

Burkert Valuation Advisors, LLC

VALUATION AND LITIGATION CONSULTANTS

Spotlight on Value: Buy-Sell Agreements

by Rod P. Burkert, CPA/ABV, CVA

Introduction

Court decisions in *St. Louis County Bank* (674 F.2d 1207, 8th Cir. 1982), *Lauder* (TC Memo 1990-530 and TC Memo 1992-936), *Bommer* (TC Memo 1997-380), *True* (TC Memo 2001-167), *Smith III* (2004-2 USTC (CCH) 60,488 W.D. PA), and *Blount* (TC Memo 2004-116) highlight the importance of having a well-crafted and thoroughly understood buy-sell agreement (“BSA”) between and among a corporation, its shareholders, and their legal and valuation advisers. For example, on appeal, the Tenth Circuit in *True* (94 AFTR2d 2004-7039 (CA-10, 2004)) stated: “Where the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute.” Translation: a device to transfer wealth at less than fair market value.

What Is a BSA?

Generally, a BSA is a legal contract that delineates how ownership interests will be bought and sold in the event of specific triggering mechanisms. A BSA can cover a variety of shareholder circumstances, such as what happens in the event of death or disability, voluntary or involuntary withdrawal, and divorce, bankruptcy, or insolvency. Corporate protection features can also be addressed, such as restricting transfers that violate an S-election, outlining non-compete provisions of exiting shareholders, specifying first refusal rights for available shares, and stating if purchase obligations are optional or mandatory.

Because a BSA governs how stock will be bought and sold, a BSA is most often used to guarantee a shareholder that, upon his/her death, his/her estate will have a buyer for the stock and/or to guarantee that remaining shareholders will have a right of first refusal to purchase the decedent’s stock.

Another interesting aspect of a BSA is that the price established therein for an ownership interest may be binding on the Internal Revenue Service for Federal estate tax purposes. Thus, in a family-owned or closely-held business, a BSA is a necessary component of a shareholder’s estate plan which should be drafted at the time a company is formed and updated, often annually, as required going forward.

Advantages of BSAs

- A BSA is inexpensive to draft because it is a contract with few state law formalities.
- A BSA is relatively easy to amend, modify, revise, or undo if all parties agree.
- A BSA creates a market for a decedent's stock, reducing estate tax issues created by owning fractional, illiquid ownership interests in a closely-held company.

Disadvantages of BSAs

- A corporate distribution to redeem stock which fails to meet the requirements of IRC Sections 302(b) or 303 will be taxed as a dividend.
- By itself, a BSA does not guarantee that the necessary funds will be available when a triggering event occurs.
- Chapter 14 eliminates the estate freeze benefits of a BSA in family-owned businesses.

Why Chapter 14?

As part of the Omnibus Budget Reconciliation Act of 1990, Congress repealed IRC Section 2036(c) retroactive to its December 17, 1987 date of enactment. In its place, Congress added Chapter 14, Special Valuation Rules. The special valuation rules of IRC Sections 2701-2704 were enacted to halt what was perceived to be abusive gift/estate tax avoidance achieved by certain transfers of closely-held business interests to younger generations. IRC Section 2703 particularly relates to BSAs. Consequently, BSA transactions entered into on or after October 8, 1990 may be subject to Chapter 14.

Impact of IRC Section 2703 on BSAs

IRC Section 2703 directs that certain rights and restriction on the sale or use of property be disregarded when valuing such property for estate, gift, and generation-skipping transfer tax purposes. In other words, unless it is established that the right or restriction qualifies as an exception, options, restrictive sale agreements, and BSA provisions that impair value will be disregarded for transfer tax valuation purposes.

A right or restriction includes any option, agreement, or other right to acquire or use property at a price that is less than fair market value. The right or restriction may be part of a BSA, partnership agreement, corporate by-laws, or articles of incorporation, or it may even be implicit in the firm's capital structure.

By regulation and legislative intent, Section 2703 is limited to BSAs among related parties, i.e., when 50% or more of an entity's ownership interests are held by family members.

BSAs and Family Members

If a BSA is entered into (or an existing BSA is substantially modified) on or after October 8, 1990, the general rule of Section 2703 is avoided only if all of the following requirements are met.

- The BSA is a bona fide business arrangement;
- The BSA is not a device to transfer property to family members for less than full and adequate consideration; and
- The BSA is comparable to similar arrangements entered into by persons in arm's-length transactions.

According to Regs. Sec. 25.2703-1(c), a “substantial modification” includes any discretionary modification of a right or restriction, whether or not authorized by the terms of an agreement, that results in anything more than a *de minimus* change in the quality, value, or timing of the rights or any party with respect to the property that is subject to the right or restriction.

Regulations under Section 2703 define family members as: (a) applicable family members, (b) lineal descendants of the parents of the transferor or the transferor's spouse, and (c) any other individual who is a natural object of the transferor's bounty. Applicable family members are generally members of the senior generation and include: (a) the transferor's spouse, (b) any ancestor of the transferor or the transferor's spouse, and (c) the spouse of any such ancestor.

If more than 50% of the ownership interests are held outside the family unit, i.e., the BSA is primarily among unrelated parties, the above requirements of Section 2703 are presumed to be automatically met. However, other requirements must still then be satisfied for the BSA to be recognized for Federal estate tax purposes.

BSAs and Unrelated Parties

The rules for BSAs not affected by Section 2703 are addressed in Regs. Sec. 20-2031-2(h). In BSAs among unrelated parties, there are four tests that must be satisfied for a BSA value to be controlling for Federal estate taxes. The Tenth Circuit in *True* synthesized other cases, including *Estate of Lauder*, T.C. Memo 1992-736 (Lauder II), on BSA formula prices into a four-part test:

- The price is determinable from the agreement;
- The BSA must be binding on the parties during life and death;
- The BSA is legally binding and enforceable; and
- The BSA was entered into for bona fide business reasons and is not a testamentary substitute intended to pass on the decedent's interests for less than full and adequate consideration.

The court also indicated that a BSA formula price is likely to pass the “adequate consideration” test if the following facts are present:

- An independent appraisal is performed for the purpose of establishing the formula price.
- The formula price is a reasonable approximation of fair market value at the time BSA is entered into.

- The BSA contains an adjustment clause or allows for periodic revaluations.
- The BSA price is reached by negotiation.

Whipsaw Potential

It is important to see that the value derived from a BSA does not automatically become the stock's estate tax value at a shareholder's death. Further, if a BSA does not pass the requisite tests for related or unrelated parties, as the case may be, the estate of the decedent shareholder could experience the worst of both worlds. To wit:

- If the BSA value is less than a fair market value, the IRS could disregard the BSA. It would value the ownership interest at a presumably higher value upon which estate taxes would then be calculated.
- If the BSA is valid under state law, the BSA value would be binding on the estate. It would receive the presumably lower value for the ownership interest and have less funds to pay the estate taxes.

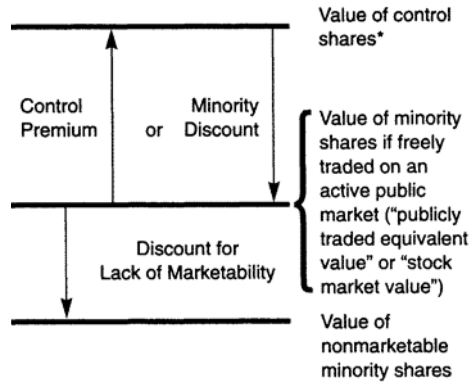
Valuation Considerations

If the BSA is not clear with respect to the valuation process, the firm and the decedent's estate will inevitably retain their own appraisers to derive a value. In order to minimize the difference between their results (which may avoid the need to hire a third appraiser to forge a conclusive determination), the BSA should set forth the following:

- The "As Of" date for the valuation. Is it the date of the triggering event, the month end preceding the event, or the most recently completed fiscal year prior to the event?
- That the Standard of Value should either be fair market value, fair value, or investment value.
- That the subject interest should be a proportionate share of some Level of Value, i.e., a control value, a marketable minority value, or a non-marketable minority value.
- The Funding Mechanism, either through insurance, sinking funds, or pre-agreed payment terms and conditions.

The first, second, and fourth points are relatively straight forward. Understanding the ramifications of the third point is more subtle. The distinction becomes apparent if the valuation language of the BSA says the subject interest should be valued as a percentage of "the fair market value of the company" or if the subject interest should be based on "the fair market value of the shares." As illustrated in the diagram below, the former wording implies the subject interest will be valued as a pro rata amount of the higher control value (possibly no discounts); the latter wording implies a pro rata value of the lower non-marketable minority value (with discounts for lack of control and lack of marketability).

Level of Value Diagram



A Final Word

Remember this about BSAs – someone will be a buyer and someone will be a seller. No one knows who that will be when the BSA is signed. So the BSA needs to work for all shareholders.

Rod is a co-founder of Burkert Valuation Advisors, LLC. With over 25 years of combined experience in public accounting and private industry, he has provided business appraisal and litigation consulting services for companies operating in a wide variety of industries and for various purposes. He is also an instructor for the National Association of Certified Valuation Analysts and a past chairman of its Executive Advisory Board and its Education Board.

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