest, until actual and final distribution of all of the assets of the Trust.

Notwithstanding the foregoing, the Trustee may not exercise any of such powers in a manner which results in the interruption or termination of insurance coverage as required by the Shareholders' Agreement.

On the death of any Grantor, the Trustee shall collect and receive all proceeds payable to the Trustee under any policies of insurance on the life of such Grantor. The Trustee is hereby authorized to make all necessary proofs of death under these policies, to execute and deliver any and all receipts and releases for the net proceeds thereof, to institute any action, suit, or proceeding to collect these net proceeds, and to pay from the trust estate all the expenses thereof, including court costs and counsel fees, and to do and perform any and all other acts that the Trustee deems necessary or advisable to collect these net proceeds, provided, however, that the Trustee shall not be under any obligation or duty to institute such action, suit, or proceeding unless it shall be advisable in the opinion of the counsel of the Trustee and unless the Trustee shall have either adequate funds in the Trust with which to pay the expenses of the action, suit, or proceeding or indemnification to its satisfaction against such expenses. Upon payment to the Trustee of the proceeds due under any such policy, the insurer shall be relieved of any responsibility to see to the application or disposition of those proceeds.

**ARTICLE IX**

This Trust shall terminate upon the first to occur of the following events:
(1) Each of the Grantors ceasing to be obligated to maintain insurance on the life of any of the other Grantors under the Shareholders' Agreement; or

(2) The written election of all of the then living Grantors who are shareholders of the Corporation to terminate the Trust, after satisfaction of any obligations hereunder which accrued prior to such election of termination; or

(3) The death of all Grantors within a 90–day period.

Upon termination of this Trust, each Grantor (or his estate, as the case may be) who is a shareholder in the Corporation shall receive his Proportionate Share of the Trust property. Each such Grantor shall be entitled to a distribution from the Trust equal to any insurance policies on his life. In such case, the Grantors shall take appropriate adjustments among themselves to assure that each Grantor receives his Proportionate Share of the value of the assets of the Trust.

If a Grantor ceases to be a shareholder in the Corporation other than by reason of his death, he shall receive his Proportionate Share of the Trust property. Such Grantor shall be entitled to a distribution of any insurance policy on his life in which case appropriate adjustments shall be made to assure that such Grantor receives his Proportionate Share of the value of the Trust property.

In the event that this Trust terminates by reason of the death of all Grantors within a 90–day period, then the estate of each Grantor shall receive from the Trust the proceeds payable on the life of each respective Grantor and such estate's Proportionate Share of the remainder of the Trust property.

ARTICLE X

As used throughout this Agreement, the "Trustee" or "Trustees" shall always refer to the original Trustee and to any successors thereto. All successors to the original Trustee shall have the same rights, privileges, powers, duties and obligations that are conferred in this Agreement on the original Trustee.
IN WITNESS WHEREOF, the Trustee hereby accepts the trust created by this Agreement and agree to carry out the provisions hereof on his part according to the best of his ability. The Grantors, Trustee and the Corporation have executed this Agreement on the date and year first hereinabove written.

WITNESS:

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__________________________________

__________________________________

__________________________________

ATTEST:

__________________________________ (SEAL)

GRANTORS:

__________________________________

__________________________________

__________________________________

__________________________________

TRUSTEE:

__________________________________

By__________________________________