ADVANCED PLANNING

Business Strategies

Buy-Sell Agreements and Estate Valuation: IRC §2703

FREQUENTLY ASKED QUESTIONS
BUSINESS CONTINUATION

Can an "appropriately drafted" buy-sell agreement fix the estate tax value of a business interest?

Yes. One of the advantages of a properly structured buy-sell agreement is that it can minimize and, in some cases, eliminate estate tax valuation problems. The theory is that, if the decedent is contractually bound to sell the business interest at a certain price, then that price should constitute the estate tax value of the business interest. However, this logic does not necessarily pass muster with the IRS.

Background

There have been IRS challenges, court litigation, and even additional legislation to resolve this issue. Due to tax legislation (Chapter 14 of the Internal Revenue Code) enacted in the 1990's, scenarios involving family members have become more complex than non-family scenarios. Let's start with the basics in the non-family scenario because these elements are carried over into any family member situation.

Non-Family Situations

The starting point for non-family situations is the key regulation, Reg. §20.2031-2(h). This regulation speaks in the negative, stating that the buy-sell agreement will be disregarded unless "the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth."

REQUIREMENTS. Under case law that developed around Reg. §20.2031-2(h), the purchase price determined under a buy-sell agreement was held to fix the value of an interest in a closely held business if the following four requirements were satisfied:

Revenue Ruling 59-60 (and subsequent modifying rulings) restates positively:

- The price must be fixed by, or determinable from, the agreement.
- The agreement must be binding on the parties during life and after death.
- The agreement must have been entered into for bona fide business reasons.
- The agreement must not be a substitute for a testamentary disposition to transfer the business interest for less than adequate consideration.

The first attempt to "codify" this judicial approach occurred in 1987 with the enactment of IRC §2036(c), which was designed to eliminate abusive estate-freezing techniques. Buy-sell agreements were pulled into this controversial and disastrous code section. After numerous "fixes," IRC §2036(c) was retroactively repealed in 1990. The void was immediately filled by the addition of the Chapter 14 valuation rules. Within Chapter 14 lives IRC §2703, which deals specifically with buy-sell agreements.

Continued on the next page.

1012411-00002-00 Ed. 01/2020

Prudential
Bring Your Challenges®

IRC §2703 Valuation Rules. IRC §2703 was enacted to curtail perceived abuses in connection with agreements among owners of closely held businesses and their families. IRC §2703(a) provides that property must be valued for transfer-tax purposes:

- Without consideration of any options, agreements, or other rights to acquire or use the property for less than its fair market value, and
- Without any restrictions on the sale and use of the property.

However, an exception to this general rule is found in IRC §2703(b). Basically, the exception provides that, if the agreement meets the following three-part test, it will fix the estate tax value of the business:

- It is a bona fide business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than full and adequate consideration.
- It has terms comparable to similar arrangements entered into by a person in arm's-length transactions.

Each of the above requirements must be satisfied independently. **It should be noted that IRC §2703 supplements the prior four-part test. So if IRC §2703 applies to a buy-sell agreement, the agreement must meet both its test and the requirements of the four-part test required by the prior law.** The statute places the burden of proof on the taxpayer.

Practically speaking, unrelated parties would have little incentive to transfer assets for less than full and adequate consideration. Reg. §25.2702-1(b)(3) recognizes this and provides a safe harbor. When individuals who are not "members of the transferor's family" own more than 50% of the value of the property, the buy-sell transaction will qualify for the IRC §2703(b) exception.

The first two requirements of IRC §2703(b) evolved over time in case law under Treasury Reg. §20.2031-2(h) before they were codified by IRC §2703(b). Even before IRC §2703 was enacted, these were difficult tests to meet. With the addition of the comparability requirement, it has become more difficult for a buy-sell arrangement in a family business to be respected for estate tax valuation purposes.

A closer look at each part of the three-part test

Bona Fide Business Arrangement Test. Courts have held that the following reasons for entering into a buy-sell arrangement constituted a bona fide business arrangement:[1]

- The maintenance of family ownership and control of a business.
- The retention of a family member as a key employee of a company in which the family members were hostile to each other.
- To create an incentive for effective management when an owner wished to withdraw from management of a business.
- To ensure the continued employment of stockholders who were valued employees and to facilitate a transition of the ownership of the company to the shareholders, thereby ensuring the company's permanency.
- To avoid expensive appraisals in determining the price.
- To prevent the transfer to an unrelated party.
- To provide a market for the equity interest.
- To allow owners to prepare for future liquidity needs.

[1] *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982); *Estate of Lauder v. Commissioner*, 64 T.C.M. 1643 (U.S.T.C. 1992).

Continued on the next page.

Testamentary Device Test. A buy-sell agreement cannot have a testamentary purpose. A determination of whether a buy-sell agreement has a testamentary purpose involves an inquiry into the intent of the parties at the inception of the agreement. In *Estate of True v. Commissioner*, the court listed eight factors that might indicate a buy-sell agreement would fail the testamentary purpose test:[2]

- The decedent's poor health when entering into the agreement.
- No negotiation of buy-sell agreement terms.
- Inconsistent enforcement of buy-sell agreement provisions.
- Failure to seek significant professional advice when selecting a price formula.
- Failure to obtain or rely on appraisals when selecting a price formula.
- The exclusion of significant assets from the price formula.
- No periodic review of the price formula.
- The decedent's business arrangements fulfilled by this testamentary intent. (For example: The fact that the children of a deceased business owner received equal percentage interests in the business despite their different management responsibilities would indicate that the transfers were based on family relationships, not business relationships.)

Comparability Test. IRC §2703 added the "comparability provision," to discourage excessive discounting situations involving family members. Reg. §25.2703-1(b)(4)(i) attempts to clarify comparability by instituting a new three-part approach. These three new requirements are that the agreement must:

- Be similar to a fair bargain among unrelated parties.
- Follow the general business practice of unrelated parties.
- Be similar in result to negotiated agreements of unrelated parties.

Other than to imply that "comparability" is to be analyzed on an industry-by-industry basis, the regulations seem to merely paraphrase the code provisions and provide little guidance as to how comparability is proven.

Intra-Family Situations

It is difficult to determine whether an intra-family buy-sell is comparable to an arm's-length transaction, as most buy-sell agreements are typically private. An agreement that provides that the purchase price is to be determined by a qualified independent appraiser should comply. What is unclear is which other valuation approaches will be recognized. If an approach other than appraisal is used, care should be taken to document why that approach meets the "comparability" requirements.

The IRS takes a broad view of the scope of IRC §2703. Where a family limited partnership is used to accomplish an intra-family transfer of business interests, the IRS has consistently used this code section to challenge the discounting effect of the partnership for valuation purposes. Taxpayers contemplating the use of a family limited partnership are well advised to employ knowledgeable legal counsel to navigate the perils of IRC §2703 as well as other Chapter 14 rules.

The Meaning of "Family." Another ambiguity of IRC §2703 is the meaning of the term "family." It may have wider application than its usual definition.

The regulations under IRC §2703 do not refer to "members of the decedent's family" but instead substitute the phrase "natural objects of the transferor's bounty." Nowhere in the regulations is this term defined. However, the preamble to the regulations specifically provides that the class of persons who may be objects

[2] T.C. Memo 2001-167 (2001).

Continued on the next page.

of an individual's bounty is not necessarily related by blood or marriage.[3] To date, it does not appear that the IRS or the courts have pursued an expansive application of this definition. However, when drafting and designing a buy-sell agreement, care must be taken to consider this "wider" definition and its implications in the individual strategy scenario.

Grandfathering Rules. IRC §2703 does not apply to buy-sell agreements entered into before October 8, 1990, unless such an agreement is "substantially modified." However, it is important to note that, even if IRC §2703 does not apply, the arrangement must still meet the prior four-part test to control value for estate tax purposes.

There is little guidance on what the IRS considers to be a substantial modification. Reg. §25.2703-1(c)(2) speaks in the negative, listing those modifications that are not considered substantial modifications:

- A modification required by the agreement.
- A discretionary modification of an agreement conferring a right or restriction that does not change the right or restriction.
- A modification of a capitalization rate, if the rate is changed in a manner that bears a fixed relationship to a specified market interest rate.
- A modification that results in the establishment of a price that more closely approximates fair market value.

It should be noted that "inaction" as well as "action" could be detrimental to grandfathered agreements. If the agreement includes a provision requiring periodic modification and none is made, Reg. §25.2703-1(c)(2) provides that such a failure to update the agreement is presumed to be a "substantial modification." However, this presumption can be overcome if it can be shown that the updating would not have resulted in a substantial change.

Taxpayers should take extreme care to consult legal counsel before altering the terms of, or the parties to, a pre-October 8, 1990, agreement.

Impact of Corporate-Owned Life Insurance in Determining Estate Value. One of the major problems with all buy-sell agreements is finding the funds to enable the buyer to purchase the interest of a deceased owner. Life insurance is usually a preferred option for funding a buy-sell triggered by the death of an owner because:

- The insurance death proceeds are paid at the time when the obligation to purchase the business interest is triggered.
- Properly structured, the proceeds may be received income tax-free under IRC §101(a).[4]
- The cost of the life insurance is generally less than the death benefit received.

Funding a buy-sell arrangement with life insurance, however, has its own tax issues. One such issue is whether business-owned life insurance must be included in determining the estate value of a decedent's stock. The Tax Court in *Estate of Blount v. Commissioner*[5] held that the life insurance owned by the corporation increased the value of the business entity for estate tax purposes. On appeal, the Eleventh Circuit court reversed the Tax Court on the life insurance valuation issue noting:

[3] Preamble to final regulations: TD 8395, 1992-1 CB 316, 320.

[4] For employer-owned contracts issued after August 17, 2006, IRC §101(j) provides that death proceeds will be subject to income tax. However, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income tax-free. Life insurance proceeds are otherwise generally received income tax-free under IRC §101(a). Internal Revenue Bulletin 2009-24, Notice 2009-48 provides further guidance concerning ownership.

[5] *Estate of Blount v. Commissioner*, T.C. Memo. 2004-116, aff'd in part and rev'd in part, 428 F. 3d 1338 (11th Cir. 2005).

Continued on the next page.

The insurance proceeds are not the kind of ordinary nonoperating asset that should be included in the value of Blount Construction Company under the Treasury regulations. To the extent that the $3.1 million insurance proceeds cover only a portion of the taxpayer's 83% interest in the $6.75 million company, the insurance proceeds are offset dollar-for-dollar by the company's obligation to satisfy its contract with the decedent's estate. We conclude that such nonoperating "assets" should not be included in the fair market valuation of a company where, as here, there is an enforceable contractual obligation that offsets such assets. To suggest that a reasonably competent business person interested in acquiring a company would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value.

Whether other circuits will follow the Blount result of excluding life insurance proceeds in determining the estate value is open to speculation. While the results of Blount should not be ignored, advisors should recognize the realities that life insurance proceeds are valuable assets and that other circuits may not follow the results of Blount.

In Summary

When using a buy-sell agreement to set the estate tax value of a business interest, it is critical to build the agreement so that it meets the four requirements described in the "Requirements" section on page 1.

Where there is an intra-family transaction, additional steps must be taken to prove that the transaction is comparable to other arm's-length sales between unrelated parties and that it represents a bona fide business purpose.