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# THE USE OF BUY-SELL AGREEMENTS FOR THE DISPOSITION OF AN OWNERSHIP INTEREST IN A SMALL BUSINESS

Wrede Smith\*

When advising a client with regard to the formation of a partnership or close corporation, a lawyer should be prepared to raise questions and give advice with respect to the disposition of the partnership interest or the corporate stock<sup>1</sup> upon the death or retirement of a partner or shareholder. The importance of planning for the death or retirement of an owner is not likely to occur to the owners at a time when their business is merely trying to get off the ground. Yet consideration of death and retirement problems at the formative stage alleviates the possibility of the owners being caught off guard should one of them die prematurely. Also, such considerations may bear upon the decision of whether to structure the business as a partnership or corporation.<sup>2</sup>

A common means of providing in advance for the orderly disposition of a business interest upon the death or retirement of a partner or shareholder is the adoption of a buy-sell agreement whereby either the surviving business associates or the business entity itself agrees to purchase the interest from the retiring owner or from the deceased owner's estate.<sup>3</sup> Such an agreement serves several purposes. First, from the standpoint of the business, the agreement assures continuity and eliminates the possibility that the beneficiaries of a deceased partner or shareholder will be able to interfere with the management of the business.<sup>4</sup> Likewise, it prevents a retiring owner from selling his interest to an undesirable outsider.

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1. The partnership interest or corporate stock held by an owner shall hereinafter be collectively referred to as ownership interests or business interests.

2. In spite of the importance of planning for the death of a partner or shareholder at the time when the partnership or corporation is formed, the remarks in this paper apply generally to all agreements for the disposition of a business interest, whether executed at the time of the formation of the business or at a subsequent time during the existence and operation of the business.

3. The following articles are recommended for their discussions of problems arising in connection with the use of buy-sell agreements: Note, *The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death*, 71 HARV. L. REV. 687 (1958); Abrams, *Tax Planning for Agreements Disposing of a Shareholder's Closely Held Stock at Death*, 57 GEO. L.J. 1211 (1969); Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business, Part II—Planned Disposition of a Partnership Interest*, 45 IOWA L. REV. 46 (1959); Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business, Part III—The Corporation: Stock Purchase Agreements and Redemption of Shares*, 46 IOWA L. REV. 516 (1961); Vernava and Martin, *Tax Aspects of the Disposition of Control in a Closely Held Corporation*, 58 IOWA L. REV. 221 (1972).

4. If the widow or other beneficiary of the decedent is allowed to retain the decedent's business interest, the business policies of such a beneficiary will characteristically be adverse

Second, from the standpoint of the partners or shareholders, a buy-sell agreement assures their estates of a ready market for their ownership interests at a fair price after death. In the absence of such an agreement, an estate wishing to sell the business interest would probably be forced to accept a price far below the value of the interest immediately prior to the decedent's death. This would be particularly true if the decedent's business interest were a minority interest. With a buyer and a fair price assured, the estate is relieved of the problem of searching for liquidity to cover debts, expenses, and death taxes. A buy-sell agreement likewise assures a retiring owner of a market for his interest.

Third, the agreement may be effective to establish conclusively the valuation of the decedent's interest for estate tax purposes. Section 2033 of the Internal Revenue Code of 1954<sup>5</sup> requires inclusion of the deceased owner's interest in his gross estate.<sup>6</sup> Section 2031 states that the interest included shall be valued according to its value at the time of the decedent's death.<sup>7</sup> But the value of a business interest is a subjective thing over which there can be enormous disagreement depending upon the method of valuation used, the factors considered in applying the method chosen, and the interests of the party or parties doing the evaluation. If there is no buy-sell agreement or if there is a buy-sell agreement with no valuation provision, the executor of the estate will be in a relatively weak position in bargaining with the Internal Revenue Service over the proper value to be assigned to the business interest. On the other hand, if there is a prior agreement between or among the co-owners of the business as to the value of their respective interests, the Service will generally accept this agreed-upon value for purposes of Section 2031, providing it is the result of a good-faith bargain which satisfies certain basic conditions to be discussed later.<sup>8</sup>

There are certain disadvantages to a buy-sell agreement, also. The agreement restricts the free alienability of the business interest and therefore might prevent a co-owner from taking advantage of a more desirable offer. Furthermore, depending on the valuation method used, the agreed price may ultimately be far out of line with the actual value of the business interest at death. The risk of this happening is greatest in the case of a rapidly growing business whose assets may double or triple in the course of a few years. Of course, the problem can be avoided if the parties to the agreement are careful to keep their valuation figure current.

A buy-sell agreement commonly takes one of two forms. Either the partnership or corporation agrees to purchase the ownership interest of the

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to those of the surviving owners. The widow or other beneficiary normally favors a high rate of dividends and a conservative outlook which would guarantee a steady income stream. The surviving owners, on the other hand, usually prefer retention of earnings by the business for growth purposes.

5. 26 U.S.C.A. § 2033. (Sections of the 1954 Code will hereinafter be cited I.R.C. § —.)

6. Section 2033 states, "The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

7. Section 2031(a) states, "The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

8. See text accompanying notes 21-28, *infra*.

deceased or retiring co-owner, or the surviving partners or shareholders individually agree to purchase that ownership interest. Where the business firm itself is the purchaser the arrangement is generally called an entity plan although it may also be called a stock redemption plan in the case of a corporation. If the surviving co-owners are the purchasers, the agreement is commonly referred to as a cross-purchase plan.

Under either an entity or a cross-purchase plan, the availability of liquid funds to meet the obligations of a buy-sell agreement at the death or retirement of an owner may present a problem. A corporation or partnership could establish a reserve fund specifically to meet such a contingency, but such a fund has several drawbacks. First, it is of little or no value in the case of a premature death. Second, it requires taking funds out of the business which could otherwise be used for expansion and capital improvements. Third, in the case of a corporation, as the reserve fund increases, so does the risk that the accumulations will become subject to an excess profits tax under Section 531 of the Internal Revenue Code.<sup>9</sup>

Therefore, it is common to fund buy-sell agreements through the use of life insurance and annuities. In the typical case, the business (or the individual owners if a cross-purchase plan is used) takes out insurance on the lives of each owner, names itself as beneficiary, and upon the death of one of the owners uses the proceeds of the policy to buy out the decedent's interest. Since life insurance proceeds by definition are not paid until the insured dies, annuities are often used in conjunction with life insurance to provide funds in the event of retirement rather than death. The discussion in this article relates to life insurance only; however, the principles generally apply to annuities.

Even though life insurance is commonly used, it is important to recognize that life insurance does not solve all funding problems. For example, it may be that one of more of the co-owners is uninsurable due to his age or health, thereby precluding the use of insurance to fund the buy-out of his interest. Moreover, frequently, the business seeking funding for a future buy-out may simply be so large that the expense of life insurance on the owners' lives is prohibitive. Finally, businesses which initially use life insurance to fund a buy-sell agreement may grow beyond the ability to procure additional insurance.

The result is that finding ways to handle buy-out payments which are not backed by insurance proceeds is a major practical problem for many businesses. Reserve funds, installment arrangements, borrowing arrangements, or some combination of the three may be useful substitutes for life insurance in those situations.

This article will examine the use of buy-sell agreements in general and

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9. Sections 531-537 of the 1954 Code impose a surtax on corporations "formed or availed of for the purpose of avoiding the income tax with respect to . . . [their] shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." Note that if the accumulated funds are used to purchase a deceased owner's interest, they will not be subject to the § 531 surtax to the extent they are used to meet the estate's § 303 expenses (death taxes, funeral and administration expenses). I.R.C. § 537(a)(2). But if the funds are used to purchase a retiring partner's interest, there are no § 303 expenses, and therefore § 537(a)(2) will provide no relief.

will focus particularly upon the use of life insurance to fund those agreements. The approach will be as follows: first, a brief summary of the problems encountered in attempting to place a value on the decedent's business interest at a time when it is not known which partner or shareholder will die first or what will happen to the business in the meantime; second, an examination of certain estate tax problems which can be voided by a carefully drafted agreement; third, a general comparison of the entity plan and the cross-purchase plan; finally, a discussion of certain income tax implications which must be considered in choosing between an entity and a cross purchase plan.

### I. VALUATION METHODS

One of the most difficult problems in drafting a buy-sell agreement is to formulate a method for valuing the business in order to arrive at a price for an ownership interest at the time of the death of an owner.

The simplest valuation provision would merely state an agreed-upon price for each ownership interest. This would eliminate the need for placing a value on the business after death and would also allow each prospective purchaser to know exactly how much life insurance would be needed to cover the cost of the buy-out. However, serious inequities may result from the use of a fixed-price method. The estate of the decedent is most likely to suffer these inequities, for if the business is expanding, its value is likely to increase over time and the fixed price will end up far below the fair market value at death.<sup>10</sup> To prevent this problem from arising, the parties are often required by agreement to redetermine the value of the business each year. However, since it is not realistic to expect business owners to do this, it is a lawyer's function to impress upon his clients the imperativeness of keeping the agreed-upon price current.

The agreement might alternatively specify that the purchase price be determined in accordance with the "book value" of the decedent's ownership interest at the date of his death. The book value of a business is equal to "net worth" or "owner's equity" as listed on its balance sheet. In accounting terms, net worth and owner's equity are synonymous expressions for the excess of a business's assets over its liabilities. The book value of a share of corporate stock of a certain class is computed by dividing the stockholder's equity applicable to the class by the number of shares of the class outstanding. Likewise, the book value of a partner's ownership interest is computed by multiplying the total owners' equity of the partnership by the percentage of the individual partner's share.

The problem with using book value as a method of valuation is that assets are almost always listed on the balance sheet at cost less depreciation, rather than fair market value. If a business paid \$10,000 for a parcel of land in 1900, that land will most likely be listed on its current balance sheet at \$10,000, even though it may now be worth \$100,000. The result is that

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10. For example, see *Estate of Strange*, P-H 1942 T.C. MEMO ¶ 42,247, where a deceased owner's estate sold the decedent's interest in stock of a close corporation for the option price set in the buy-sell agreement, \$10,000, even though the fair market value of that interest at death was \$238,000. The estate tax was levied on the option price only—\$10,000.

the owner's equity is really understated by \$90,000. The balance sheet may similarly overstate the value of certain assets, resulting in a corresponding overstatement of owner's equity. The point is that a price based solely on unadjusted book value is likely to be unrealistic and consequently unfair to one or more of the parties.

Another common method for determining price is the capitalization of earnings. Under this method the agreement would provide that the average earnings for some stated length of time prior to the partner's or shareholder's death would be capitalized at a stated rate, i.e., multiplied by a set figure. The capitalization rate would reflect the percentage of profits generally earned in such a business.<sup>11</sup> If the rate chosen is appropriate and the pattern of earnings is adjusted for irregularities, this method is likely to result in an accurate valuation figure.

The buy-sell agreement may also provide for an independent appraisal of the worth of the business at death. If this method is used, the agreement should specify how many appraisals should be made, who should select the appraisers, and what standards should be used in valuing certain assets.

One significant disadvantage is common to each of the book value, capitalization and appraisal methods. Since the valuation under each of these methods is not made until after an owner dies, the purchase price of an ownership interest is never certain until it is time for the purchase to be made. Thus, a prospective purchaser who intends to use life insurance to fund his purchase cannot be certain how much insurance will be needed.

Since none of these valuation methods are entirely satisfactory, often a combination of methods is employed. For example, it is common for an agreement to set a fixed price for an interest, to require periodic redetermination of the price, and to provide for an appraisal in the event that the agreed-upon price has not been recently re-examined.

## II. ESTATE TAX PROBLEMS

Section 2001 imposes a tax on the value of a decedent's taxable estate, which is defined as the value of his gross estate less certain exemptions and deductions.<sup>12</sup> In determining the value of a decedent's gross estate, two questions must be asked. First, what interests must be included? Second, what value should be placed on the interests which are included?

Normally an interest in a business, whether it represents an interest in a partnership or a stock interest in a corporation, is includable in a decedent's gross estate. Section 2033 requires this result by requiring the inclusion of "the value of all property to the extent of the interest therein of the decedent's at the time of his death."

In drafting a buy-sell agreement, care should be taken so that the life insurance proceeds on the life of the insured payable at his death will not

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11. See 1 W. BOWE, ESTATE PLANNING AND TAXATION 499 (1957). For example, if a particular type of business normally earned five per cent on its investment, its capitalization rate would be five and its multiplier would be twenty. If a business of that type had a steady pattern of earnings over the several years prior to the date of valuation, and its average earnings for those years was \$50,000, its value would be computed to be \$1,000,000 (20 times \$50,000).

12. See generally I.R.C. §§ 2001, 2051-2056.

also be included in his gross estate. Section 2042 provides for inclusion of insurance proceeds only when payable to or for the benefit of the decedent's estate, or when the decedent, at death, possessed any incidents of ownership.<sup>13</sup> Under a standard entity or cross-purchase plan, the proceeds are payable to and the incidents of ownership are in the possession of persons other than the decedent-insured. Therefore, there is little danger that the value of both the business interest and the insurance proceeds will be included in the decedent's gross estate if the buy-sell agreement is in the form of a standard entity or cross-purchase plan.<sup>14</sup>

The problems arise when there is a deviation from the standard entity or cross-purchase plan. For example, what if proceeds which are to be used to purchase the decedent's interest under a cross-purchase plan are made directly payable to the estate or to a beneficiary of the insured, rather than being made payable to the surviving owners who have agreed to purchase the decedent's interest. A literal reading of both Section 2033 and Section 2042 would seem to require inclusion of both the business interest and the proceeds, but the cases have taken a less harsh, more sensible approach.<sup>15</sup>

Likewise, what if the proceeds of a policy owned by the business are payable to the surviving owners, but the respective insured under each policy has the right to change the beneficiary? Such a right is an incident of ownership which gives rise to the inclusion of the insurance proceeds under Section 2042; meanwhile, the ownership interest passing from the decedent would be included under Section 2033. The Tax Court, faced with these facts in *Estate of Tompkins*,<sup>16</sup> engaged in some strained reasoning in

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13. A person will be considered to have an incident of ownership in an insurance policy if he has, for example, the right to change the beneficiary, surrender or cancel the policy, assign the policy, or borrow against it. "Generally speaking, the term has reference to the right of the insured or his estate to the economic benefits of the policy." Treas. Reg. § 20.2042-1(c)(2) (1958).

14. This has not always been so. In 1971, the Treasury ruled that under a standard entity arrangement, the life insurance proceeds paid to the closely-held corporation were includible in the estate of the decedent where the decedent was president and a 75 per cent shareholder in the corporation. Rev. Rul. 71-463, 1971 CUM. BULL. 333. The ruling seized upon the last sentence of Treas. Reg. § 20.2042-1(c)(2), which states that the term "incidents of ownership" includes a power to change the beneficiary reserved to a corporation of which decedent is sole shareholder. It was reasoned that if a sole shareholder is deemed to have incidents of ownership by virtue of his control of the corporation, the regulation should apply wherever the insured decedent or his estate could exercise voting control of the corporation.

Rev. Rul. 71-463 was withdrawn by the Treasury in March, 1972, according to P-H REP. BULL. 35, Aug. 31, 1972. It is to be replaced by an amendment to the regulations which states in part: "In the case of economic benefits of a life insurance policy on the decedent's life that are reserved to a corporation of which decedent is sole or controlling shareholder, the corporation's incidents of ownership will not be attributed to the decedent through his stock ownership to the extent the proceeds of the policy are payable to the corporation." Proposed Treas. Reg. § 20.2042-1(c)(2) (1972).

Nor will incidents of ownership be attributed to constituent partners if a partnership owns an insurance policy. *Estate of Knipp*, 25 T.C. 153, 167-169 (1955).

15. *Estate of Mitchell*, 37 B.T.A. 1 (1938) (Where two shareholders had entered into an agreement providing that in the event of the death of either, the survivor should purchase the other's stock and further that the proceeds of a policy on the life of each, payable to his estate, should be applied to the purchase price to be paid by the survivor for such stock, the insurance proceeds which were actually paid to the estate under the terms of the policy were held includible under § 2042 and the value of the stock was also included (under § 2033), but only to the extent of the excess of the agreed-upon value over the amount of the insurance proceeds.)

16. 13 T.C. 1054 (1949).

order to reach a fair result. It included the value of the proceeds only, and did not include the value of the decedent's partnership interest. It appeared to base its result on the grounds that the agreement which bound the estate to sell the partnership interest served to reduce the value of that interest.

While it appears that the Tax Court will strive for fair treatment of the decedent's estate no matter how poorly drawn the buy-sell and insurance agreements may be, a client would be well advised to avoid these problems by sticking to a pure, properly executed entity or cross-purchase plan.

A separate issue of includibility may arise if the agreement among the business owners provides that the deceased owner's successor in interest has a right to receive income from the business for a period of time after the owner's death. Should the right to receive income be included in the gross estate for federal estate tax purposes even though payments will also be subject to income tax when received?

In *Bull v. United States*,<sup>17</sup> the Supreme Court answered this question in the negative. In that case the firm had no capital assets, so the court reasoned that payments made to the estate could not constitute payments made in exchange for the decedent's interest in the capital of the firm. Thus it held that the right of the estate to receive those payments should not be included in the gross estate.

The *Bull* decision was substantially qualified, however, in *Estate of Riegelman*.<sup>18</sup> There the partnership agreement provided that upon the death of a partner, the partnership should continue and the decedent's estate should be entitled to payments which would represent a share of the partnership income for a specified period of time. The Second Circuit held that the present value of the right to future income payments should be included in the deceased partner's estate. It distinguished *Bull* on its facts, but went on to rule that an addition to the tax law since the date of the *Bull* decision required a change in result. In that intervening period, Congress had enacted the forerunner to Section 691, which introduced the concept of "income in respect of a decedent." That section provides in general that if income is generated by the decedent but is not taxed to him, it is to be taxed to his estate or to his heirs when received by them, and is not to be included in the decedent's final income tax return. The section further provides for a deduction from gross income of the estate tax attributable to the inclusion in the gross estate of the right to receive such income. The *Riegelman* court reasoned that this deduction provision indicated Congress's intent that an estate tax be paid on items constituting income in respect of a decedent. It then found that the post-death partnership income received by *Riegelman's* estate did constitute income in respect of a decedent.

The consequence of the *Riegelman* case is that even though an owner may have made no capital contributions to the firm, and even though the firm may hold no significant tangible assets, payments by the firm to the deceased owner's successor in interest after death must be included in the decedent's gross estate.

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17. 295 U.S. 247 (1935).

18. 253 F.2d 315 (2d Cir. 1958).



At what value should a decedent's ownership interest be included in his gross estate? The Treasury Regulations accompanying Section 2031 state that all property should be included at its fair market value at the time of the decedent's death.<sup>19</sup> The regulations go on to define fair market value as the price at which a willing purchaser would agree to buy from a willing seller, absent any coercion or misrepresentation. But, as was stated in the introduction and discussed in Section I, there are bound to be wide differences of opinion on what fair market value to assign to a business interest.

One of the advantages which flows from the use of a buy-sell agreement is that if the agreement meets certain requirements, the price of the interest established by such an agreement will be accepted as the value of the interest for estate tax purposes. Not only will this eliminate the possibility of expensive litigation with the Internal Revenue Service to establish the value of the interest, but it will also eliminate the "chance of the estate's being taxed on a high valuation and simultaneously being bound to sell the interest at a lower figure."<sup>20</sup>

In order for the Internal Revenue Service to accept the agreed price as the estate tax value, the agreement must first of all be a bona fide agreement for full and adequate consideration.<sup>21</sup> Agreements among members of a family are naturally suspect since such agreements can easily be used to make a testamentary gift by passing an interest to a loved one at far less than its true value.<sup>22</sup> However, it is not impossible to meet the burden of proving an arm's length transaction for full and adequate consideration in cases involving buy-sell agreements within a family.<sup>23</sup>

Certain restrictions must also be met for the agreement price to be accepted by the Service for estate tax purposes. First, there must be a restriction on the right of the owner of the business interest to sell the interest during his life.<sup>24</sup> Without any such restriction the owners would be free to sell their interest at any time and obtain a price which conceivably could be much higher than the price specified in the buy-sell agreement.<sup>25</sup> A right of first refusal, whereby the interest must be offered to the business or other owners before it is offered to outsiders, may be sufficient to satisfy this requirement. In order to be a sufficient restriction, the right of first refusal must be available at a price which is either equal to or computed by the same formula as the agreed-upon price at death.<sup>26</sup>

Second, after the death of one of the owners, his estate must be obligated to sell his interest under the buy-sell agreement in order for the value

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19. Treas. Reg. § 20.2031-1(b) (1965).

20. Note, *The Use of Life Insurance to Fund Agreements Providing for the Disposition of a Business Interest at Death*, 71 HARV. L. REV. 687, 691 (1957).

21. Treas. Reg. § 20.2031-2(h) (1965).

22. Edith M. Bensel, 36 B.T.A. 246 (1937), aff'd 100 F.2d 639 (3rd Cir. 1938).

23. Although the agreed-upon price was challenged in Bensel, *supra*, the taxpayer prevailed.

24. Treas. Reg. § 20.2031-2(h) (1965); see also Estate of Matthews, 3 T.C. 525 (1944).

25. Matthews, *supra* at 528.

26. See Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955), where a provision in the partnership agreement that a partner wishing to withdraw from the partnership should first offer his interest to the remaining co-partners at a price equal to book value was held sufficient to set the value for estate tax purposes where the surviving co-partners were obligated to purchase and the estate was obligated to sell the interest at book value after death.

specified in the agreement to be accepted for estate tax purposes. This obligation to sell may be either absolute or at the option of the prospective purchaser under the agreement.<sup>27</sup> But it is not sufficient for the estate which is not obligated to sell to merely be required to grant a right of first refusal to the business or co-owners should it decide to sell.<sup>28</sup>

### III. COMPARISON OF ENTITY AND CROSS-PURCHASE PLANS

Once the owners have agreed upon a fair price for their respective interests or have worked out an arrangement for establishing such a price upon the death of an owner, the next step is to decide who should agree to purchase the deceased owner's share. Should the purchaser be the firm itself (entity plan) or the individual survivors (cross-purchase)? Some of the factors which should be considered in choosing between an entity and cross-purchase plan will be considered in this section and the following section.

#### A. Premium Payments

Under both an entity and a cross-purchase plan, the prospective purchaser typically buys insurance on the lives of the individual owners in order to be assured that the funds required to make the purchase will be available.<sup>29</sup> Ordinarily the premiums paid toward such insurance are not deductible for tax purposes either by the corporation or partnership under an entity plan or by the individual shareholders or partners under a cross-purchase plan.<sup>30</sup>

If shareholders or partners own unequal interests in the business, the question of who bears the greater burden of premium payments will depend upon the type of buy-sell agreement adopted. Assume a business in which Abe owns 75 per cent and Bob owns 25 per cent. Under a cross-purchase plan the insurance owned by Bob on Abe's life must cover the cost of Abe's 75 per cent interest. Since Abe's interest is larger than Bob's, Bob must own more insurance than Abe, and the cost of such insurance will naturally be higher than the cost to Abe of insurance on Bob. Thus the cross-purchase plan will require the owner with the smaller interest to bear the major portion of the premiums paid by the two.

On the other hand, if the business pays the premiums under an entity plan, premium payments will be borne by each owner in proportion to his ownership interest. This result follows from the fact that distributions made by a partnership and dividends paid by a corporation are paid out of business assets. When premium payments made by the business cause a reduction of total assets available for distribution or dividend payment, the respective payments to the individual owners will be reduced accordingly. Thus in the above example, Abe would bear 75 per cent of the premium payments and Bob would bear 25 per cent if an entity plan were adopted.

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27. *May v. McGowen*, 194 F.2d 396 (2d Cir. 1952).

28. See *Worcester County Trust Co. v. Comm'r*, 134 F.2d 578 (1st Cir. 1943).

29. See the discussion on funding in the text accompanying note 9, *supra*.

30. I.R.C. § 264(a)(1). The disallowance of any deduction is justified by the fact that the proceeds will be received free from income tax according to § 101(a).

The cross-purchase plan is arguably more equitable since each owner must bear the cost of the benefit which is expected to accrue to him in the future. However, the entity plan may be more practical in the sense that the partner with the larger interest is likely to be better able to afford the larger share of premium payments.

The relative ages of the owners is an additional variable which frequently must be considered in deciding how premium costs should be distributed among owners. Insurance on older persons costs more than insurance on younger persons since older persons are naturally higher risks. If Abe and Bob own equal interests in a two-man business, but Abe is 60 and Bob is 30, insurance on Abe's life will be higher than that on Bob's life. It can be argued that Bob should pay a greater portion of the total premiums since it is more likely that Bob, rather than Abe, will be the survivor who will be able to collect on the insurance. If this is what the parties desire, a cross-purchase plan can be used. On the other hand, Abe is likely to be more financially secure than Bob since he is thirty years older. So Abe may be willing to split the premium payments equally with Bob. The entity plan will achieve this result.

It should be recognized that under either plan adjustments may be made to allocate the cost of buy-out funding. If the business is a partnership, Section 704(a) provides that, in the absence of tax avoidance, a partner's distributive share of income will be determined according to the partnership agreement. Thus, the cost of the insurance paid by the partnership using an entity plan can be allocated among the partners in the partnership agreement. Alternatively, if there is a cross-purchase plan, the partner with the higher insurance cost may be allocated a greater share of the profits. The same flexibility is available to shareholders of a corporation.

Because it is possible to make adjustments under either an entity or a cross-purchase plan, the question of how the premium costs will be allocated should not be a crucial factor in making a choice between the two plans. Moreover, if the interests of the individual owners are relatively equal and their ages are also equal, the question is of no importance at all in making the choice between plans.

One final observation is necessary with respect to premium payments. If the parties are contemplating the use of an entity plan they should be aware that the Internal Revenue Code treats the individual owners differently depending upon whether the premium payments are made by a partnership or by a corporation. If made by a partnership, Section 705(a)(2)(B) requires that the adjusted basis of a partner's interest in a partnership shall be reduced by his distributive share of the total expenditures for premium payments made by the partnership.<sup>31</sup> If the same payments were made by a corporation, no reduction in the individual shareholder's basis in their stock would be required. The significance of increases and decreases in

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31. I.R.C. § 705(a): "The adjusted basis of a partner's interest in a partnership shall . . . be the basis of such interest . . . (2) decreased . . . by the sum of his distributive share for the taxable year and prior taxable years of—(A) . . . , and (B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account."

the basis of ownership interests is discussed in the following subsection dealing with income tax considerations.

### B. *Receipt of Proceeds and Purchase of Interest*

In choosing between an entity and a cross-purchase plan, consideration should be given to the income tax consequences to the various parties upon receipt of the insurance proceeds and purchase of the deceased owner's interest. Is gain or loss realized by the estate, or by the party or parties who purchase the interest? How does the exchange affect the basis of the parties' ownership interests? These questions shall be explored in this subsection. Remaining to be discussed in Section IV is the question of whether the gains which are realized are to be classified as capital gains or as ordinary income.

For purposes of comparison let us hypothesize four separate plans: a partnership cross-purchase, a corporate cross-purchase, a partnership entity, and a corporate entity. Let us assume for purposes of illustration a three-man business valued at \$150,000 in which the owners have equal interests.

If the business is a partnership which adopts a cross-purchase plan, each owner must own, pay premiums on, and be the beneficiary of two \$25,000 policies one on the life of each of his co-partners. When the first partner dies, each surviving partner would receive \$25,000 in proceeds upon which he would not be taxed.<sup>32</sup> Each then would pay that \$25,000 to the deceased partner's estate in exchange for half of the decedent's partnership interest.

In each of these two exchanges, no gain is realized by either the estate or the surviving partner. The amount realized by the estate in each exchange is \$25,000, the amount of cash received.<sup>33</sup> The estate's adjusted basis in the portion of the partnership interest sold to each survivor is also \$25,000 pursuant to Section 1014, which gives a deceased owner's estate a "stepped-up" basis equal to the "fair market value of the property at the date of the decedent's death." Thus the gain to the estate from the sale of each half of the interest is zero under Section 1001(a) since the amount realized and the adjusted basis both equal \$25,000. Likewise, each surviving partner realizes no gain under Section 1001(a) since he has received property worth \$25,000 at a cost of \$25,000 cash. Upon the exchange, each survivor's adjusted basis in the partnership is increased by \$25,000, which is the cost to him of acquiring the deceased partner's interest.<sup>34</sup> Thus if the survivors subsequently sell the partnership for \$150,000, neither would realize any gain on the portion of the interest purchased from the estate.

Precisely the same result is reached when a corporate cross-purchase plan is used. The surviving shareholders receive the proceeds and purchase the stock of the decedent from the decedent's estate. The estate real-

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32. I.R.C. § 101(a)(1): "Except as otherwise provided . . . , gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured."

33. I.R.C. § 1001(b).

34. I.R.C. § 742, 1012.

izes no gain, the surviving shareholders realize no gain, and each survivor's basis in the stock acquired from the estate is equal to his cost.

Assume now a partnership entity plan where the partnership owns, pays premiums on, and is beneficiary of a \$50,000 policy of insurance on the life of each partner. When the first partner dies, the partnership, rather than the surviving partners, receives \$50,000 in proceeds, which it uses to acquire the decedent's interest. There is no gain or loss to either the partnership or the estate for the same reasons discussed in the cross-purchase context.<sup>35</sup> Even though the partners did not individually purchase the deceased partner's interest, their respective basis in the partnership is increased.

Section 750(a)(1)(B) provides that upon receipt of the proceeds the adjusted basis of each partner's interest in the partnership shall be increased by his distributive share of the proceeds.<sup>36</sup> It was apparently the intention of Congress in enacting Section 705(a)(1)(B) to give the surviving partners the same basis treatment they would receive under a cross-purchase plan.<sup>37</sup> It has just been stated that under a cross-purchase plan, the basis of each surviving partner in the partnership is increased by the cost to him of acquiring the decedent's interest. There was some question prior to the 1954 Code whether under the entity plan the surviving partners received an increase in basis when the partnership purchased the deceased partner's interest. Section 705 (a)(1)(B) was inserted to clarify that question. The provision makes sense as a matter of policy since the surviving partners are left with essentially the same thing whether an entity or cross-purchase plan is used. Under the cross-purchase plan, after the survivors purchase the decedent's interest, each is left with a 50 per cent ownership interest in a business worth \$150,000. Likewise under the entity plan, the purchase of the decedent's interest by the partnership leaves each surviving partner with a 50 per cent ownership interest in a \$150,000 business.

Does Section 705(a)(1)(B) mean that the decedent's estate is also entitled to an increased basis equal to its distributive share of the proceeds received by the partnership? The answer to this question is not clear. However, it raises two interesting issues. First, can a deceased owner's estate claim a "distributive share" of the insurance proceeds received by the business, even though that business is going to turn around and use the proceeds to purchase the very interest which is the basis of the estate's claim? This issue will be deferred briefly until completion of the discussion of basis treatment.

Second, assuming it can claim a distributive share of the proceeds, should the estate be regarded as a partner for purposes of Section 705(a)(1)(B)? It can be argued that Section 705(a)(1)(B) refers simply to "a partner's interest" and not to "a surviving partner's interest", and that therefore the section applies to the estate as well as to the surviving partners.

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35. See text accompanying and following note 33, *supra*.

36. The section states in pertinent part that "[t]he adjusted basis of a partner's interest in a partnership shall . . . be the basis of such interest . . . (1) increased by the sum of his distributive share for the taxable year and prior taxable years of—(A) . . . , (B) income of the partnership exempt from tax under this title, . . ."

37. A. WILLIS, WILLIS ON PARTNERSHIP TAXATION 487 (1971).

Yet, as was just discussed, the purpose of Congress in enacting Section 705(a)(1)(B) was to give the surviving partner the same basis treatment under the entity plan as he would receive under the cross-purchase plan.<sup>38</sup> Moreover, allowing all the estate an increased basis under Section 705(a)(1)(B) would lead to an absurd result. Remember, the estate always get a stepped-up basis equal to the fair market value of the ownership interest passing from the decedent pursuant to Section 1014. If it were allowed to further increase its basis by an amount equal to a portion of the proceeds received by the partnership, it would realize a loss upon the sale of the interest to the partnership. There is no policy reason for allowing the estate to realize a loss. Hence, it is more sensible to conclude that Section 705(a)(1)(B) was designed to increase the survivors' basis only, and not the basis of the estate.

There is no equivalent to Section 705(a)(1)(B) in the corporate section of the Internal Revenue Code. Therefore, insurance proceeds received by the corporation under an entity plan become part of the general corporate assets and the basis of each survivor's stock will remain unchanged. This result would be unfavorable to the survivors if they later decided to sell the business, since a lower basis means a higher gain under Section 1001(a). Thus, other things being equal, the surviving corporate shareholder would prefer a cross-purchase to an entity plan if he contemplated a future sale of the corporate stock acquired from the decedent.

Returning to the first issue raised by Section 705(a)(1)(B), a lawyer must ask if an estate may claim a distributive share of the insurance proceeds received by the business when an entity plan is used. This is not important in deciding questions of basis if one is persuaded by the argument that Section 705(a)(1)(B) was not meant to apply to a deceased owner's estate. However, the issue is important in deciding what value to place on the decedent's estate. Should the value of the proceeds received by the business be included as part of the total assets of the business for purposes of computing the size of the decedent's interest in the hands of the estate?

Let us again assume a three-man business valued at \$150,000, in which the owners have equal interests. Assume also that the business owns and pays premiums on and is the beneficiary of a \$50,000 policy of insurance on the life of each owner. When the first owner dies, the business will receive \$50,000 in proceeds, thus increasing its total assets to \$200,000. If it then pays the decedent's estate \$50,000 in return for the deceased's one-third interest in the firm, it may appear as though the estate is being less than fairly compensated for its one-third ownership interest. After the buy-out each surviving owner holds a share of the business worth \$75,000, and the deceased's estate holds only \$50,000 in cash in spite of the fact that all owners theoretically contributed equally to the business and to the premium payments made by the business. Although arguably unfair to the estate, this is precisely the same result which would accrue to the respective parties under a cross-purchase plan.

The unequal treatment to the estate could be eliminated by drafting the entity agreement to provide that the decedent's estate is entitled to its

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38. See text accompanying note 37, *supra*.

distributive share of the proceeds. The result of such a provision would be that the business would then need to pay \$66,667 to the estate for the deceased's one-third interest, and the purchase price would not then be fully funded by the \$50,000 of insurance proceeds. There are two ways to handle this gap in funding. The business could merely pay the \$16,667 difference out of the assets of the firm, which would reduce the net worth of the firm in the hands of the surviving owners from \$150,000 to \$133,333 (\$66,667 each). Alternatively, the business could try to fully fund the buy-out with insurance. This arrangement could require a total of \$250,000 of insurance, \$75,000 on the life of each partner. On the death of the first partner, the firm would receive \$75,000 of insurance proceeds, increasing its net worth from \$150,000 to \$225,000. Then on exchange of the proceeds for the decedent's interest, the estate would receive \$75,000 in cash in exchange for an interest worth \$75,000, and the survivors would be left with a business worth \$150,000 (\$75,000 each). The result is equal treatment for all parties without a reduction in the net worth of the business.

A \$150,000 business may not be able to afford the cost of three \$75,000 policies. Yet, the owners may still wish the insurance to fully cover the cost of the buy-out. The solution in this case is to draft the entity agreement to provide (1) that the partnership should purchase \$50,000 policies on the life of each partner, (2) that any amounts realized from the insurance proceeds should be allocated solely among the surviving owners, and (3) that the deceased owner should have no interest in and no distributive share of such insurance. Although this solution results in a windfall to the owners who survive, it is the cheapest way to accomplish an entity buy-out which is fully funded by insurance.

An estate tax problem may arise if the entity agreement values the decedent's interest at \$50,000, but neglects to provide that the deceased owner shall have no interest in and no distributive share of insurance proceeds received by the business. In that case, the Internal Revenue Service might not accept the value specified in the agreement as the value of the decedent's interest for estate tax purposes. As a result the estate might receive only \$50,000 from the partnership, but would be required to pay estate tax on \$66,667. So it is important that the parties understand the problem of allocating insurance proceeds among the parties to an entity plan and make some provisions therefore in the agreement.

### *C. Problems Encountered in Connection with Use of a Cross-Purchase Plan*

If a cross-purchase arrangement is used in planning for a business with more than three co-owners, the large number of policies required makes the arrangement cumbersome and impractical. For example, if a business with six owners adopted a cross-purchase plan, at least five policies would have to be acquired by each owner, one on the life of each co-owner, resulting in a total of at least thirty separate policies. An entity arrangement would require only six policies.<sup>39</sup>

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39. The problem of cumbersomeness due to multiplicity of policies may be avoided by use of jointly owned policies. The buy-sell agreement could provide that a single policy be issued on the life of each owner and each policy would be held in joint tenancy by the owners other

When, under the cross-purchase plan, one of the six co-owners dies, each of the five survivors purchases a portion of the decedent's interest with the proceeds of his policy on the decedent's life. Thus the share of each survivor in the business is increased, and each survivor then needs additional insurance to fully cover the augmented interests of the other survivors. At the same time, the decedent's estate now owns five insurance policies on the lives of the surviving owners, and it probably desires to dispose of those policies.<sup>40</sup> Therefore, it is common for survivors to acquire the necessary additional insurance by purchasing from the estate portions of the policies held by the estate on the lives of the other survivors.

Two major problems arise if the survivors agree to purchase the policies formerly owned by the decedent from his estate. First, the existing relationships among the survivors become further complicated. Each of the five policies formerly owned by the decedent would have to be split into four separate policies on the life of each of the other survivors. Thus each survivor would now own four of his five original policies (one having matured at decedent's death) and four additional policies stemming from those originally owned by the decedent.<sup>41</sup>

Second if the business is a corporation, there may be adverse tax consequences to the surviving shareholders who purchase the policies formerly owned by the decedent on the lives of the other shareholders. These adverse tax consequences result from the so-called "transferee-for-value" rule which is described in the following paragraph. Keep in mind that the transferee-for-value rule presents no problem in the case of a partnership cross-purchase plan. The following explanation indicates why this is so.

Generally, the receipt of the proceeds of a policy by the taxpayer who originally purchased the policy and paid the premiums does not result in taxable income if the proceeds are paid "by reason of the death of the insured."<sup>42</sup> However, if the proceeds are received by a taxpayer who has purchased the policy for valuable consideration, he is taxed on the gain that

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than the insured. The agreement would further provide that upon the death or retirement of an owner, the continuing owners other than the insured should acquire the deceased or retired owner's interests in the jointly held policies on the lives of the other owners.

The use of jointly held policies is only satisfactory in the partnership setting, however. In a corporate setting, the acquisition by the controlling shareholders results in unnecessary taxation of the continuing shareholders under the transferee-for-value rule, discussed in the text accompanying notes 42-46, *infra*.

40. These insurance policies formerly owned by the decedent on the lives of others are subject to estate tax ". . . to the extent of the interest therein of the decedent at the time of his death" under § 2033. The value at which the policies should be included is the replacement cost; or if such policies could not be purchased, then the value should be set at the interpolated terminal reserves, which is the reserve value which the insurance company keeps on its books against its liability on the contracts plus the adjustment of the reserve to the specific valuation date. *Estate of DuPont v. Comm'r*, 233 F.2d 210 (3rd Cir.), *cert. denied*, 352 U.S. 878 (1956).

41. The transition can be accomplished smoothly with only three original co-owners. Assume a partnership among A, B, and C. Each partner owns insurance on the lives of the other two. C dies. A purchases  $\frac{1}{2}$  of C's interest plus the policy which C owned on B's life. B purchases  $\frac{1}{2}$  of C's interest plus the policy which C owned on A's life. The interests of A and B are increased, but so is the amount of insurance held on the other's life.

42. I.R.C. § 101(a)(1).



he realizes as a result of the transfer.<sup>43</sup> The rationale for this "transferee-for-value" rule is to prohibit a taxpayer from using the Section 101 tax shelter for a profit motive. Congress realized, however, that certain transfers are made for valid personal and business reasons. Thus, it exempted from the transferee-for-value rule transfers made ". . . to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."<sup>44</sup> For some unexplained reason a shareholder-transferee is not exempt even though a partner-transferee is.<sup>45</sup> Therefore, there is good reason for caution if a cross-purchase scheme is utilized in a corporate setting.<sup>46</sup>

A further problem under the cross-purchase plan is that the individual partners or shareholders could become delinquent on their premium payments with the consequence that the policy would lapse and the agreement would no longer be fully funded. The partnership or corporation could agree to pay the premiums for the individual policyholders. However in the case of a corporation (and possibly in the case of a partnership), such payments would result in income to the individual policyholders under the familiar doctrine of *Old Colony Trust Company v. Comm'r*,<sup>47</sup> which provides in general that when the obligation of a taxpayer is discharged by a third party, the discharge is equivalent to receipt by the obligor and is taxed to him as income.

In *Paramount-Richards Theatres*,<sup>48</sup> a corporation paid premiums on insurance policies in which the shareholders actually held the beneficial interests. The court held that the amounts of the insurance premiums represented distributions to the shareholders which were taxable to the shareholders as dividends and which were not deductible by the corporation as a business expense under Section 162. Thus, shareholders who today anticipate that the corporation may pay some of their premiums should specify in the agreement that such payments be charged to them as compensation for services rendered, since salary expenses are deductible as business expenses under Section 162(a)(1).

No cases were found in which the partnership paid premiums on policies held by the partners. However, if the analysis in *Paramount-Richards* is applied to partnerships, the payments would be regarded as current distributions by the partnership. Taxable gain would not be realized by the res-

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43. The gain would be the amount of proceeds received less the cost of the policy to the transferee, including premiums paid by the transferee.

44. I.R.C. § 101(a)(2)(B).

45. At least one commentator has suggested that an exempt transferee should simply be anyone who has an insurable interest in the life of the insured. See Dolpheide, *The Federal Income Taxation of Life Insurance*, 6 Institute of Estate Planning, University of Miami Law Center, ¶ 72.19 (1972).

46. One way to avoid the transferee-for-value rule in the corporate setting would be to change over from a cross-purchase to an entity arrangement after the death of the first shareholder. The corporation could purchase the policies of the surviving shareholders since a corporation is an exempt transferee. Note, however, that a change in the other direction, i.e., from an entity to a cross-purchase plan, would again subject the shareholders to income tax under the transferee-for-value rule.

47. 279 U.S. 716 (1929).

48. 153 F.2d 602 (5th Cir. 1946).

pective partners,<sup>49</sup> but the basis of each partner's interest in the partnership would be reduced.<sup>50</sup> The partnership would be allowed no business deduction. If the partnership premium payments were designated as salary payments, they would be regarded as guaranteed payments falling under Section 707(c), rather than distributions. The individual partners would realize income under Section 61, and the partnership would get a Section 162 business deduction.

An entity method provides for ease and assurance of premium payments without the need to be concerned about constructive income and possible business deductions.

#### IV. FURTHER INCOME TAX CONSIDERATIONS

The foregoing comparison between an entity and a cross-purchase plan included a number of income tax considerations. Among those considerations was the observation that in the case of a deceased owner's estate, there will probably be no gain or loss on sale or liquidation of the deceased's interest because such interest receives a stepped-up basis equal to its fair market value under Section 1014, and this would be the value of such interest as established by the buy-sell agreement. However, there are situations in which a gain or loss is realized pursuant to the exercise of a buy-sell agreement. This is true, for example, in the case of a retiring owner where Section 1014 does not operate. It may also be true in the case of a deceased owner. This section of the paper will examine how a buy-sell agreement should be structured in order to obtain the desired income tax treatment when a gain or loss is realized on the sale or exchange of an interest in a business. Because partnerships and corporations are treated separately under the Internal Revenue Code, they demand separate treatment here.

##### A. Partnerships

An extensive discussion of the complicated law of the partnership taxation is beyond the scope of this paper. However, under the 1954 Code the answer to whether payments for a deceased or retired partner's interest will be treated as capital gains or ordinary income depends to a large degree on the buy-sell agreement. Therefore, it is crucial to understand something about partnership taxation before drafting such an agreement.

First of all, the drafter must recognize that if an entity plan is used and payments are made by the partnership, Section 736 applies; whereas if the individual partners make the payments under a cross-purchase plan, the transaction is governed by Section 741.<sup>51</sup> Although the flexibility afforded by Section 736 makes it an attractive tool in many cases, there will be instances in which Section 741 will be preferred.

Let us first examine the operation of Section 736. Under this section

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49. I.R.C. § 731(a).

50. I.R.C. § 733.

51. The regulations at § 1.736-1(a)(1)(i) (1965) state: "Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. . . ." (1965).

payments for a deceased or retiring partner's interest are divided into two categories:

- 1) payments in exchange for an interest in the partnership property (Section 736(b) payments), and
- 2) payments made as a distributive share of partnership income or as guaranteed payments (Section 736(a) payments).

All payments which do not fall specifically within Section 736(b) are treated as either a distributive share or a guaranteed payment under Section 736(a), and any gain resulting from Section 736(a) payments will be taxed as ordinary income under either Section 702 or Section 707(c).

Section 736(b)(1) provides that if payments are made ". . . in exchange for the interest . . . in partnership property. . ." they shall be regarded as a "distribution". Distributions generally receive capital gains treatment under Sections 731 and 741, unless a portion of the distribution falls within Section 751. Section 736(b)(2) states that payments made for unrealized receivable<sup>52</sup> and for good will, ". . . except to the extent that the partnership agreement provides for a payment with respect to good will"<sup>53</sup> will not be regarded as payments made in exchange for an interest in partnership property. Thus such payments are excluded from the operation of Section 736(b) and are thrown back into Section 736(a) where they will be treated as ordinary income.<sup>54</sup>

The general operation of Section 736 can be illustrated by the following example. Assume that the entity agreement provides that the retiring partner<sup>55</sup> is to receive \$50,000 for his share of net assets other than unrealized receivables, \$15,000 for his share of unrealized receivables, and \$25,000 in five equal annual installments for his interest in the good will of the partnership. Only the \$15,000 paid for the unrealized receivables would be treated as a distribution of partnership income to the retired partner.<sup>56</sup> The remaining \$75,000, including the good will payments, would be treated as proceeds from the sale of a capital asset, and the excess of such proceeds over the retired partner's basis in his partnership interest would be taxed as a capital gain.<sup>57</sup> Were the payments made to the estate of a deceased partner rather than to a retiring partner, the \$15,000 would still be taxed as income, but no capital gain on the \$75,000 would be recognized to the estate because the estate would get a stepped-up basis under Section 1014.

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52. Unrealized receivables are accounts receivable on the books of the business which have not been reported as income since they have not been collected. For the technical definition used in the CODE, see § 751(c).

53. I.R.C. § 736(b)(2)(B).

54. Note that § 751 also treats payments for unrealized receivables as ordinary income. However, since § 736(b)(2) takes unrealized receivable payments out of § 736(b)(1), there is no need for § 751 to operate in a case in which a partnership is making such payments. Section 751 still has vitality, however, where the partnership interest which the partnership purchases includes substantially appreciated inventory items. The present discussion will not deal with substantially appreciated inventory.

55. Section 736 applies to a deceased partner's successor in interest in exactly the same manner. This example uses a retired partner, however, in order that gains upon exchange will not be eliminated by operation of § 1014.

56. I.R.C. §§ 736(b)(2)(A) and 736(a)(2).

57. I.R.C. §§ 736(b)(1); 736(b)(2)(B); 731(a); 741.

If the partners had allocated no portion of the purchase price to unrealized receivables and had added the amount attributable to this item to the good will sum payable to the retiring partner or the deceased partner's estate, the retiring partner or the estate would not escape ordinary income tax on the amount attributable to the receivables. Only the portion of the purchase price reasonably allocable to good will or other capital assets can be treated as proceeds from the sale of capital assets.<sup>58</sup>

If the entity agreement merely had provided a lump sum amount of \$90,000 to be paid to the retiring partner or deceased partner's estate without specifying what value was to be assigned to which assets, the agreement would have been very poorly drafted. Nonetheless, allocation would be made under Section 736 between payments for property interest in the partnership and income payments. The approach would be as follows. The fair market value of the partnership assets other than good will and accounts receivable would have to be determined, and the retiring partner's share of those assets would be fixed accordingly. If the fair market value of such a share were computed to be \$50,000, then \$50,000 of the \$90,000 payment made by the partnership would be treated as a payment for an interest in the partnership under Section 736(b). The retiring partner's share of the firm's unrealized receivables would then be computed, and payments for that asset (assume them to be \$15,000) would be treated as ordinary income under Sections 736(b)(2)(A) and 736(a)(1). This would leave \$25,000 of the total payment which would be deemed to be payment for the withdrawing partner's share of the partnership good will. Since no value was placed on good will in the entity agreement, the \$25,000 payment for good will would receive ordinary income treatment under Section 736(a).<sup>59</sup>

Both the payment for unrealized receivables and the payment for good will would be deemed "income in respect of a decedent" under Section 691.<sup>60</sup> According to Section 1014(c), no stepped-up basis is allowed with respect to property which constitutes a right to receive income in respect of a decedent. Therefore, if the withdrawing partner in the above example were a deceased partner, the normal stepped-up basis which is applied to assets passing at death under Section 1014(a) would not be applied to the good will and unrealized receivables. The effect of Section 1014(c) is to preserve the income component of the amounts which would have been ordinary income to the decedent had he collected them before his death.

Thus, the Code taxes partnership payments to a retiring partner or a deceased partner's estate in accordance with the nature of the underlying assets comprising the interest sold. Payments of the retiring or deceased partner's interest in partnership property, exclusive of unrealized receivables and good will, must be treated as a distribution by the partnership under the rules of Sections 731 and 741. Payments for the deceased or retiring partner's interest in unrealized receivable must be treated as income payments under Section 736(a). But the parties have some flexibility in determining how payments for good will are taxed. If they wish payments for

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58. Treas. Reg. § 1.736-1(b)(3) (1965).

59. I.R.C. § 736(b)(2)(B).

60. I.R.C. § 753.

good will to be taxed as payments for a capital asset, then the buy-sell agreement should provide for a payment with respect to good will. If the partnership agreement makes no provision with respect to good will, any such payment will be taxed to the retiring partner or deceased partner's estate as an income payment under Section 736(a). When payments for good will are taxed as income to the retiring partner or deceased partner's estate, such payments will be deductible to the continuing partnership, or the surviving partners' distributive shares of partnership income will be reduced accordingly. The ability to dictate the desired tax treatment of good will gives foresighted partners an opportunity to do some clever tax planning.<sup>61</sup>

The flexibility afforded by Section 736 under an entity plan is not available under a cross-purchase plan. Payments made by the purchasing partners not attributable to accounts receivable are regarded as proceeds from the sale of capital assets, and are not deductible by the partnership as expense or distributions of firm profits.<sup>62</sup>

Problems arise in cases where the buy-sell agreement is so poorly drafted that there is doubt whether the parties intended the purchaser to be the partnership or the individual partners.<sup>63</sup> In such cases, the retiring partner or deceased partner's estate will argue that the transaction was a sale to the individual partners, in which case payments are deemed to be made for capital assets under Section 741. The continuing partners will argue that the transaction was a Section 736 liquidation by the partnership and that part of the payments are income payments which are deductible by the firm. The fact that resolution of such disputes often requires a court's analysis of the agreement to determine the intent of the parties illustrates the importance of a carefully drafted agreement.

One final note is in order. If the partnership files a Section 754 electing the basis of the partnership's assets may be adjusted pursuant to Section 743 on the transfer of a partnership interest.

### B. Corporations

In the corporate area, income tax consequences to the deceased shareholder's estate or to the retiring shareholder may, as in the partnership area, have a bearing upon the choice between an entity (stock redemption) plan and a cross-purchase plan. Again the cross-purchase plan results in the simplest treatment. The transaction is taxed as a sale of stock, and the selling shareholder recognizes a capital gain or loss to the extent of the difference

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61. If the individual partners are in high tax brackets, it is advantageous on the whole to make sure the retiring partner is taxed at ordinary income rates. The tax savings resulting to the remaining partners due to the deduction from partnership income outweigh any tax detriment to the retiring partner resulting from ordinary rates rather than capital gains rates. If this is the desired result, the partners should make no mention of payments for good will in their buy-sell agreement. For a good, but somewhat detailed, example of how these overall tax savings are realized, see A. WILLIS, WILLIS ON PARTNERSHIP TAXATION 443-446 (1971).

62. I.R.C. §§ 741, 751. In the case of a deceased partner, the estate may get a stepped-up basis in respect of the underlying unrealizable receivables, notwithstanding section 691, but the law on this point is still unsettled, see *Quick Trust v. Comm'r*, 54 T.C. 1336 (1970), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971).

63. See David A. Foxman, 41 T.C. 535 (1964), *aff'd* 352 F.2d 466 (3rd Cir. 1965); Charles F. Phillips, 40 T.C. 157 (1963).

between his basis in the stock and the amount realized.<sup>64</sup>

On the other hand, the payment by the corporation to the estate or retiring shareholder in redemption of the stock under an entity plan may give rise to either dividend or capital gain treatment, depending on the circumstances. Payments received in redemption of stock are to be treated as dividends in accordance with Section 301 unless the redemption (1) terminates the shareholder's interest in the corporation, or (2) is substantially disproportionate with respect to the shareholder whose stock is redeemed, or (3) is not "essentially equivalent to a dividend." These tests are set out in detail in Section 302(b). If any one of the three tests are met, the redemption payments will be treated as payments in exchange for a capital asset, rather than dividends.<sup>65</sup>

In determining the number of shares a shareholder owns after a redemption for the purpose of satisfying the Section 302 tests, the rules of constructive ownership set out in Section 318 must be applied. A thorough examination of the operation of Section 318 is outside the scope of this article. However, one must be aware of the section because its application often prevents shareholders from receiving the capital gains treatment they would otherwise receive under Section 302 when their stock is redeemed by the corporation.

#### CONCLUSION

No universal rules can be stated as to the choice between the entity and cross-purchase arrangements. However, practitioners do favor the entity plan. Willis states: "I have drafted many partnership agreements since the 1954 Code was adopted, and I cannot recall using a cross-purchase agreement once. All were entity agreements."<sup>66</sup> If his statement reflects a true pattern with respect to partnership agreements, it certainly must also be the pattern in corporate agreements where the transferee-for-value rule provides additional incentive for staying away from cross-purchase plans.

The general preference for entity agreements stems from a combination of the factors discussed. An entity agreement is simpler to administer and less likely to collapse due to delinquency of premium payments. For a partnership, liquidation under an entity plan has the advantage of allowing the continuing partners a deduction to the extent of the price of good will. For a corporation, an entity plan will protect the shareholders from the transferee-for-value problem which arises under a cross-purchase plan. Finally, owners are not likely to be able to afford to purchase their associates' interests individually, even with the help of life insurance, unless the business is very small or the individuals are independently wealthy.

The unavailability of a cost basis to the continuing shareholders under an entity plan is a problem only if a future sale of the business or the purchased stock is anticipated. The disadvantages stemming from Section 302 and 318 will haunt the retiring shareholder or deceased shareholder's estate

64. I.R.C. §§ 1001; 1002; 1221.

65. I.R.C. § 302(a); *see also* I.R.C. § 303.

66. A. WILLIS, WILLIS ON PARTNERSHIP TAXATION 704 (1971).

only in the case of closely related shareholders, and even those problems can be overcome through farsighted planning. So the balance comes down in favor of an entity plan in most cases after all considerations are weighed.

Finally, a word is necessary with regard to the structure which buy-sell agreements commonly take when no insurance funding provisions are used. In those cases it is often agreed that the business entity shall have first option to purchase interests of retiring or deceased owners, and if the entity fails to exercise that option within a specified time, the individual owners are given the same chance. If the individuals are wealthy persons who are involved in other enterprises, they may be able to raise the funds even though the partnership or corporation could not.