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Section of Taxation
and
Section of Real Property, Probate and Trust Law

Splitting Up a Family Business:
Estate and Gift Tax Considerations-
Business Succession Planning

Buy-Sell Agreements Under Section 2703 After True and Blount

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I. General Principles

A. Early Prior Law

1. Restrictive agreements have had their greatest impact and have created the most controversy in the area of valuing shares of a closely held business for estate tax purposes.

2. The value of corporate stock may be limited for federal estate tax purposes as a result of an enforceable buy-sell agreement or option contract, which fixes the price at which the stock may be offered for sale to the remaining shareholders. Bommer Revocable Trust v. Comm'r, 74 T.C.M. (CCH) 346 (1997).

3. Buy-sell agreements restricting the transfer of securities in family corporations have often been accepted by the courts as establishing value for transfer tax purposes. See, e.g., May v. McGowan, 194 F.2d 396, 397 (2nd Cir. 1952) ("an outstanding option to purchase restricts the market value of stock in the hands of the owner to the option price"); Lomb v.

Sugden, 82 F.2d 166, 168 (2nd Cir. 1936) ("Because of the agreement, the decedent could not have secured a price greater than $69.445 at the time of her death"); and Wilson v. Bowers, 57 F.2d 682, 683 (2nd Cir. 1932) ("the sale value of the stock during the testator's life could have been no more than the low price at which he was obliged to offer it").

4. Agreements establishing a fixed price for a mandatory sale and purchase at death have been recognized as establishing the estate tax value of corporate stock or partnership interests even though there were significant discrepancies between the agreement price and the fair market value of the property in question. Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Fiorito v. Comm'r, 33 T.C. 440 (1959), acq. 1960-2 C.B. 3; Estate of Weil v. Comm'r, 22 T.C. 1267 (1954), acq. 1955-2 C.B. 3; and Estate of Bischoff v. Comm'r, 69 T.C. 32 (1977).

5. Early cases focused on two relevant questions: was the agreement binding throughout life and death, and was it legally binding and enforceable? See May v. McGowan, 194 F.2d 396 (2nd Cir. 1952) (court found no purpose of the agreement was to evade taxes); Lomb v. Sugden, 82 F.2d 166 (2nd Cir. 1936) (agreement between decedent and other shareholders); and Wilson v. Bowers, 57 F.2d 682 (2nd Cir. 1932) (agreement not solely between family members).

6. In Brodrick v. Gore, the Tenth Circuit Court of Appeals focused on whether the shares were burdened by specific contractual provisions, and whether such provisions equally bound all parties to the contract at life

and at death. Because the court found that the estate was legally bound to sell the shares at the contractual price, and this restriction was binding both during life and death, the value of the shares for estate tax purposes was based on the contract terms rather than the fair market value. In making its decision, the court relied on May, Lomb, and Wilson. 224 F.2d 892 (10th Cir. 1955), overruled by Estate of True v. Comm'r, 390 F.3d 1210 (10th Cir. 2004).

7. It has been noted that these early cases were decided principally "by the use of a syllogism: the then Revenue Act provided that the estate tax value is the value of the decedent's property at the date of death; the value at the date of death is the amount the estate will receive for the property under the buy-sell agreement; therefore, the estate tax value is equal to the amount payable under the buy-sell agreement." Roger R. Fross, *Estate Tax Valuation Based on Book Value Buy-Sell Agreements*, 49 TAX LAW 319, 327-28 (1996). See also Fiorito, 33 T.C. at 444 (1959) (where agreement sets price to be paid for property and binds all parties equally during life and at death, price term controls for estate tax purposes); and Estate of Littick v. Comm'r, 31 T.C. 181, 185-87 (1958), acq. 1959-2 C.B. 5, acq. withdrawn in part, 1984-2 C.B.1 (agreement that binds all parties to set price at life and at death will control for valuing property in the estate).

B. Regulatory Response

1. An initial statement of the Internal Revenue Service's position on the impact of restrictive agreements to set values for estate tax purposes is articulated in Treasury Regulation § 20.2031-2(h), promulgated in 1958 and applicable to the transfer of estates of decedents dying after August 16, 1954.

    a. The Second Circuit Court of Appeals in May v. McGowan foreshadowed this legislative action when, after citing several cases supporting its holding that an outstanding option to purchase restricts the market value of stock, the court stated "If [the decisions] leave a loophole for tax evasion in some cases…[s]uch a loophole, if important, should be closed by legislative action…." 194 F.2d at 398.

    b. Under this regulation, it was necessary that the agreement represent a bona fide business arrangement and was not a device to pass a decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

2. The 1958 regulation was followed by Revenue Ruling 59-60. Section 8 of that regulation provides that, in determining whether a restrictive agreement should control for estate tax purposes, consideration should be given to whether the agreement is the result of voluntary action by the shareholders and binding during the life as well as at the death of the shareholders, the relationship of the parties, and other material facts in

order to distinguish a bona fide business arrangement from a device to pass shares to the decedent's logical beneficiaries for less than full consideration. 1959-1 C.B. 237.

II. Interpretation of Treasury Regulation § 20.2031-2(h) and Revenue Ruling 59-60

A. Generally

1. Numerous courts have analyzed and applied the guidelines set out in Treas. Reg. § 20.2031-2(h) and Revenue Ruling 59-60.

2. Under this regulatory guidance, for a buy-sell agreement to fix, rather than merely affect, the value for estate tax purposes, it must first satisfy three requirements: 1) the price is determinable from the agreement, 2) the terms of the agreement are binding throughout life and death, and 3) the agreement is legally binding and enforceable.

3. Even if these three requirements are met, however, the arrangement still must be found to be a bona fide business arrangement that is not intended as a device to transfer shares to the natural objects of the decedent's bounty for inadequate consideration.

B. Treas. Reg. § 20.2031-2(h) Requirements

1. The price must be determinable from the agreement.

a. This requires either stating a fixed price or providing a clear pricing formula.

(i) In Estate of Littick, 31 T.C. at 183, the agreement stated a fixed price, but provided for an annual reevaluation by a majority of the shareholders.

(ii) In May, 194 F.2d at 397, the stock option price was a fixed price, reduced by a fraction of indebtedness.

(iii) In Brodrick, 224 F. 2d at 894, and Fiorito, 33 T.C. at 442, the price was listed as the book value of the decedent's interest in the partnership.

(iv) In St. Louis County Bank v. United States, 674 F.2d 1207, 1209 (8th Cir. 1982), the formula price was ten times the average annual net earnings per share for the preceding five years adjusted to eliminate gains or losses on real estate and the income tax consequences of such gains or losses.

b. Price is disregarded where no bona fide or arm's-length negotiations occurred in determining the fixed price and the decedent had the effective ability to amend the agreement to alter price. Bommer Revocable Trust v. Comm'r, 74 T.C.M. 346 (1997).

c. If a fixed price is adjusted periodically pursuant to a revaluation formula, it is important that the stock actually be revalued in accordance with the agreement. See Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir.), cert. denied, 479 U.S. 1007 (1986).

2. The terms must be binding at life and at death.

a. For agreements satisfying this requirement, see May, Brodrick, Lomb, and Wilson, supra, at I.A. See also Estate of True v.

Comm'r, 82 T.C.M. (CCH) 27, aff'd 390 F.3d 1210 (10th Cir. 2004) (although the decedent controlled the corporation, the consent of other shareholders was required to amend buy-sell agreement).

b. To the contrary, see Bommer Revocable Trust v. Comm'r, 74 T.C.M. (CCH) 346 (1997) (decedent's effective ability to amend buy-sell agreement made it not binding on him during his lifetime); United States v. Land, 303 F.2d 170 (5th Cir.), cert. denied, 371 U.S. 862 (1962) (because purchase restrictions expired upon the shareholder's death, full fair market value at death was controlling for estate tax purposes); and Estate of Blount v. Comm'r, T.C. Memo. 2004-116 (agreement not binding during lifetime because of decedent's ability, on behalf of himself and his company, to unilaterally modify the agreement).

3. The agreement must be legally binding.

a. The estate of the decedent must have a contractual obligation to sell the shares, which obligation is, and remains, in effect at death. Estate of Anderson v. Comm'r, 36 T.C.M. (CCH) 972 (1977), aff'd, 619 F.2d. 587 (6th Cir. 1980).

b. As long as the estate must sell, the other parties need not be obligated to purchase; an option to purchase is sufficient. Wilson v. Bowers, 57 F.2d 682 (2nd Cir. 1932). A nonbinding option is

not sufficient. Dorn v. United States, 828 F.2d 177 (3rd Cir. 1987).

c. A right of first refusal is sufficient. Slocum v. United States, 256 F. Supp. 753 (S.D.N.Y. 1966). A right of first refusal with an exercise price based on the third party's offer price, however, would not be seen as providing a determinable price establishing estate tax value.

4. The agreement must be a bona fide business arrangement that is not intended as a device to transfer shares to the natural objects of the decedent's bounty for inadequate consideration.

a. Bona fide business arrangement.

(i) Maintenance of family ownership and control over a business has been found to be a legitimate business purpose. See St. Louis County Bank, 674 F.2d at 1210, Estate of Lauder v. Comm'r, 64 T.C.M. (CCH) 1643, 1657 (1992) ("Lauder II"); and Estate of Bischoff, 69 T.C. at 39-40.

(ii) In United States v. Dorn, the Third Circuit Court of Appeals refused to recognize gratuitous but legally enforceable options to purchase publicly traded stock at a stated price as limiting the value of the stock held by the transferor at her death to the option price rather than the higher publicly traded price because the stated purpose of

the options was the shifting of appreciation out of the transferor's estate for estate tax purposes. 828 F.2d 177 (3rd Cir. 1987).

(iii) See also Estate of Godley v. Comm'r, 80 T.C.M. (CCH) 158 (2000), aff'd, 286 F.3d (2002) (options found to be "gifts" and testamentary substitutes given without adequate consideration disregarded in determining stock value).

b. Two-prong nature of test.

(i) As the law continued to scrutinize buy-sell agreements, especially where the shareholders were related, courts began asking whether the agreement fulfilled a bona fide business purpose *and* was also not some form of device to transfer stock without adequate consideration (i.e., a testamentary substitute).

(ii) This requirement is conjunctive and requires that both tests be satisfied. See, e.g., Dorn, 828 F.2d at 182; St. Louis County Bank, 674 F.2d at 1210; Estate of Gloeckner v. Comm'r, 152 F.3d 208, 213 (2nd Cir. 1998). Contra Estate of Seltzer v. Comm'r, 50 T.C.M. (CCH) 1250, 1254 (1985) ("If the contract fixing the price is a substitute for testamentary grant or devise, the contract is held to lack a bona fide business purpose").

(iii) In St. Louis County Bank v. United States, the Eighth Circuit Court of Appeals overruled a lower court decision that found the existence of a valid business purpose necessarily excluded the possibility that the agreement was a tax-avoidance testamentary device. Although the appellate court stated that the fact of a valid business purpose could, in some circumstances, completely negate the alleged existence of a tax-avoidance testamentary device as a matter of law, such circumstances were not present in that case. 647 F.2d at 1210.

(iv) When the Internal Revenue Service promulgated regulations under Section 2703, it reinforced the double prong nature of this test. See Special Valuation Rules, 56 Fed. Reg. 14,321, 14,325 (1991) ("Consistent with the legislative history, the proposed regulations clarify that these…tests are independently applied.").

c. Adequacy of Consideration.

(i) In considering the adequacy of consideration, most courts have limited their inquiry to the time the agreement was entered into rather than the time the option was exercised. See, e.g., Bensel v. Comm'r, 36 B.T.A. 246, 253 (an increase in value of the shares was a circumstance which was within the reasonable contemplation of the parties at

the time they entered into the agreement); Slocum, 256 F. Supp. at 756-57 (the fact that no federal estate tax existed when restriction imposed negated any tax avoidance purpose; to alter the effect of a finding of adequate consideration at the agreement's inception by circumstances many years after the adoption of the agreement would be to taint the agreement retroactively); Estate of Bischoff, 69 T.C. at 41 (in situations involving a unilateral agreement to sell stock in a closely held corporation, court has looked to the adequacy of the consideration at the time the agreement was entered into in determining whether the agreement operates as a substitute for a testamentary disposition for less than adequate consideration); and Lauder II, 64 T.C. M. (CCH) at 1659 (court considered the adequacy of the consideration in terms of the price to be paid for decedent's stock as of the dates the agreements were executed).

(ii) To the contrary, the Eighth Circuit Court of Appeals in St. Louis County Bank seemed to indicate that, in determining whether the agreement is a testamentary device, it might be reasonable to restrict its inquiry to the adequacy of the consideration and the conduct of the parties only at the time of the agreement only in a situation

where a wide disparity in formula price and other valuation methods, such as book value, is a result of failure of the business to generate a profit or other economic conditions outside the control of the parties to the agreement. 674 F.2d at 1211. In that case, however, although the stock-purchase agreement provided for a reasonable price at the time of its adoption, the corporation's business changed substantially several years later and the agreement was not changed.

(iii) Several courts have interpreted Treas. Reg. § 20.2031-2(h) as allowing an option price to affect the value of stock only if the option is granted at arm's-length. Dorn, 828 F. 2d at 181 (court's interpretation of Treas. Reg. § 20.2031(h) was "informed by the fact that Congress's overarching goal in this area was to limit circumvention of the general rule of fair market value at date of death by transaction [sic] that are not at arm's-length"); Carwright v. United States, 457 F.2d 567, 571 (2nd Cir. 1972), aff'd 411 U.S. 546 (1973) (if the restrictive agreement is created in an arm's-length transaction, the regulation requires the price so specified be the fair market value); Lauder II, 64 T.C.M. (CCH) at 1660 (the phrase "adequate and full consideration" is best interpreted as requiring a price that is not lower than that

which would be agreed upon by persons with adverse interests dealing at arm's-length); Estate of Littick, 31 T.C. at 187 (price controls where the owners set it in an arm's-length agreement); Bensel, 36 B.T.A. at 253 (price agreed upon was not lower than the price at which persons with adverse interests dealing at arm's-length might have been expected to have agreed); and Estate of Godley, 80 T.C.M. (CCH) at 164 (low price with no adjustment mechanism and agreement between father and son strongly suggests no arm's-length bargain for option price).

d. Testamentary Device Factors

(i) Health or age of the decedent when entering into the agreement. See Estate of Gloeckner, 153 F.3d at 216 (decedent was not in poor health and planned to run the business another twenty years, indicating lack of testamentary intent); St. Louis County Bank, 674 F.2d at 1210 (family relationship among shareholders and poor health of one of them at time agreement entered into raised inference of testamentary agreement); Slocum, 256 F. Supp. at 755 (same); and Estate of Lauder v. Comm'r, 60 T.C.M. (CCH) 977, 978-79 (1990) (decedent was not suffering from nor apprehensive of any terminal illness or

impending fatality during the period preceding and at the time of the execution of the shareholder's agreement).

(ii) The lack of regular enforcement of the agreement. See St. Louis County Bank, 674 F.2d at 1211 (at death of another shareholder, shares not offered to company or other shareholders); Lauder II, 64 T.C.M. (CCH) at 1657 (waivers of rights under buy-sell agreement not a problem if made pursuant to terms of the agreement because agreements consistently adhered to by the parties).

(iii) The exclusion of significant assets from the agreement. See Lauder II, 64 T.C.M. (CCH) at 1659 (exclusion of all intangible assets for cosmetic company questionable).

(iv) The arbitrary manner in which the price term was selected, including the failure to obtain appraisals or seek professional advice. See Lauder II, 64 T.C.M. (CCH) at 1658 (determination of price without formal appraisal, without considering the specific trading prices of comparable companies, and without significant professional advice was arbitrary); Estate of Gloeckner, 153 F.3d at 216-17 (where decedent hired an independent accountant to value stock, court distinguished contrary cases in which formal appraisals were not done); and Bommer Revocable Trust, 74 T.C.M. (CCH) at 356

(decedent failed to obtain a professional appraisal and did nothing more than consult with his attorney).

(v) The lack of negotiation between the parties in reaching the agreement terms. See Bommer Revocable Trust, 74 T.C.M. (CCH) at 357 (court viewed with suspicion a buy-sell agreement that was not reached by bona fide negotiations with respect to the price terms, and in which all the parties to the agreement were represented by the same lawyer), and Lauder II, 64 T.C.M. (CCH) at 1658-59 (wherein the court expressed concern about buy-sell agreement in which the family patriarch appeared to decide unilaterally on formula price for the exchanged interests and had no intention to negotiate). But cf. Bensel, 36 B.T.A. at 253 (father and estranged son were constantly bargaining over the price terms).

(vi) Whether the agreement allowed for adjustments or revaluation of its price terms. See Estate of Godley 80 T.C.M. (CCH) at 164 (fixed price of option, without any adjustment mechanism to reflect changing conditions invites close scrutiny); and Bommer Revocable Trust, 74 T.C.M. (CCH) at 356 (lack of periodic revaluation of price term one factor contributing to conclusion that buy-sell agreement was testamentary substitute).

(vii) Whether all parties to the agreement were equally bound to its terms. See Brodrick, 224 F.2d at 896 (all parties were bound by agreement); Bischoff, 69 T.C. at 41 (buy-sell agreement not testamentary device where all provisions equally applicable to all patterns); and Littick, 31 T.C. at 187 (where agreement equally binding on all family members regardless of who died first, no testamentary intent found).

(viii) Generous payment terms. See Bommer Revocable Trust, 74 T.C.M. (CCH) at 356 (payment could be made in ten annual installments with interest accruing at 5% when market interest rates in 1975 and 1981 were 11.8% and 21%, respectively).

(ix) Any other testimony or evidence that the agreement supported the decedent's testamentary plan. See Estate of Godley, 80 T.C.M. (CCH) at 161 (decedent indicated in a pre-death deposition that the transfer of certain interests to his son was a gift executed for the purpose of circumventing estate tax liability).

III. Estate of True v. Comm'r

A. In Estate of True v. Comm'r, 390 F.3d 1210 (10th Cir. 2004), the Tenth Circuit Court of Appeals affirmed the tax court's decision that a decedent's buy-sell agreement did not control the date of death value of closely held business interests for estate tax purposes.

B. The appellate court's focus was on the second part of the fourth prong of the test – whether the agreement is a device to transfer business interests to the natural objects of the decedent's bounty for inadequate consideration.

C. Facts

1. David True formed several businesses involved in oil and gas exploration, marketing and transportation, as well as several ranching operations. Five of these businesses were owned by David, his wife, and his three sons. One of the businesses was owned by David's family and by David's brother and his family. Some of these businesses were established as S-corporations and some as partnerships. All of these businesses were subject to longstanding buy-sell agreements, which provided that i) no owner could transfer or encumber his interests in the business, ii) each owner had to work in the business, iii) failure to work in the business, any attempted transfer of an ownership interest, or death or disability were all treated as if the owner notified the others that he was withdrawing from the business, and iv) upon such notice, the other owners were required to purchase the departing owner's interests at tax book value. All of the agreements were the same, except that the agreement among David's family and David's brother's family provided that if either family desired to sell their interest to a third party, the other family had the right to buy the interest, but at the price contained in the third party's offer and not at tax book value.

2. Tax book value was the basis on which the True businesses characteristically kept their business records, and in some cases, the prices specifically excluded certain assets. Under the tax book value method of accounting, the businesses were able to take greater advantage of certain tax deductions and accelerated rates of depreciation granted to the oil and ranching industries. The result is that the businesses had tax book values much lower than fair market value and, in some cases, some of the businesses showed a negative book value figure.

3. In 1971, all three sons and a daughter acquired interests in some of the True businesses by purchases at tax book value, which were not reported on a gift tax return. True and his wife also made gifts of some interests in 1973, which were reported on a gift tax return. The Internal Revenue Service determined gift tax deficiencies for both years, but the district court sustained the Trues' argument that the fair market value of the transferred interests was the reported tax book value.

4. In 1984, the daughter withdrew from the True companies to open a ranch operation wholly independent from the True operations. In accordance with the buy-sell agreement, True and his wife and sons purchased the withdrawing daughter's interests at tax book value. At this time, True and his wife also ceased making annual exclusion gifts to the withdrawing daughter and amended their wills and other estate planning documents to delete any specific provision for the withdrawing daughter or her family members, as she had "severed her financial ties with the True companies,

and thus her potential inheritance" had been fully satisfied as a result of the sale of her interests.

5. True died unexpectedly in 1994 and his remaining interests in the True companies were transferred to his wife and sons at tax book value. True's wife then sold her interests in the businesses to her sons at tax book value. The estate reported the date of death value as equal to the proceeds the estate received under the buy-sell agreements and the Internal Revenue Service issued deficiency notices for the transfers made by True and his wife. The increased gift and estate taxes amounted to over $75 million. In addition, the Internal Revenue Service imposed substantial understatement of value penalties of over $30 million.

6. At trial, the tax court rejected the estate's argument that the buy-sell agreements determined the value of the transferred interests for estate and gift tax purposes, but reduced the deficiency to approximately $18.2 million and the penalties to approximately $3.1 million. The taxpayers appealed to the Tenth Circuit Court of Appeals.

D. The Court's Analysis

1. The primary issue was whether the price terms in the buy-sell agreements controlled for the purpose of valuing the interests in David True's estate.

   a. The appellate court found that, as developed in case law and embodied in Treas. Reg. § 20.2031-2(h), the stated price in a buy-sell agreement will control where 1) the price is determinable from the agreement, 2) the terms of the agreement are binding

throughout life and death, 3) the agreement is legally binding and enforceable, and 4) the agreement was entered into for a bona fide business reason and is not a testamentary substitute intended to pass on the decedent's estate for less than full and adequate consideration. The court referred to this test as the "price term control test."

b. Only the fourth prong of this test was at issue on appeal.

c. The court first noted that the fourth prong is conjunctive, such that the buy-sell agreement must be entered into for a legitimate business purpose and it cannot be a testamentary device. Because the tax court found that the True buy-sell agreements were entered into for a variety of legitimate business reasons, and the Internal Revenue Service did not contest this finding, the appellate court's inquiry was limited only to whether the True buy-sell agreements served as testamentary substitutes.

2. With regard to whether an agreement serves as a testamentary substitute, the court noted the dearth of cases outlining the full process by which a court should make its determination. The court also noted, however, that courts generally begin their analysis by examining a variety of factors from which an inference may be drawn that an agreement served as a testamentary substitute. See supra at II.B.4.d.

3. The court noted that intrafamily agreements restricting the transfer of stock in a closely held corporation are subject to greater scrutiny that that

given to similar agreements between unrelated parties, citing Bommer Revocable Trust, 74 T.C.M. (CCH) at 355. See also Estate of Gloeckner, 152 F.3d at 214-15 (beneficiary of buy-sell agreement not natural object of decedent's bounty); and Bensel, 36 B.T.A. at 252-53 (buy-sell agreement between father and son who were hostile and estranged from one another not testamentary device).

4. The appellate court agreed with the tax court and held that the buy-sell agreements were testamentary devices for several reasons.

   a. David True sought only a limited amount of professional advice in determining to use the tax book value for the price terms, and he did not substantially rely on any independent appraisals in doing so.

   b. In addition, the tax book value accounting excluded the company's proven oil and gas reserves, a large intangible asset, and the agreement did not contain a mechanism by which to reevaluate the price terms.

   c. Also, there was no negotiation between the children and their father as to the terms of the agreements, and, although the True companies represented only 44% of the decedent's total estate, the child who had withdrawn from the business was excluded from her father's estate completely, an indication that the price paid to her under the agreement when she withdrew was her inheritance.

5. The court then turned to whether the agreements were supported by adequate consideration.

   a. The taxpayers argued that, because the agreements were binding, they constituted adequate consideration.

      (i) The taxpayers' argument was based on the Tenth Circuit's earlier decision in Brodrick in 1955. As described supra, at I.A.6., the Tenth Circuit had affirmed a district court decision that the price at which an estate was compelled to sell interests under a binding buy-sell agreement was the proper value reported on the estate tax return.

      (ii) The court analyzed the development of the case law since its decision in Brodrick and overruled Brodrick to the extent it held that the terms of a buy-sell agreement were wholly controlling for estate tax purposes when the terms bound all parties equally at life and death.

   b. The taxpayers also relied on their previous 1971 and 1973 gift tax cases, in which the transfers were valued based on a tax book value price established in the buy-sell agreements. The court ruled that it was not bound by these earlier decisions because in the present case, the principal issue was whether the agreements were testamentary substitutes, an issue not present in the gift tax cases.

   c. The court found that other courts tended to agree that the option price will be deemed adequate consideration where it represents

the price a willing buyer and willing seller would have reached in the course of an arm's-length negotiation, citing Dorn, 282 F.2d at 181; Estate of Godley, 80 T.C.M. (CCH) at 164; and Lauder II, 64 T.C.M. (CCH) at 1660.

d. The court pointed out that there are cases in which book value has been found to represent fair market value or adequate consideration, but distinguished these cases on the basis that those courts rejected any potential inferences that the agreements served as testamentary substitutes, citing Estate of Carpenter v. Comm'r, 64 T.C.M. (CCH) 1274, 1280 (1992) (lack of familial relation between parties to agreement); Estate of Hall, 92 T.C. at 334-35 (court determined Internal Revenue Service's argument regarding testamentary intent not supported by evidence); and Estate of Bischoff, 69 T.C. at 41-43 (agreement not testamentary device because it was equally binding on all partners, not all partners were related, and there was no proof that a brother's and sister's families were the natural objects of each other's bounty). See also Lauder II, 64 T.C.M (CCH) at 1660 (a formula price may reflect adequate and full consideration notwithstanding that the price falls below fair market value).

e. The appellate court could not find that the lower court erred in determining that the interests in the companies were transferred for less than adequate consideration for several reasons.

(i) The taxpayers' witness at trial acknowledged that it would be very hard to justify tax book value as fair market value;

(ii) The tax book value was greatly reduced by the deductions and rates of acceleration allowed for the oil, gas, and ranching industries;

(iii) David True did not initially use tax book value when outside parties were present;

(iv) The buy-sell agreement with David's brother's family had a different price term; and

(v) There was no evidence that in an arm's-length negotiation with an unrelated party tax book value would have been used.

f. The court rejected the taxpayers' argument that it was applying Section 2703 retroactively by using an arm's-length test because it noted that courts had used this test before the adoption of Section 2703 in determining whether the price terms in buy-sell agreements established the value for estate tax purposes. See supra at II.B.4.c.(iii).

6. The Tenth Circuit then considered whether, even though the price terms might not be controlling, the other restrictions in the agreement should be considered in determining the value of the interests.

a. The court found that if an agreement is first determined to be a testamentary substitute, the non-price (restrictive) terms of the

agreement cannot be used to automatically depress the value of the transferred interests or else the agreements whose very validity is at issue would be presumed to be viable.

b. Notwithstanding this analysis, however, the court determined that the tax court had in fact applied discounts for lack of marketability. See also Estate of Lauder v. Comm'r, 68 T.C.M. (CCH) 985 (1994) ("Lauder III") where the court stated that it would be anomalous to allow particular provisions of a buy-sell agreement to affect the stock's value once it is determined that the price served a testamentary purpose and thus would not be respected for federal estate tax purposes. The Lauder III court nonetheless found that because the agreement demonstrated the family's commitment to maintain family control over the company, the court properly accounted for this element by applying a discount to reflect the lack of a public market. 68 T.C.M. (CCH) at 999. See also Estate of Blount, T.C. Memo 2004-116 ("the terms of the disregarded agreement are generally not taken into account in determining the fair market value of the shares subject to the agreement").

7. Finally, the Tenth Circuit upheld the tax court's imposition of penalties, finding that although it was a close call in that the taxpayers had relied on the previous gift tax cases and the holding in Brodrick, the court could not

conclude that the tax court had been clearly erroneous in imposing the penalties.

8. Although True deals with the law before the effective date of Section 2703, the court's careful analysis of the price control test should be useful in applying the fourth prong of Section 2703.

IV. Application of Section 2703

A. Generally

1. Section 2703(a), enacted in 1990, essentially codified the rules laid out in Treas. Reg. 20-2031-2(h). See Estate of Gloeckner, 152 F.3d at 214 ("the 1990 Act for all intents and purposes codifie[d the] pre-existing regulatory language" of 20.2031-2(h)).

2. Section 2703(a) provides generally that for purposes of the gift tax, the estate tax and the generation-skipping transfer tax, property is valued without regard to options or agreements to acquire the property for less than fair market value and without regard to any restriction on the right to sell or use the property.

3. A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement or any other agreement. A right or restriction may also be implicit in the capital structure of the entity. Treas. Reg. § 25.2703-1(a)(3).

4. Section 2703(b) sets forth three requirements to overcome the general rule of Section 2703(a). If all three of these requirements are met, an agreement or restriction will not be disregarded for transfer tax valuation

purposes. Each of these tests must be satisfied independently. See Treas. Reg. § 25.2703-1(b)(2).

B. Section 2703(b) Requirements

1. First, the agreement or restriction must be a bona fide business arrangement. The continuation of family control has generally been recognized as a bona fide business arrangement. See, e.g., Littick v. Comm'r, 31 T.C. at 187; St. Louis County Bank, 674 F.2d at 1210.

2. Second, the arrangement must not be a device to transfer property to members of the transferor's family for less than full and adequate consideration.

    a. See infra at IV.B.4. for the definition of "members of the transferor's family."

    b. The legislative history to Chapter 14 makes it clear that the device test is separate from the bona fide business arrangement test. Under Chapter 14, and as in St. Louis County Bank, the existence of a bona fide business arrangement does not necessarily mean that the agreement is not a "device" to transfer family wealth. See Report of Senate Finance Committee (October 13, 1990) and St. Louis County Bank, 674 F.2d at 1210. See also Estate of Lauder, 60 T.C.M. 977 (1990) ("device" test is separate from the "bona fide business arrangement" test, although legitimate business purposes are often "inextricably mixed" with testamentary

objectives where the parties to a restrictive stock agreement are all members of the same immediate family).

c. An agreement designed to maintain family control does not necessarily satisfy both tests.

3. Third, the terms of the agreement or restriction must be comparable to similar arrangements entered into by persons in an arms' length transaction.

a. Legislative history offers guidance on this third prong.

(i) The Senate Finance Committee Report provides that:

"Such determination would entail consideration of such factors as the expected term of the agreement, the present value of the property, its expected value at the time of exercise, and consideration offered for the option. It is not met simply by showing isolated comparables but requires a demonstration of the general evidence of such practice. Expert testimony would be evidence of such practice. In unusual cases where comparables are difficult to find because the taxpayer owns a unique business, the taxpayer can use comparables from similar businesses."

(ii) The Conference Committee Report modifies this somewhat:

> "The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement."

b. It has been argued that the "fair bargain" test is a new requirement that was not present in prior law.

(i) But courts were considering this test as early as 1937. In Bensel v. Comm'r, 36 B.T.A. at 253, the court upheld the price terms of a buy-sell agreement in part because the price terms were not lower than the price at which persons with adverse interests dealing at arm's-length might have been expected to agree. See also Estate of Littick, 31 T.C. at 187 (upholding price term of agreement, noting that price was arrived at by an arm's-length negotiation).

(ii) Most recently, the Tenth Circuit Court of Appeals in Estate of True pointed out that, in determining whether an agreement is supported by adequate consideration, court have tended to agree that the option price will be deemed

adequate consideration where it represents the price a willing buyer and willing seller would have reached in the course of an arm's-length negotiation. 390 F.3d at 1225.

(iii) See supra at II.B.4.c.(iii) for cases applying an arm's-length test under pre-2703 law.

(iv) But see infra at V.D.1. for analysis that "fair bargain" test is applied differently under Section 2703 in light of Blount v. Comm'r, T.C. Memo 2004-116.

c. The Internal Revenue Service has provided regulatory guidance on this "new" third requirement.

(i) The regulations provide that a right or restriction is comparable to similar arrangements entered into by persons dealing with each other at arm's-length "if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business" or if the right or restriction "conforms with the general practice of unrelated parties under negotiated agreements in the same business. Treas. Reg. § 25.2703-1(b)(4).

(ii) Determination as to whether an arrangement meets the "fair bargain" test, compared to agreements in the same business, depends upon such factors as the term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the

arrangement and the adequacy of consideration given for rights granted. Id.

(iii) Evidence of general business practice is not met by showing isolated comparables. A right or restriction is considered a “fair bargain among unrelated parties” if it is similar to negotiated buy-sell agreements among unrelated parties in the same type of business as the one at issue. The term “same business” refers to the general line of businesses in which the entity is a part. Explanation of Proposed Regulations, PS-92-90 (4/4/91), 1991-1 C.B. 998. If the business is unique, comparables from similar businesses may be used. Treas. Reg. § 25.2703-1(b)(4)(ii).

4. An agreement is deemed to satisfy all three tests if more than 50% of the value of the property subject to the agreement is owned directly or indirectly by individuals who are not members of the transferor’s family. Treas. Reg. § 25.2703-1(b) (3).

a. The regulations specifically provide that the term “member of the family” includes the persons described in Treasury Regulation § 25.2701-2(b)(5) and “any other individual who is a natural object of the transferor’s bounty.” Treas. Reg. § 25.2703-1(b)(3).

b. Family includes the transferor, any lineal descendants of the parents of the transferor or the transferor’s spouse, and applicable family members, who include the transferor’s spouse, ancestors of

the transferor and the transferor's spouse, and the spouses of such ancestors. Treas. Reg. § 25.2701-2(b)(5).

c. This definition includes nieces and nephews, and the statute has been so applied. See P.L.R. 9222043 (February 28, 1992).

d. Members of the transferor's family include any individual who is the natural object of the transferor's bounty. This broad definition also enables the Internal Revenue Service to maintain that a donative transfer has occurred even where no blood relative is involved but a business partner has a history of personal relationships extending to his partners' family.

e. The regulations do not define "natural objects of [decedent's] bounty," but when the Internal Revenue Service promulgated them, it explained why it omitted a definition for this particular phrase. The agency said "this concept has long been part of the transfer tax system and cannot be reduced to a simple formula or specific classes of relationship. The class of person who may be the objects of an individual's bounty is not necessarily limited to persons related by blood or marriage." Special Valuation Rules, 57 Fed. Reg. 4250, 4253 (1992).

f. Unrelated parties are *presumed* not to be natural objects of each other's bounty. Explanation of Proposed Regulations, PS-92-90 (4/4/91), 1991-1 C.B. 998.

g. Whether related parties are natural objects of each other's bounty can be a question of fact for the courts to consider. See Bensel v. Comm'r, 36 B.T.A. 246 (1937) (agreement fixed fair market value of stock for estate tax purposes where father and son were estranged).

h. An option granted to one who is the natural object of the bounty of the optioner requires substantial proof to show that it rested upon full and adequate consideration. Hoffman v. Comm'r, 2 T.C. 1160 (1943), aff'd Giannini v. Comm'r, 148 F.2d 285 (9th Cir.), cert. denied, 326 U.S. 730 (1945).

i. Although an intended beneficiary need not be a "relative" in the commonly understood sense of the word, the beneficiary must have enjoyed a relationship with the decedent in which is was considered as though he were in some manner related to the decedent. Estate of Gloeckner, 152 F. 3d at 215 (beneficiary who had business relationship with decedent not found to be natural object of bounty although decedent loaned him money and made a small bequest to him). But cf. Estate of Schwab v. Comm'r, 42 T.C.M. (CCH) 989 (1981) (decedent's housekeeper and companion, who lived and traveled with decedent for roughly 33 years, was a natural object of the decedent's bounty for purposes of determining whether certain of decedent's lifetime transfers were made in contemplation of death).

j. In making this determination, the existence of past transfers of property at significantly less than market value, or of arrangements designed to do the same may give rise to an inference that the transferee is effectively considered a member of decedent's family. See Estate of Gloeckner, 152 F.3d at 215.

k. Where there is no blood or marital tie between a decedent and the other parties to the agreement, it is less likely that the agreement evinces a testamentary intent. See Estate of Seltzer, 50 T.C.M. (CCH) at 1254 ("In this case, only two of the five agreeing shareholders were legally related…. With those facts, it is less likely that relationship would have played a role in the execution of the Agreement"); and Estate of Carpenter, 64 T.C.M. (CCH) at 1280 ("the lack of [a family] relationship has been considered evidence of a lack of testamentary intent by the agreement").

l. To the contrary, if an agreement is among family members, it should be given greater scrutiny that similar agreements among unrelated parties. See Lauder II, 64 T.C.M. (CCH) at 1657; Bommer Revocable Trust, 74 T.C.M. (CCH) at 355.

m. If a natural object of decedent's bounty is not found to benefit from the conveyance in the restrictive agreement, a court must conclude that the agreement is not a testamentary device. Estate of Gloeckner, 152 F.3d at 214.

5. If there are multiple rights or restrictions and one fails to satisfy one of the three tests, it does not follow that another one cannot meet the three tests. Whether separate provisions are separate rights or restrictions, or are integral parts of a single right or restriction, depends on the facts and circumstances. Treas. Reg. § 25.2703-1(b)(5).

6. It is important to note that the statutory requirements are not all inclusive regarding the valuation impact of buy-sell agreements. The long-established rules that 1) the agreement must have lifetime restrictions in order to be binding at death, and 2) the value determined under the agreement at its inception must approximate fair market value at that time must still be met. See 136 Cong. Rec. S15683 (daily ed. Oct. 18, 1990) ("The bill does not otherwise alter the requirements for giving weight to a buy-sell agreement. For example, it leaves intact present law rules requiring that an agreement have lifetime restrictions in order to be binding on death").

7. A buy-sell agreement can be enforceable according to its terms as a matter of state law, even if does not satisfy the three requirements of Section 2703(b) and is disregarded for estate tax valuation purposes.

    a. There may be a state law right of contribution from the bargain purchaser if values are higher for estate tax purposes than the price paid under the terms of the buy/sell agreement.

    b. An alternative is to address the possible effects of varying values in a tax allocation clause.

C. Application of Section 2703

1. Section 2703 applies to agreements and restrictions entered into or granted after October 8, 1990, and to agreements and restrictions "substantially modified" after October 8, 1990.

2. There is no guidance in the legislative history on the meaning of "substantially modified."

3. The treasury regulations provide that "[a]ny discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value or timing of the right or restriction is a substantial modification." Treas. Reg. § 25.2703 1(c).

    a. The failure to update a right or restriction required to be updated is presumed to be a substantial modification unless it can be shown that the updating would not have resulted in a substantial modification. Id.

    b. The addition of a family member as a party to the right or restriction, including by reason of a transfer of property that subjects the transferee to a right or restriction, is a "substantial modification," unless the addition is mandatory under the terms of the original right or restriction. Id.

    c. For example, the addition of a family member will constitute a substantial modification unless (1) the terms of the agreement make the addition mandatory or (2) the added family member is

assigned to a generation (determined pursuant to the generation-skipping transfer tax rules of Section 2651) no lower than the lowest generation occupied by the individuals already subject to the agreement. Id.

4. Treasury Regulation § 25.2703-l(c)(2) provides the following exceptions to the definition of a "substantial modification."

   a. A modification required by the terms of a right or restriction;

   b. A discretionary modification of the agreement containing a right or restriction that does not change the right or restriction;

   c. A modification of a capitalization rate if it is modified in a manner that bears a fixed relationship to a specified market interest rate; and

   d. A modification that results in an option price that more closely approximates fair market value.

5. Since the treatment of buy-sell agreements under the law as it existed before enactment of Section 2703 is more favorable to taxpayers, any action with respect to a "grandfathered" agreement should be undertaken carefully.

6. A private ruling request may be advisable where available before a grandfathered agreement is altered in any way. Several rulings have been issued in this area:

   a. Amendments to articles of incorporation and bylaws changing the number of directors and the indemnity and immunity provisions

for officers and directors and providing for a stock split are not a substantial modification because they do not change the quality, value or timing of the rights of any party. P.L.R. 9141043 (July 16, 1991).

b. Buy-sell provisions and transfer restrictions in a partnership agreement entered into before October 9, 1990 and not substantially modified thereafter will be taken into account in valuing interest in the partnership. P.L.R. 9151045 (September 26, 1991).

c. A supplemental agreement under which holders of preferred stock agree to execute irrevocable proxies giving voting rights to holders of common stock was consistent with, and did not constitute a substantial modification of, the original shareholder agreement for purposes of the Section 2703 effective date. P.L.R. 9218074 (January 31, 1992).

V. Estate of Blount v. Comm'r

A. Estate of Blount v. Comm'r, T.C. Memo. 2004-116, is the first known case to apply Section 2703 to the terms of a buy-sell agreement. (Even the Internal Revenue Service draftsman of Section 2703 is not aware of any other case involving the application of this section). Although the agreement was initially entered into 1981, it was substantially modified after October 8, 1990.

B. Facts

1. The decedent and his brother-in-law each owned 50% of the shares of an asphalt company. In 1981, the two men entered into a buy-sell agreement restricting transfers of stock during their lifetimes and at death. At death, a shareholder's estate was required to sell, and the company was required to buy, the shareholder's shares at book value, as redetermined annually or, in the absence of a redetermination, book value at the fiscal year-end immediately preceding the deceased shareholder's death. This price could be paid in installments. The agreement could be modified only with the consent of the parties to the agreement.
2. Both shareholders subsequently transferred shares to an ESOP established by the company. The ESOP's participants were company employees, excluding the decedent and his brother-in-law. The decedent's brother-in-law died first, and the company purchased his shares pursuant to the agreement, leaving the decedent and the ESOP as the only shareholders, with the decedent owning 83.2% of the company. The brother-in-law's estate received a price based on the company's book value of approximately $6.4 million at the preceding fiscal year-end.
3. Upon discovering that he was terminally ill, the decedent and the company modified the agreement to provide an obligation of the company to purchase the decedent's shares at his death for $4 million, paid in one lump sum. This price was selected because, after the redemption of the decedent's shares at this price, the company would be left with sufficient cash and cash equivalents to operate without the need for personal

guaranties for the company's performance bonds and the company would be able to meet any obligations to its ESOP participants. This price was selected although the most recent appraisal of the company valued it at approximately $8 million, suggesting a fair market value of decedent's shares of $6.7 million. Without the modification, the purchase price would have been approximately $7.6 million.

4. After the decedent's death, the company redeemed his shares for $4 million as required by the 1996 agreement. After the redemption of decedent's shares, the ESOP owned 100% of the company's stock. The Internal Revenue Service issued a notice of deficiency, wherein the Service determined a fair market value of the decedent's stock of approximately $7.9 million.

C. The Court's Analysis

1. The tax court first held that the 1996 agreement was a modification of the 1981 agreement, rather than a novation. If the 1996 agreement were construed as a novation of the 1981 agreement, the 1996 agreement would not have met the requirement that the agreement be binding during life and at death because the 1996 agreement contained no provisions restricting lifetime transfers of the stock.

2. The court, in considering the 1981 and 1986 agreements as a whole, then held that the binding-during-life requirement was nonetheless not satisfied because the decedent had the unilateral ability to change the agreement. The agreement could be modified only by the written consent of the

"parties thereto," which, after the death of the decedent's brother-in-law, were the decedent and the company, which the decedent controlled as majority shareholder. By virtue of the decedent's control of the company, the court found that the decedent could (and did) unilaterally modify the 1981 agreement. Because no other shareholder had to consent to the modification, the restrictions of the agreement were not binding on decedent during his lifetime.

3. The court then held that, even had the modified agreement satisfied the binding-during-life requirement, the agreement would nonetheless be disregarded under Section 2703.

    a. First, the court held that, because the 1996 modification was a substantial one, Section 2703 applied.

        (i) The modifications were: 1) replacing book value as the redemption price with a fixed price of $4 million, 2) removing the automatic adjustment mechanism for adjusting the price annually based on book value, 3) eliminating the shareholders' right to set the price annually, and 4) precluding the right of the company to pay in installments.

        (ii) These modification were more then de minimus because the difference in the price at which the stock was to be purchased changed from approximately $7.6 million to $4 million. Furthermore, because the evidence suggested that

the fair market value of the stock was much closer to $7 million, the modification did not result in a change in price that more closely approximated fair market value, an exception that otherwise would have caused the modification to be deemed to be de minimus.

b. Second, the court held that the agreement did not satisfy the third prong of Section 2703, in that the estate did not prove that the agreement's terms were comparable to similar transactions entered into by persons in an arm's-length transaction.

(i) The court found that Section 2703(b)(3) contemplates a taxpayer's production of evidence of agreements actually negotiated by persons at arm's-length under similar circumstances and in similar businesses that are comparable to the terms of the challenged agreement. In particular, the taxpayer must demonstrate that the terms of an agreement providing for the acquisition or sale of property for less than fair market value are similar to those found in similar agreements entered into by unrelated parties at arm's-length in similar businesses.

(ii) The court found that although the taxpayer's expert testified that the agreement was comparable, he opined that it was comparable because it set the price at fair market value. Thus, because the court found that the price

established by the agreement was not fair market value, there was no evidence of its comparability to other agreements.

(iii) Furthermore, the court found the best comparable to be the 1981 agreement, which was negotiated between two 50% shareholders who did not know who would predecease the other. Given the disparity between the prices in the 1981 agreement and the 1996 agreement, the court had no confidence that the 1996 agreement was comparable to an arm's-length bargain.

4. The court did not address whether the agreement constituted a bona fide business arrangement under Section 2703(b)(1) because the court concluded that the estate did not satisfy the third prong.

5. After the sales transaction, the company's stock was owned 100% by the ESOP, the participants of which had no personal relationship with the decedent outside of work and were not the natural objects of decedent's bounty. Thus, the court found there was no doubt that the agreement was not a device to pass the decedent's shares to either his family or the natural objects of his bounty for less than adequate consideration, thus satisfying Section 2703(b)(2).

D. Analysis of Blount

1. Interestingly, a different result may have been reached under pre-2703 law if Section 2703 had not applied to the agreement. Although under pre-

2703 law, the courts did in fact consider whether an agreement was comparable to that negotiated in an arm's-length transaction, this consideration applied in determining whether the agreement was a testamentary device. It was not a separate and distinct requirement that applied even if it were first established that the agreement was not a testamentary device to transfer value to the natural objects of the decedent's bounty. Thus, because there was no doubt that the agreement was not a testamentary device, the tax court would not have had to separately consider whether the agreement was comparable to those entered into in an arm's-length transaction.

2. Had the ESOP owned more than 50% of the company at the decedent's death, presumably all three prongs under Section 2703 would have been deemed to have been satisfied. Of course, pre-1990 law still would have applied and the price terms still would have been disregarded by the tax court since it found the agreement not to be binding during the decedent's lifetime. In this case, if the ESOP had been a party to the modification (or deemed to have been so) and the decedent did not control the ESOP (he was only one of three trustees who held a fiduciary duty to the ESOP), the modified agreement likely would have been upheld.

3. In a situation where there are two, unrelated shareholders who are not the object of each other's bounty and each of whom owns 50% of a business, Section 2703 as applied by the Blount court would require the price terms of a buy-sell agreement to satisfy the comparability requirement.

4. Blount has been appealed to the 11th Circuit and oral arguments were scheduled for the second week of August, 2005.

VI. Drafting Buy-Sell Agreements After Blount and True

A. Remember that Section 2703(a) is triggered only by a buy-sell agreement that sets a price below fair market value.

B. The terms of a buy-sell agreement must be applicable during lifetime and at death and must be binding on the estate. Even if Section 2703 applies, these requirements must continue to be satisfied.

C. If the transferor owns less than 50%, or if more than 50% is owned by parties who are not family members, Section 2703 should not apply to the buy-sell agreement.

D. If a party to the agreement is not a family member, there is a presumption that the agreement is not a testamentary device, although facts could indicate that such person is a natural object of the other's bounty. Apparently, though, even if the agreement is not a testamentary device, under Blount, the agreement must still be comparable to other agreements entered into by parties dealing at arm's-length.

E. The price terms of the agreement should be based on objective appraisals and be subject to negotiations among the parties.

F. The price terms should be subject to adjustments based on changing economic conditions and company performance.

G. The price terms should be comparable to those entered into by parties dealing at arm's-length.

1. A lawyer should create a record indicating the arm's-length nature of the transaction.

2. Satisfying the comparability requirement will be easier if the taxpayer can shift the burden of proof to the Internal Revenue Service under Section 7491.

H. It does appear that, even if there is adequate consideration at the time the agreement is entered into such that the agreement is not a testamentary device under the second prong of Section 2703, the third prong will nonetheless require that the agreement reflect fair market value at the time of the decedent's death. For this reason, the "fair bargain test" does appear to be a new requirement in the manner in which the arm's-length transaction is considered.

1. One of the primary reasons for entering into a buy-sell agreement is to enable shareholders and business partners to plan for each other's death and to have certainty of value, which is particularly important when the owners are relying on insurance proceeds to fund the purchase or redemption of a deceased's shareholder's interest.

2. As Jim Spratt points out in his article, *"Business Succession Planning,"* included in these materials, typically fair value, rather than fair market value, is the appropriate method for buy-sell purposes because the selling party is disposing of the business interest after a trigger event that is beyond his or her control – death or disability. Fair value is an equitable concept aimed at achieving a fair result for a shareholder whose interest is being cashed out perhaps involuntarily – in other words, a shareholder who is not a "willing seller." Further, fair market value typically takes

into account the application of discounts, which could result in a windfall for the continuing business owners.

3. Recall that the court in Lauder II stated that, when considering adequate and full consideration, the appropriate standard forces the formula price generally to “bear a reasonable relationship to the unrestricted fair market value of the stock in question.” 64 T.C.M. (CCH) at 1660.

I. The purchase price could be substantially lower than fair market value if the stock value is not adjusted. In such a case, if the Internal Revenue Service successfully argues that the buy-sell agreement’s terms should be disregarded, the deceased shareholder’s estate will face an estate tax burden that exceeds the purchase price.

1. The ACTEC Business Planning Committee Shareholder Agreement Subcommittee suggests language in the agreement that would allow the purchase price to be adjusted if the value of the shares for estate tax purposes is determined to be greater than the price specified in the shareholder’s agreement.

2. The purchase price may be adjusted to equal the (i) sum of the purchase price pursuant to the shareholder’s agreement and the estate tax liability or (ii) the value of the shares as finally determined for estate tax purposes.