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DISPOSITION OF BUSINESS INTERESTS

BOYD H. ANDERSON, JR.*

Most writers on the subject of estate planning seem to agree that some of the most knotty problems arise because of the estate owner's business interests.[1] In spite of the fact that this is a difficult phase of a complex field, the general practitioner must be prepared to meet and attempt to solve some of these problems each time a new business client comes into his office. He must guide his client through a maze of problems ranging from the simple matter of choosing a business name to the technicalities of valuing good will upon retirement or death, and beyond this through such complex subjects as "attribution" in the redemption of closely-held corporate stock.[2]

Most laymen tend to think that estate planning consists of the preparation and execution of a will, generally in an emergency, before beginning a trip, or after the death of a friend. By a few well-chosen questions in a discussion of business problems, the attorney will often be able to change this attitude and pave the way for the performance of an invaluable service for the client and his heirs. In connection with his business, as nowhere else, the average client can be made to realize that the initiation of a plan of present accumulation of wealth, with appropriate disposition thereof for the welfare of his family after his death, is a practical matter presenting problems that cannot be ignored and, further, that the making of a will alone is not enough.

When considered from an estate planning standpoint, the problem is the disposition to be made of the estate owner's business interest during his lifetime, or upon his death, in a manner best suited to further his objective of providing for the beneficiaries of his estate. The specific problems and their solutions will of necessity be as varied

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[1]See, *e.g.*, BOWE, TAX PLANNING FOR ESTATES 80 (rev. ed. 1952); CASNER, ESTATE PLANNING 740 (2d ed. 1956); SHATTUCK and FARR, AN ESTATE PLANNER'S HANDBOOK 60 (2d ed. 1953); WORMSER, THEORY AND PRACTICE OF ESTATE PLANNING 129 (2d ed. 1948).

[2]See, *e.g.*, INT. REV. CODE OF 1954, §318.

as the individuals and businesses involved. At best, therefore, this article can only call attention to some of the more common problems and their generally recognized solutions.[3]

Although the three broad forms of business ownership pose widely varying problems for the attorney in correlating the estate plan, a good starting point and a check list equally applicable to all are found in eight pertinent questions for the estate owner posed by Professor Casner:[4]

(1) Will the business have any going-concern value after his death?
(2) Should he change the form of ownership of the business during his lifetime?
(3) Is a member of his family qualified to succeed to his business responsibilities?
(4) Is it feasible for a trustee to succeed to his business responsibilities and carry it on for the benefit of his family?
(5) Should his interest in the business be liquidated?
(6) If the business should be liquidated, should an inter vivos agreement of sale be executed? If so, what method should be adopted to fix the price on the death of the owner and what provision should be made to give assurance that the buyer will be able to finance the purchase?
(7) What value is likely to be placed on the business for death tax purposes?
(8) Where will the estate of the business owner obtain funds to pay death taxes?

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[3]For a more detailed discussion of the various phases of this subject see authorities cited *supra* note 1; see also Davis, *Recent Developments in Business Purchase Agreements,* 94 TRUSTS AND ESTATES 284 (1955); Dean and Leake, *How to Redeem Stock Under Section 303 to Pay Death Taxes Plus Funeral Administration,* in LASSER, TAX INSTITUTE ESTATE TAX TECHNIQUES 1467 (1956); Egger, *Liquidation and Valuation of Business Interest in Estates,* 95 TRUSTS AND ESTATES 104 (1956); Gutkin, *How to Use the Close Corporation in Estate Planning,* in LASSER, *op. cit. supra;* McKenney, *Estate Planning for Business Interests,* 95 TRUSTS AND ESTATES 1000 (1956); Maduro, *Stock Perpetuation,* 95 TRUSTS AND ESTATES 1000 (1956); Minahan, *Some Phases of Business Insurance,* 95 TRUSTS AND ESTATES 430 (1956); Murphy, *Survivor-Purchase Stock Agreements,* 1 THE PRACTICAL LAWYER, No. 7, 44 (1955); Willis, *Income Tax Problems of the Professional Partnership,* 2 THE PRACTICAL LAWYER, No. 7, 66 (1956); Wormser, *Preserving the Family Enterprise for the Family,* 2 THE PRACTICAL LAWYER, No. 8, 44 (1956).

[4]CASNER, *op. cit. supra* note 1, at 740.

Sole Proprietorship

The planner's initial questioning of the sole proprietor should pursue with some diligence the problem "Will the business have any going-concern value after his death?" The general type and size of the business — for example, whether service or capital is the major income-producer — as well as the division and organization of management functions will often be the decisive factors in this discussion. It is surprising to find that many astute businessmen somehow feel that their wives, "who used to help out a little," can continue their businesses at the same rate of profitable return after their deaths. This feeling flourishes among optimistic proprietors in spite of the fact that they have spent their lives learning their businesses. Perhaps it is the proprietor's inborn modesty that forces the attorney to pry from him the admission that only his skill and the personal good will he has created have made his business profitable over the years; or perhaps his unwillingness to face the problem of no value after his death, dimly seen as hovering just over the horizon and ready to swoop in at his demise, is attributable to his gloomy thought that there is no solution. Unfortunately, this is more nearly the case with the sole proprietor than with other forms of business ownership. Thus the client might be asked to consider changing the form of business ownership during his lifetime.

By bringing in other investors and changing to partnership or corporate form, the sole proprietor tends to give his business a going-concern value that survives his death. In addition, he erases some of the problems of successor management and he has a ready purchaser for his interest in the event that a sale is indicated. The main difficulty involved in this solution — and it is an exceedingly practical one — is that most proprietors "got that way" because they enjoyed doing business alone. They may have tried partnerships with unfortunate consequences, or for other reasons they prefer to let their businesses be liquidated at death with considerable loss to their families rather than endure a partner or stockholders. About all that can be recommended to these proprietors is that they increase their life insurance or sell their businesses while they are alive.

Continuation of the Business

If the business will have a going-concern value after death, the proprietor should consider whether a member of his family is really qualified to succeed to his responsibilities and, if not, whether it is feasible for a trustee to carry the business on for the benefit of the family.

By Nontrustee. If the proprietor has some member of his family or beneficiary of his will who will be capable and desirous of managing the business after his death, it is vital that he start laying plans for this eventuality. He should set about collecting information that will be necessary for operation of the business by a comparative stranger to it, acquaint the successor with these facts, and if possible have him take an active part in the business during the proprietor's lifetime. Further, in Florida, a going business must be wound up within a fairly restricted time after a proprietor's death;[5] if this is not desired, it is essential that he make adequate provision in his will for continuation of the business by his executor until it may be turned over to the appropriate beneficiary for management.[6] If it is desirable that several beneficiaries share in the enterprise but that only one manage the business, it may be well to consider instructing the executor to incorporate the business and divide the stock into voting and nonvoting classes of common, giving the voting stock to the beneficiary who will control and the nonvoting stock to the remaining beneficiaries. Appropriate arrangements should be made for the disposition of the voting stock upon the death or resignation of the managing beneficiary.

If a member of the family cannot be used as a successor, great care in the selection of another is essential; it is an unusual individual who is not only capable but also willing to assume the responsibilities of managing a business unless it is his own or unless he has definite plans for obtaining it. Most persons with such ambitions will be unwilling to await the proprietor's death.

It is beyond the scope of this article to discuss the various methods used to encourage and insure the future loyalty of the successor who is so essential. A few commonly used plans are stock options, pension and profit-sharing arrangements or other "deferred compensation" devices, death benefits, and "fringe" benefits, such as group insurance and discount purchases. All of these plans involve the proprietor's giving up a certain amount of current income and tolerating other possible disadvantages to his immediate interests. He must therefore

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[5]See FLA. STAT. §733.08 (1955).

[6]See STEPHENSON, DRAFTING WILLS AND TRUST AGREEMENTS — ADMINISTRATIVE PROVISIONS 129-56 (1952).

carefully weigh them against the hoped-for benefits of successor management. Unless the business at stake is a large one that might be successfully managed by any one of several possible successors, the proprietor should think twice before pinning the hopes for his family's fortune on one man.

By Trustee. An alternative to the foregoing plan is to leave the business to a trustee to manage for the family's benefit. A particular set of circumstances must exist before this solution will work out satisfactorily. Actually, no trust companies except perhaps those located in the largest financial centers have trained men capable of supervising the management of a going business. Most trust companies would advise the hiring of a trusted employee, or other person who has demonstrated an ability to run the business, to serve under the trust company as manager of the business. Under this type of arrangement the problems duplicate those of the nontrustee arrangement.

If the proprietor feels that the trustee arrangement would be practical in his particular situation, the will or trust agreement must give the executor and trustee every power that may be required in the management of the business.[7] The executor might be instructed by the terms of the will to incorporate the business in order to protect the other estate assets should the business not flourish under the new management. This may not be necessary or even desirable in estates in which the business itself is the only significant asset, but it should at least be considered by the planner and his client.

Liquidation of the Business

If the problems of successor management cannot be successfully resolved, the proprietor must turn his thought to the possibility of liquidating the enterprise. The natural questions to be asked are "When?" and "How?" In determining "When?" it must be conceded that the client will probably be able to sell or liquidate the business himself for a far better price and on more favorable terms than can be obtained by his executor or heirs. Nevertheless, the prospect of selling during his lifetime will come as a distinct shock to the average client. The idea may be palatable to those who come to the lawyer late in life, but even these tend to agree with their younger brethren that the income-producing value of the business is much greater than

[7] *Ibid.*

that obtainable by the conservative investment of its sales price. This income is a necessity in most cases. Furthermore, the client must face the thought of being through with his life's work, of having to part with the business that he conceived and nurtured to maturity, of being put out to pasture.

Assuming that the above solutions are unsatisfactory, the sole proprietor should seriously consider selling the business at his death to a competitor or to a trusted employee; a standard "buy and sell agreement" is discussed below. Although such a plan is often desirable from a theoretical estate planning standpoint, it operates at its optimum only in the context of a particular group of circumstances. Many clients feel that such a plan requires them to be too closely tied to the employee or competitor who is the prospective purchaser. On the other hand, most competitors feel that they have enough trouble managing their own businesses without purchasing a brand new set of troubles upon the death of a sole proprietor. Furthermore, if the competitor desired to expand, he probably would do it on his own rather than acquire an entirely different business that is organized in most cases along lines different from his own and manned by employees who might be anything but friendly to him.

If the employee is to be the buyer, other difficulties are encountered. The problems that arise when an employee is to be chosen as a successor manager occur with equal immediacy when the business is to be sold to him. In addition, the proprietor is bound by contract to the employee-purchaser for a rather protracted period. This gives the employee a preferred status – a position almost beyond discharge – and tends to put the aging proprietor somewhat at the employee's mercy. Finally, there is the almost universal problem of the employee's financing his purchase. This particular problem can usually be solved by having the employee purchase insurance on the life of the proprietor.[8] Since most employees ordinarily live to the limits of their salaries, it is generally recommended that the proprietor increase the employee's salary in an amount sufficient to fund his purchase of the required life insurance policy.

Although this may sound good in theory, under such an arrangement the proprietor actually gains a ready market for his business only by the purchase of insurance on his own life with his own money. It is true that the premiums on this insurance are deductible by the

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[8]*E.g.,* Moorehead and Gordon, *How to Coordinate Business Transactions with Estate Planning,* in LASSER, TAX INSTITUTE ESTATE TAX TECHNIQUES 1423 (1956).

employer in the form of wages paid to his employee; this will have some income tax advantage for him — perhaps a quite substantial one, depending upon his bracket. On the other hand, the proprietor might free himself and his heirs from any entangling alliances by having his widow or heirs purchase the insurance policy — through a funded insurance trust if income tax savings are desired — and then liquidate the business for a few cents on the dollar at death. It is conceivable that in fortunate circumstances the executor might sell the business to some going concern at an amount approaching its real value. In any event, the heirs would be benefited more by receiving the insurance proceeds as well as the purchase price or liquidating value of the business itself than by having the business sold to an employee for the proceeds of insurance purchased for him by the proprietor.

Some authorities propose other schemes for the purchase of the proprietor's interest that will be only rarely employed by the general practitioner.[9] These include sale of the business to a profit-sharing trust set up by the proprietor for his employees, a purchase that is funded with pre-tax dollars; incorporation of the proprietorship and the use of different classes of stock to make gifts to charitable foundations; and similar plans. If the general practitioner has thoughts of such arrangements he should call in a tax expert and spend a considerable amount of his own time reading literature on the specific subject.

Avoidance of Unintended Liquidation at Death.

Before leaving the sole proprietor, Casner's questions (7) and (8), dealing with the problems of estate taxes, should be considered. It is somewhat unfortunate that these two questions are discussed last, since they deal with the problem of liquidity, which underlies all estate planning and may present controlling considerations in many situations. If the business is retained until death, the sole proprietor does not enjoy the opportunity afforded partners and stockholders to fix the estate tax value on his business. As pointed out above, buy-out agreements, which are the most readily available tool used to fix such values, are available to proprietors only in limited situations. Consequently, the planner must use diligence in prying from the proprietor a realistic estimate of the true value of the business, and then attempt to determine within reasonable limits the cash that will be

[9]Gutkin, *supra* note 3, at 1504-05; Moorehead and Gordon, *supra* note 8, at 1420.

required to pay estate taxes and the expenses of administration. The proprietor must be made to realize that, unfortunately, these items cannot be paid "in kind." His investments must be chosen or, if possible, the business operated in a manner that provides sufficient assets readily convertible into cash to meet these payments; otherwise the business or other assets may have to be sold at a considerable loss.

If capital is a material income-producing factor of a business and the proprietor is paid a fair salary for his services, systematic formation of a family partnership or corporation by regular gifts of interests in the business may be necessary to reduce the eventual estate tax burden, particularly when the business is to be continued and successor management has been found in the family group. A supplemental or alternative answer may be increased insurance on the proprietor's life, owned by some member of his family in order to prevent its inclusion in his taxable estate.[10] Other solutions often suggested to the wealthy, such as gifts of business interests to family-controlled foundations, are beyond the scope of this article.

Although there are many estate planning problems dealing with proprietorships that have not been touched upon, some of the major considerations have been pointed out. The writer regrets that he cannot offer more hopeful solutions to the individual who is determined to work alone in hewing his path through the world of business; but here, as in other situations, he and his family must pay the price for the freedom and independence that he enjoys. In most cases, without careful planning and considerable effort he and his family cannot look forward to a satisfactory continuation of the business or to a profitable liquidation after "the business" dies.

PARTNERSHIP

Although the partnership presents problems similar to those of the sole proprietorship as well as many others of its own, this business form offers many ready-made solutions of the difficulties encountered in the case of the sole proprietor. This good fortune arises from the fact that the remaining partners are ready-made purchasers of the decedent's interest at a fair price and on reasonable terms. Although the sale of the decedent's interest will not replace the income earned for the family by his own efforts, this is more than offset

[10]See INT. REV. CODE OF 1954, §2042.

in most cases by the elimination of the problems attendant upon the operation of the business after death, a few of which were pointed out in the discussion of proprietorship. Furthermore, if all parties agree that it is wise to retain the decedent's interest in the existing partnership, the surviving partner furnishes a solution of the biggest problem of a successor management. One dim note is sounded by the fact that the survivor of a two-man partnership becomes a sole proprietor, who must then consult his attorney for the solutions of the problems that he so neatly solved for his late partner simply by surviving him.

In spite of its advantages, all is not automatically joy in the ranks of estate planners merely because a partnership is involved. Every general practitioner knows that, in the absence of special provisions to the contrary in the partnership agreement, death terminates a partnership and makes the surviving partner or partners liquidating trustees who must dissolve the business at the earliest practicable moment.[11] Too few partners are made acutely aware of this rule of law and of its effect. Consequently, they fail to realize that the dissolution of the average partnership frequently works havoc on the business, from the standpoint of the survivors as well as of the decedent's estate. Under certain circumstances it is possible that up to twenty-three months of partnership income will be crowded into one taxable year of the deceased and the surviving partners.[12] If this happens, with the consequent tremendous increase in income taxes, a blow has been dealt that only those in the heartiest financial position can well endure. The surviving partner may hope to purchase the interest from the heirs of the decedent, but he is faced with the ethical restraints involved in bargaining on the price with the widow and children. The problem of finding the money with which to effectuate the purchase and the delays inherent in dealing with an estate are not small matters. To top it off, the survivor suddenly has to manage the business without the assistance of the deceased partner, who was somehow contributing considerably more in the way of management than the survivor realized. Thus the hiring of additional employees is usually necessary, resulting in further depletion of the survivor's financial resources. All of these matters make an unplanned sale to the survivor a hazardous gamble at best.

In attempting to suggest to the partner the best method of dispos-

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[11]See FLA. STAT. §733.37 (1955).

[12]See U.S. Treas. Reg. 1.706-1 (c) (1956).

ing of his business interest, Professor Casner's eight questions will again be consulted. It will be presumed that the partners are not closely related, since special tax problems involved in the case of family partnership may make the suggestions presented here inapplicable.

Survival of the Entity

The partnership, unlike the proprietorship, is likely to have a going-concern value after the death of an individual. The surviving partner tends to maintain the business' management policies and "personality," so that customers are retained and the organization remains intact. Nevertheless, the going-concern value after one death must still be investigated, because partnerships exist in which one dominant personality is "the" partnership. His death might leave no going-concern value for the others, who may be only his financiers or persons new in the business. In this case a different approach to the problem is in order. The survivors may feel that there will be little or nothing of value to buy from his heirs; their solution may be to plan liquidation or to purchase "key-man" insurance to compensate them for their loss and to give them funds with which to hire a replacement. There will be only incidental gratuitous benefits to the family of this man who was so good that he took most of the firm's value with him when he died.

Assuming that the surviving partners will not liquidate the business on the death of their colleague, it should be asked whether there is any inherent advantage in changing the form of doing business to that of a corporation. Normally, no advantage is gained; this may be in order, however, in cases in which it is practical to pass the business interest on to the family rather than sell to the other partners, since the division of financial interest and control is more easily accomplished in a corporation or limited partnership than in the usual partnership.

Many partners feel that their heirs should continue the business and share its income with the surviving partner or partners. It is not to be denied that in certain cases and in particular types of businesses this may actually be a practical solution. If this course is elected, certain precautions should be taken; among these is the drafting of the partnership articles to provide the surviving partner with complete control of the business and a salary commensurate with his managerial efforts. Even then the survivor must be able economically to obtain an employee or employees to replace the deceased partner without giving him or them proprietory interests. In such cases, the formation of a limited partnership or a corporation is often necessary in order to protect the decedent's family from business creditors and to give the necessary control to the survivor. Generally, however, the situations in which this solution is feasible are limited to those in which the parties are closely related, for example, brothers who got along well and whose whole families are compatible, or to those in which the family of the decedent has familiarity with the business and a friendly business-like attitude toward the situation and the survivor.

In other cases there is almost always a basic conflict of viewpoint between the survivor, who is generally interested in a long-range plan of plowing the proceeds back into the business, and the widow and children, who in this hour of need probably require all the income they can place their hands on. As Shattuck and Farr state:[13]

> "In this welter of unanswered questions, one central risk of great importance is shared by both sides, the risk that the hard-won value of the partnership may disappear in the struggle. Add one bit of dishonesty and a modicum of selfishness, and the contingency of death of one of two or more general partners may become fatal."

Casner's questions (3) and (4), with respect to retaining the business and providing successor management by a member of the family or a trustee, are generally best answered in a partnership by relying on the surviving partner to fill this post, with adequate compensation and on whatever terms are reasonably necessary to protect his management policies from interference by the financially interested family. The question of management by family members or trustees still should be explored, however, for cases will be found in which a son of the partner shows promise in the business, or the partners have so segregated the responsibilities that one will know little about the services performed by the other or, even having knowledge, will not possess the skill or personality necessary to perform these added functions for the partnership. In these circumstances, the partners must recognize the existence of a serious impediment to the continuation of the business after the death of one of them. Successor management

[13]SHATTUCK and FARR, *op. cit. supra* note 1, at 62.

must be planned much as suggested for continuation of a sole proprietorship.

Because of the problems described above and many unmentioned ones that will come to the mind of the reader, the "buy-out" agreement suggested by Casner's questions (5) and (6) is, under most circumstances, the best estate planning solution for the partner. Such an agreement has many advantageous results, some of which are: a ready market for the decedent's partnership interest, a certain knowledge that the widow and family will receive a fair price for his years of effort, assurance that they will receive an immediate cash payment that can be invested profitably, and creation of the necessary liquidity for the payment of estate expenses, claims, and taxes. If well drawn, the agreement will eliminate many income tax problems of the decedent and his survivors and will also "freeze" the value of the partner's interest for federal estate tax purposes. In those estates in which an estate tax of considerable size may be encountered, the latter benefit may well prove to be the greatest obtainable by careful planning. A detailed discussion of some of the provisions of such agreement will be found in the part of this article dealing with "buy-out" agreements between corporate stockholders and corporations; yet at this point it would be well to note that it is possible for the agreement between the partners to take two distinct forms. These are generally known as the "entity" plan and the "cross-purchase" plan. The distinction between the arrangements arises in the selection of the purchaser for the deceased partner's interest; it is based upon federal tax considerations and convenience.

The Purchase Agreement: Entity or Cross-Purchase

Before going into a consideration of these two plans, it should be observed that many of the tax problems encountered arise from the fact that the purchase price is normally funded by insurance policies on the lives of the respective partners. In many if not most cases, this is necessary because the parties have insufficient funds of their own to pay the purchase price comfortably. Each partner will desire to have his widow receive the purchase price in cash, if possible, to supply her immediate needs and to prevent her having to rely for eventual payment on the surviving partners' business abilities and continued survival. The insurance arrangement is not without drawbacks in addition to the tax planning that the use of insurance requires, as stated by a well-known authority:[14]

> "It must be realized, however, that the partner generally makes a sacrifice for such assurance. He can take out insurance on his own life, without making any specific purchase agreement. Or he can take out insurance on his own life, and see that the partnership agreement provides either for the purchase of his interest by the survivor or for the method of liquidating his interest. In either case, the money which would ordinarily be used to pay the premiums on the life insurance for his associate would now be used to buy insurance on his own life payable to his own beneficiaries. On death, therefore, the estate of the deceased partner or his beneficiaries would receive the insurance proceeds and would also receive his partnership interest. If the partnership interest were subject to a purchase agreement, the estate would receive the purchase price; otherwise, it would receive its share of the proceeds of partnership liquidation. Under the usual reciprocal insurance arrangement, the deceased partner's estate receives insurance proceeds for which the decedent has indirectly paid (by paying the premiums on the policy covering the other partner's life), while the survivor receives the decedent's partnership interest as windfall (at least to the extent that the decedent's partnership interest is worth more than the total premiums paid by the survivor.) These considerations are frequently overlooked in the usual insurance programs of partners. The considerations, however, are different where the surviving partner is obligated to pay a substantial amount for good will or other intangible assets. Since normally the true value of these assets might not be realized upon liquidation, an insurance purchase program could guarantee full and prompt payment to the estate of the deceased partner."

Turning to details of the two forms of the agreements, it is noted that under the entity plan the partnership itself is endowed by the tax laws and by the partnership agreement with the legal fiction of constituting a separate entity that survives the death of a partner; this is true even though the entity is not recognized for other purposes by state law. Under the entity plan the partnership itself purchases

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[14] RABKIN and JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS 160c (1955).

the deceased partner's interest for the benefit of the surviving partners, whose interests in the partnership business increase proportionately. If the purchase price is funded by life insurance, the partnership itself owns the policies, pays the premiums, and at death collects the proceeds; they are paid to the deceased partner's estate for his entire interest in the business, which then accrues to the partnership, and through it to the survivors proportionately.

By use of the cross purchase plan, the partners themselves are the purchasers of the deceased partner's interest, and each acquires directly from the deceased's estate a pro rata portion of his interest in the business. If the purchase price is funded by insurance, each of the partners owns a life policy insuring each of the other partners, pays the necessary premiums, and collects the proceeds, which are paid by him to the deceased partner's estate for a direct transfer of a proportionate share of the decedent's interest.

Prior to enactment of the 1954 revenue code there was much concern about the tax safety of the entity plan because of the danger of taxing both the insurance and the business interest in the estate and the disadvantage of continuing the old basis for the survivors. These questions seemingly have been erased by specific provisions in the new code.[15] Prior to 1954 the cross-purchase method, although considered safe from the problems arising under the entity plan, presented a serious tax problem: the surviving partners could not purchase from the decedent's estate the policies on the lives of their fellow surviving partners without encountering the "transfer of value" rule,[16] which made the proceeds, in excess of the consideration and premium payments, taxable as ordinary income to the purchaser. Such a purchase by the survivors is very desirable and is often essential to assure adequate funding of the purchase price of the partnership interest owned by the next partner to die, whose interest increased in value after the first death. This objection to the partnership cross-purchase plan has now also been eliminated by specific code provisions.[17]

If the partner's tax adviser takes the view that most of the above tax difficulties have been eliminated, the choice between methods is simplified. It then will generally depend on the number of partners

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[15]See INT. REV. CODE OF 1954, §§705 (a) (1) (B), 2042; Proposed U.S. Treas. Reg. 20.2042-1 (1956).

[16]See Int. Rev. Code of 1939, §22 (b) (2).

[17]See INT. REV. CODE OF 1954, §101 (a) (2) (B).

involved, their attitudes toward dividing the premium burden, and their intentions regarding eventual sale of the business by the survivors.

To illustrate – assuming a five-man partnership under the entity plan, the partnership itself will own five large policies of insurance. If one partner dies, the partnership still owns, without any division of policies or transfers, the policies on the lives of the other four; and the partners may readily agree to divide the premium payments to lessen the premium burden on the younger partners. If the tax adviser is conservative in his approach, however, two clouds loom on the horizon. The surviving partners may fail to obtain as large an income tax basis for their interests received from the decedent as they would under the cross-purchase plan. Although tax-exempt insurance proceeds increase the partners' basis, the premium payments will decrease their basis, since they are nondeductible by the partnership. There is no corresponding decrease under the cross-purchase plan.[18] If a partner later sells his interest in the business, he may therefore incur considerably more income tax than he would have under the cross-purchase method. Furthermore, the insurance as well as the partnership interest may be included in the deceased partner's estate – the big problem under pre-1954 law with the "indirect premium payment" test – because of the present "incidents of ownership" test for inclusion of insurance proceeds.[19] This arises from the provisions of the Internal Revenue Code requiring insurance proceeds to be included in the gross estate, even though they were not payable to the estate, if the "decedent possessed at his death any of the incidents of ownership [of the policy] exercisable either alone or in conjunction with any other person."[20] If, under the entity plan, the partnership's ownership of a policy is imputed to each of the partners individually, estate taxation of the insurance proceeds and the partnership interest would arise at each partner's death.

The recently proposed estate tax regulations[21] do not fully clarify this problem; in fact, they make its injection inevitable if there is any question that the agreement was arrived at for less than "full and adequate consideration." In determining whether the consideration

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[18]See U.S. Treas. Reg. 1.705-1 (a) (1956).

[19]1 RABKIN and JOHNSON, *op. cit. supra* note 14, at 164f.

[20]INT. REV. CODE OF 1954, §2042; see Proposed U.S. Treas. Reg. 20.2042-(1) (c) (1956).

[21]U.S. Treas. Reg. 20.2042-1 (c) (1956).

for the agreement meets this test, the Treasury Department states that it will consider the proceeds of the insurance as constituting an asset of the partnership. What can this mean? Apparently the conservative planner must advise that a great deal of uncertainty still exists as to the tax results under the entity plan.

In contrast, under the cross-purchase plan the same five partners would have the following arrangement: Partner *A* would own and pay premiums on an insurance policy on the life of Partner *B* equal to one fourth of *B's* interest. Partners *C, D,* and *E* would own and personally pay premiums on similar policies covering *B's* life. This arrangement would prevail as to each of the other partners, so that each owned a policy on the life of each of his four fellow partners, with a minimum of twenty policies outstanding for the five. If the insurance coverage were increased, twenty additional policies would be required. If *A* died and the survivors, desirous of continuing the funding of the cross-purchase plan by insurance, elected to purchase the insurance that he owned on their lives, each of the policies owned by *A* would have to be divided into three policies, with one sold to each of the surviving partners other than the insured. Needless to say, the cross-purchase arrangement can become most cumbersome when a number of partners are involved.

Another feature of the cross-purchase plan is that each partner pays the premiums on the policies owned by him on the lives of his fellow partners. This results in the youngest partner, who no doubt has the least income, bearing a very heavy premium burden if his fellow partners are much older than he – an obligation that he may be unable to meet. Because of this, partners frequently want to rearrange this premium burden and blithely do so in spite of the fact that the insurance company's actuaries have computed the mathematical probabilities of the youngest outliving the others and becoming sole owner of the business through the insurance he purchases; these probabilities are reflected in the premium differences. The youngest pays only his fair share when paying the premiums prescribed, and the other partners in bearing part of his premium load are directly buying a part of the insurance on their own lives for the youngest partner to use in buying their interests in the business – not very sound economics, but often necessary if insurance funding is desired.

Finally, the individual partners, purchasing from their deceased partner's estate with insurance proceeds they have paid for, assuredly get an increase in the income tax bases of their partnership interests. The basis increase is equal to the price paid. Under this plan the partners avoid the problem of imputed incidents of ownership of the insurance that under the entity plan raises the possible double tax results recited above. Because of these last two advantages, which are certainties under the cross-purchase plan but subject to doubt under the entity plan, it is expected that the growing trend toward the entity plan that arose shortly prior to and after the enactment of the 1954 code will reverse itself and that in the future the cross-purchase plan, despite its clumsiness in certain cases, will once more be the favored method.

The entity plan will probably retain a prominent place in partnerships in which the partners expect to incur only small estate taxes and do not foresee a sale of the business during their respective lifetimes, and in cases in which the number of partners is extremely large and the simplicity of the entity plan compels its use.

Specific Terms of Agreement

Regardless of whether the cross-purchase or the entity plan is selected, there are some major provisions of the business purchase agreement peculiar to partnerships that should not be overlooked by the draftsman.

First, the surviving partners will require provisions for continuing the partnership after the death of a partner. These must enable them to operate and control the business during the period immediately after the death and prior to the closing of the purchase of the decedent's interest. Next, from an income tax standpoint thought should be given to selecting the date on which the sale will actually take place. One writer on the subject suggests the following clause in order to provide needed flexibility with respect to the income tax burden: "At the close of the month in which any partner dies (but in no event before the day following the day of his death), his estate shall sell . . . ."[22]

The reason for this clause is that under the 1954 code the effective date of the sale closes the partnership taxable year for the purpose of computing the decedent's income tax.[23] If the sales date is the date of death, all of the decedent's share of partnership income for the partnership year to that date must be included in his final return. In certain circumstances this may bunch more than twelve months of income into the decedent's final return. Under the suggested clause,

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[22]REDEKER and WISE, SPECIMEN AGREEMENTS FOR PURCHASE AND SALE OF BUSINESS INTERESTS AT DEATH 20 (1956).

[23]INT. REV. CODE OF 1954, §706 (c) (2) (A).

the decedent's share of partnership income for its current fiscal year to the date of sale would be income to his estate.[24] The estate may hold the interest and pay the tax, or it may distribute a portion or all of it to the widow and allow her to pay the income tax on the joint final return with the decedent, if this is more advantageous.[25] If the decedent owns a fifty per cent or greater interest in the partnership, the need for a clause directing continuation of the business with the estate as a partner to the end of the partnership year is most important if termination of the partnership as to all partners, including the survivors, is to be avoided.[26] If no such provision is made and the partnership and the partners are on different fiscal years, this termination may lump over twelve months of partnership income into the return of the surviving partners.[27]

Other income tax considerations affect partners that do not affect corporate shareholders. Among these are the special problems concerning the taxability of the purchase price to the recipients as ordinary income or at capital gain rates. Ordinarily the sale of a partnership interest will be a capital transaction.[28] If the sale takes effect at or near death, there will be little if any taxable gain, since the estate gets a new basis that will usually be the amount of the purchase price.[29] If the purchase price is paid in installments, however, capital gain provisions do not apply to sale of good will under the entity plan unless the agreement specified a payment for good will.[30] The code also provides for taxing as ordinary income portions of the purchase price attributable to the decedent's interest in "substantially appreciated inventory" and "unrealized receivables."[31] The buy-out agreement cannot change these results, but the partnership may make certain elections under code sections 743, 754, and 755 that will change the results. Although this article in its limited space cannot hope to delve into the complexities of matters such as these, the reader should be aware of them and should consult the appropriate authorities to see that the problems will not be greater than is necessary.

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[24] U.S. Treas. Reg. 1.706-1 (c) (3) (ii) (1956).
[25] INT. REV. CODE OF 1954, §§661-62.
[26] INT. REV. CODE OF 1954, §708 (b) (1).
[27] See U.S. Treas. Reg. 1.706-1 (c) (1956).
[28] U.S. Treas. Reg. 1.731-1 (a) (3) (1956).
[29] INT. REV. CODE OF 1954, §1014.
[30] INT. REV. CODE OF 1954, §736 (b) (2) (B); U.S. Treas. Reg. 1.736-1 (b) (3) (1956).
[31] INT. REV. CODE OF 1954, §751.

The Professional Partnership

Before leaving partnerships, attention should be given to the distinctive characteristics of the "professional" or "service" partnership, which normally has a fairly high earning power but relatively low value capital assets to be purchased by the survivors. As standard practice in purchasing a deceased partner's interest, cash payment for the physical assets is in order, with periodic payments continued thereafter for a number of years to represent unrealized receivables and good will engendered by the deceased partner prior to his death. Here the draftsman must avoid infractions of the ethical considerations opposing fee-splitting. Although it was possible prior to 1954 to introduce considerable variation in the income tax burden of these continuing payments after death, the new code eliminates most of these variations and in most instances makes the payments deductible by the partnership and ordinary income to the decedent's beneficiaries.[32]

Evaluation of Interest for Estate Tax

As discussed at some length under the proprietorship section, all business interests raise the important problems brought to mind by Professor Casner's last two questions, which may be boiled down to "How much estate tax?" and "How will it be paid?" Once again the solutions of these problems may tip the mental scales in favor of a buy-out agreement, whereas otherwise it might be feasible to retain the business interest for the family.

The reasons for this inclination are two: First, a properly drawn buy-out agreement fixes the value of the business for estate tax purposes.[33] This tends to prevent the diversity of opinion on this subject between the tax collector and the taxpayer that otherwise is a perennial problem. Secondly, the funds for payment of taxes and expenses are automatically provided upon payment to the estate of the purchase price for the decedent's share of the business. This device can produce these blessings only if the instrument is properly drawn; the carelessly drawn buy-out agreement can produce a situation far worse than would result if no agreement had ever been made and the partners

[32]INT. REV. CODE OF 1954, §736. For a good discussion of the income tax problems of the professional partnership and instructions for their avoidance see Willis, *Income Tax Problems of the Professional Partnership*, 2 THE PRACTICAL LAWYER, No. 7, 66 (1956).

[33]See Weil, 22 T.C. 1267 (1954).

were left to their own devices under the general laws requiring dissolution of partnerships on death. This deplorable condition befalls the decedent's estate when the purchase price under the buy-out agreement is only a fraction of the true value of that interest, as, for example, when the purchase price is determined solely by the book value of tangible assets, which may reflect excessive depreciation for income tax purposes in a business in which actual good will is worth several times the value of the tangible assets. Under these circumstances the Government might not be bound to adopt for purposes of the decedent's estate tax the valuation stated in the agreement.[34] If the agreement is not drawn with due consideration to these tax pitfalls, the estate may find itself owing more estate tax on the business interest alone than the amount of the entire purchase price it receives for this interest. These and other pitfalls of buy-out agreements will be discussed in further detail later in this article.

In the absence of an effective business purchase agreement between the partners, they must seek solutions similar to those of the sole proprietor in determining the amount and source of payment of estate tax.

CORPORATION

The form of business ownership nearest and dearest to the heart of tax writers is the corporation, particularly one with a sizable income. Corporations have many advantages from a tax planning standpoint, among them the following: lifetime gifts of preferred and common nonvoting stock will reduce the estate value of the decedent's equity without reducing his lifetime control; a family foundation may purchase or receive gifts of stock during the stockholder's lifetime or on his death; and pension and profit-sharing trusts may be used to defer income during lifetime and to purchase interests on death. The list goes on to include refinements that the general practitioner will have little use for and will find too involved to handle without the benefit of truly expert advice and a great deal of research. These are peculiarly the problems and solutions of the wealthy; only those problems that are common both to those of wealth and to those of moderate means will be covered.

In every corporation, large or small, certain problems must al-

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[34]See Camp v. United States, 44 F.2d 126 (4th Cir. 1930); City Bank Farmers Trust Co., 23 B.T.A. 663 (1931).

ways be considered. They include the disadvantageous position of minority stockholders and their ability to harass the majority; the relative lack of marketability of closed corporation shares, coupled with the fact that the surviving stockholders often lack control over the transfer of corporate interests and may wind up with competitors or undesirable persons as fellow stockholders; and nonparticipation of the decedent's family in the distribution of corporate earnings in the form of salaries to officer-stockholders. For income tax purposes, these salaries tend to overcompensate for services rendered in order to avoid the double tax on dividends. When the officer-stockholder dies, his salary stops. This leaves his heirs with an asset having a high value in the estate and a relatively low capacity to earn dividends. There is the additional problem of evaluating the stockholder's interest if his estate is subject to the federal estate tax. This is often more acute than in the partnership or proprietorship because the corporation survives the death of a stockholder and the decedent's interest is readily transferable; any good will of the business is less apt to die with an individual and therefore is more likely to raise the valuation placed on the stockholder's interest.

As in the discussions in the proprietorship and partnership sections, Professor Casner's eight questions will be consulted to find for the stockholder the best plan for disposing of his business interest. The discussion will be limited to corporations in which two or more stockholders not closely related are involved. In a corporation owned by a single stockholder the problems are similar to those of a sole proprietor. If close relatives form the shareholder group, the following statements of tax results will often not apply. Discussion of the distinctions in these particular situations are beyond the scope of this article, with the exception of the few specific pitfalls noted.[35] In most cases the comments under the discussion of partnerships in regard to Professor Casner's first two questions about going-concern value after death and the advisability of changing the business form during a stockholder's life will apply with equal force to the corporation.

Factors Producing Decision to Sell

Many corporation owner-managers desire to leave their lucrative businesses to their families rather than have them disposed of upon

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[35]For a more detailed discussion see BOWE, TAX PLANNING FOR ESTATES 94 (rev. ed. 1955).

death, in the hope that the families will reap the rewards that they have. The same inherent problems exist here as in the case of the partnership, plus those peculiar to corporations discussed above. It may be more practical to leave corporate stock to the members of the family, if there are a reasonably large number of stockholders and good management, than it would be to leave them an interest in a partnership. If the interest is small this may be done outright or – as was done in the partnership situation by creating a limited partnership – by creating nonvoting common stock or making trust arrangements that clearly forbid the family to interfere with the management of the business. Despite the dilution of control, the wealth represented by the business interest can still provide earnings for the family. The planning stockholder must carefully evaluate the integrity of his management personnel before vesting them with complete control, particularly because of the almost universal practice of paying out corporate earnings in as high salaries as are practicable rather than in the form of dividends. The surviving officer-stockholders normally will want to perpetuate such a salary arrangement to the resulting detriment of the heirs, who cannot take an active part in the business. Thus, unless the decedent was the majority stockholder, regardless of the method used to transfer his stock to the beneficiaries they normally will not receive income proportionate to the value of the capital invested. For these reasons, assuming that it will not be desirable to liquidate the entire corporation, the most satisfactory solution will probably be one that provides an appropriate business purchase agreement for liquidating the holdings of the decedent. Professor Casner's questions (5) and (6) will therefore be answered "Yes" for the corporation shareholder in most cases.

Choice of Purchaser

In any sale arrangement it is necessary to determine who will be the purchaser and the exact manner in which the sale will be effected. Again it is possible to sell to an employee, a particular heir, one of the remaining stockholders, the corporation, or to its stockholders in proportionate shares. The last named arrangement usually works most successfully. No matter who the parties to the stock purchase agreement may be, the universal need is for the availability of monies with which to fund the purchase; the discussion of this problem under the partnership section is equally applicable here. Today's high income tax rates and the normal desire of most persons to invest the money they accumulate make the life insurance policy the answer to this problem in most cases, in spite of the factors against its use discussed in the partnership section. With the selection of this means of funding, again comes the problem of who will become the purchaser. This problem is similar to that existing when partners must determine whether to use the entity plan or the cross-purchase arrangement; as previously stated, the tax plan problems here may be considerably different from those of the partnership.

Entity Plan. The corporation is the purchaser under the stock retirement plan, which will be called the entity plan because of its similarity to the partnership plan of this designation. Several possible deterrents to the use of this plan exist. First, there is no possibility — as there is in the partnership entity plan — that the surviving shareholders will have the income tax basis of their shares increased because of the purchase price paid by the corporation.[36] Thus, on sale of his shares at a later date, or on dissolution, a surviving stockholder will assuredly pay added capital gain tax because of this increase in the value of his holdings without the neutralizing effect of personal payment, which would increase his basis. As in the case of the partnership entity plan, this will not be an important factor if the survivor expects to retain his holdings until his death, when his estate will be provided with a new basis equal to the stock's value at the date of death.[37]

Another problem to be faced by the user of the entity plan in Florida is that presented by a statute,[38] which forbids a corporation to purchase its own shares except from surplus, and the code provision[39] that prohibits the accumulation of corporate surplus in any amount exceeding the reasonable needs of the business. Many writers[40] feel that an accumulation for this purpose, either in the corporate treasury or in the form of premiums for insurance policies on the lives of the stockholders, is for a reasonable purpose within the meaning of the code. In general they rely on *Emeloid Co. v. Commissioner*[41] for com-

[36]INT. REV. CODE OF 1954 contains no provision increasing the stockholders' basis because of the receipt by the corporation of tax exempt insurance proceeds, as is provided in the case of partners under §705 (a) (1) (B).

[37]INT. REV. CODE OF 1954, §1014.

[38]FLA. STAT. §608.13 (9) (b) (1955).

[39]INT. REV. CODE OF 1954, §531.

[40]*E.g.*, SHATTUCK and FARR, AN ESTATE PLANNER'S HANDBOOK 76 (2d ed. 1956).

[41]189 F.2d 230 (3d Cir. 1951).

fort. Other writers[42] feel that the beneficial holding of this case is restricted to the purchase of the stock of key men in the corporation.[43]

If this need for corporate surplus is not met prior to the death of the stockholder whose interest must be purchased, one team of authors[44] suggests that there is at least a partial solution in the use of the Florida statute[45] that allows reduction of the stock's par value. If a paucity of surplus is anticipated, the agreement might provide for reduction of the stock's par value and addition of the released value to surplus. If the fund thus created is insufficient to accomplish its purpose of buying the estate's stock, a further addition to surplus can be accomplished by increasing the book value of assets on which unrealistic depreciation has been taken. If these two steps fail to produce sufficient surplus for the full redemption, the surviving stockholders should first purchase all known excess as they would under the cross-purchase plan, with the corporation then redeeming the remaining shares with surplus gained in the manner described above. Sale to the survivors, then redemption, seems desirable in this order if income taxation of the corporation's purchase price to the estate is to be avoided by use of the "complete redemption" exception. This method should not be used without full understanding of the impact it may have upon the rights of creditors, the working capital of the enterprise, its credit rating, and other nontax considerations. It may be regarded as bordering on if not clearly constituting an emergency procedure.

A final and often conclusive deterrent to the use of the entity plan occurs in close corporations in which several members of the same family own stock. As the reader is probably aware, the income tax law provides that complete redemption of a decedent's stock is a capital transaction that probably will be income-tax free, because of the estate's new basis for its stock.[46]

Unless all of the decedent's stock is redeemed at the same time, however, the purchase price paid by the corporation for part of his stock may be considered as a dividend to the estate and taxable as

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[42]*E.g.*, Dean and Leake, *How to Redeem Stock Under Section 303 to Pay Death Taxes Plus Funeral and Administration Expenses*, in LASSER, TAX INSTITUTE ESTATE TAX TECHNIQUES 1525 (1956).

[43]See INT. REV. CODE OF 1954, §§531-37; Syracuse Stamping Co., 4 T.C. 371 (1945); Reynard Corp., 37 B.T.A. 552 (1938).

[44]Moorehead and Gordon, *How to Coordinate Business Transactions with Estate Planning*, in LASSER, TAX INSTITUTE ESTATE TAX TECHNIQUES 1409 (1956).

[45]FLA. STAT. §608.18 (1955).

[46]INT. REV. CODE OF 1954, §§302, 1014.

ordinary income.[47] This unfortunate situation is particularly imminent in the family-owned corporation, because of the new attribution rules[48] in the 1954 code that deem an estate to own, for purposes relevant in this discussion, all stock owned by its beneficiaries or attributed to them under related provisions. Unless all the stock owned by all beneficiaries of the estate is redeemed simultaneously with the stock of the estate, total redemption of the estate's stock is not effected. The result may be taxation of the purchase price paid by the corporation to the estate at ordinary income rates. The completely disastrous results possible to the estate and the heirs under these new and little-known rules have caused at least one team of writers to scream in indigation that "the scope of the attribution rules is so great and their effect so sweeping that one is forced to conclude that they may be unconstitutional."[49] At any rate the planner who is dealing with a family corporation must exercise extreme caution when confronted with circumstances suggesting the application of these rules.[50]

In spite of these disadvantages of the entity plan this method has a large number of devotees, not only because of the drawbacks inherent in the cross-purchase plan but also because of several distinct attractions that the entity plan enjoys.

The chief advantage arises from the ability of the corporation to purchase insurance with earnings that have been touched only once by the income tax. If the stockholder is to use these same earnings to pay premiums, income tax is extracted twice, once from the corporation and again from the dividend that is income to the stockholder, before money remains to pay the premiums. Thus the corporation purchases the insurance with "pre-tax" dollars in so far as stockholders are concerned; whereas, if the stockholders desired to obtain the same policies and were in a fifty per cent tax bracket, they would have to use twice the amount of money received as corporate dividends to accomplish the same objective. It is possible that the stockholders can advantageously pay themselves additional salary — which is a deductible expense to the corporation — sufficient to allow them to purchase the policies without using double taxed dividends. Yet this

[47]See INT. REV. CODE OF 1954, §302.

[48]See INT. REV. CODE OF 1954, §318.

[49]Moorehead and Gordon, *supra* note 44, at 1403.

[50]For detailed discussions of the attribution rule and its effect see Moorehead and Gordon, *supra* note 44, 1956 Supp. 97-103; Winton, *Tax Traps in Stockholders' Agreements*, 2 THE PRACTICAL LAWYER, No. 3, 78 (1956).

is difficult, because most corporations are already paying their officer-stockholders the maximum salaries likely to be sustained as reasonable, and any further increase would invite loss of the deduction.[51]

Cross-Purchase Plan. Contrasted with the entity plan, the stockholder cross-purchase agreement is essentially the same as the cross-purchase agreement between partners, with most of the same problems and results. Here, as with partners, the purchaser is guaranteed his stepped-up basis. Further, there are no problems of corporate surplus or of attribution. The stockholders purchasing out of salaries to escape the double tax on dividends will feel the pinch of paying premiums more than the entity plan purchasers, but this should not prove too large a factor in most cases.

The big problem of the cross-purchase advocates, when corporations are involved, arises under the "transfer for value" rule that taxes insurance policy proceeds as ordinary income to the extent that they exceed the consideration and premiums paid by the purchaser. It was noted under the discussion of partnerships that this problem has been eliminated for partners; not so for stockholders. The Internal Revenue Code provides exceptions to the transfer for value consequences if the insurance is transferred 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.[52]

The reader will recall that under the cross-purchase plan it is desirable upon the death of a partner or stockholder for each survivor to purchase a pro rata part of the policies owned by the decedent on the lives of the other survivors; in this manner each is provided with additional funds with which to eventually purchase the larger interest in the business now owned by the next partner to die. This is practical for partners under the stated provisions of the code, since sales of insurance policies to a partner are within the exception. Note, however, that no such exception is made for sales between stockholders. Thus the total insurance available to fund the plan must of necessity decrease with each successive death, or the survivors will pay income tax on the proceeds of the purchased policies. This greatly reduces the net from these policies. The stockholders of the cross-purchase group must therefore provide other methods of funding the purchase for an increased price at the next death, either by carrying

[51]See INT. REV. CODE OF 1954, §162 (a) (1).
[52]INT. REV. CODE OF 1954, §101 (a) (2) (B).

excessive insurance initially or by building up their own sinking funds or other liquid reserves. Deferred payments by the survivors will often prove inevitable. If they are needed under either plan, thought should be given by the draftsman to limiting officers' salaries and dividends until the family is paid in full.

Fixing of Purchase Price

Up to this point a portion of Professor Casner's question (6), namely, "What method should be adopted to fix the price on the death of the owner?" has been ignored. Also, detailed discussion of the necessary and usual provisions in the ordinary business purchase agreement has been avoided. Having once settled upon the purchase plan to be used, whether of the entity or cross-purchase variety, it is next in order to consider some of these specific provisions. The most important of these, both to the parties and to Uncle Sam, is the purchase price and its binding effect on the tax collector.

There are many methods of determining purchase price recommended in the many articles[53] on the subject, the most important of which are as follows:

(1) The stockholders agree upon a current value of their stock and revise their agreement at regular intervals of six months or a year. They should provide for appropriate adjustments of value in the event they die without revising their agreement on schedule or in the event of unusual occurrences between valuation dates.
(2) Two appraisers are named to evaluate the stock, one appointed by the seller and one by the purchaser; if they fail to reach an agreement, the two select a third, with the decision of the majority being conclusive.
(3) A formula determines the value of the stock; it may be based upon the value of the assets as shown by the books of the enterprise plus an appropriate allowance for good will, such as payment of one or two years' average earnings or a capitalization of earnings method.

It should be emphasized that from an estate tax standpoint and in fairness to the parties the method selected should be calculated to arrive at as fair and equitable a price as is possible under the circum-

[53]See note 3 *supra*.

stances. If this is not done, the Treasury Department may refuse to recognize the price determined by the agreement as a binding value for tax purposes, even though the agreement is otherwise properly drawn.[54] This is particularly true in any situation in which members of the same family are on opposite sides of the transaction, for in this case the transaction may be deemed testamentary in character.[55] If the entity plan is used, any valuation formula should take into account the cash value of the policies owned by the business to assure the decedent's estate its return of a portion of the premiums paid, as is done in the usual sale pursuant to a cross-purchase plan.

Of the three methods proposed, the first is probably the fairest to all parties, but it meets with the least success because of the almost universal failing of humanity in postponing the making of revaluations. As a result, unless the parties have determined a fair value in the recent past, when death occurs there will probably be an outdated value that is very unfair to one of the parties to the agreement. For this reason and because of the rapid changes that sometimes occur in a business, the agreement should contain a provision for the agreed price to be adjusted to reflect any net change in the book value from the date of the last valuation to the date of death. Since this change in book value will not reflect changes in good will, it may be wise to provide further that if no price has been stipulated for a period of two or three years the entire method is to be abandoned and either an appraisal or a formula is to be used in establishing the price. A further caution: someone — the lawyer, accountant, insurance underwriter, or trust officer — must keep a tickler system to remind the client to revise the price at the agreed interval. Without this help, the plan is almost certainly doomed.

There is much to be said for the second method, arbitration: the parties have the benefit of independent thinking, they do not become emotionally involved in arriving at the price, and they are not involved in embarrassing negotiations with heirs. In many instances, however, the survivor will feel that he does not care to have appraisers know so much about his business, particularly when the only competent ones available are competitors, who might gain a decided busi-

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[54]See Rev. Rul. 77, 1954-7 CUM. BULL. 17; Gutkin, *How to Use the Close Corporation in Estate Planning,* in LASSER, TAX INSTITUTE ESTATE TAX TECHNIQUES 1501-03 (1956); Murphy, *Survivor-Purchase Agreements,* 2 THE PRACTICAL LAWYER No. 4, 48 (1956).

[55]BOWE, *op. cit. supra* note 30, at 94.

ness advantage by becoming familiar with the operation.

This leaves the third method, "book value plus a formula for good will," as the most practical solution in ordinary cases. Since book value is a part of the purchase price, the agreement must relate in considerable detail the determinations the accountant is entitled to make as well as their conclusiveness. Despite constant references to them, there are no universal "generally recognized accounting principles." There is a strong tendency among partners who are good friends to discount the good will that a business may build up, particularly if they enter into such an agreement at the outset of the business when little good will exists. This should be discouraged in fairness to their families, who may become accustomed to larger earnings and who are entitled to considerable remuneration because of good will that exists in the business at death but did not exist at the time the agreement was drawn. Of course a satisfactory formula for arriving at the amount of good will must be different in each case and should be suggested by a competent accountant, with whom the book value determination problem might also be discussed. One generally recommended method of determining good will is to take either one or two years' earnings as the measure of the value of the good will. Another method is to find the industry's average return upon invested capital, subtract that figure from the average earnings of the business of five or ten normal years, and capitalize the excess at a percentage, probably twenty per cent at most.[56]

Evaluation for Estate Tax Purposes. Professor Casner's seventh query should next be considered: "What value is likely to be placed on the business for death tax purposes?" The first reaction naturally is to assume that it will be the purchase price under the agreement. To be certain that this is the result, the clients must be willing to have the agreement contain four important elements:[57]

(1) A restriction on the disposition of the stock as long as the agreement is in force, whether during lifetime or after death.
(2) A fair sales price for the stock.
(3) An arrangement that under the circumstances is genuinely at arm's length.

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[56]Moorehead and Gordon, *supra* note 44, at 1808.
[57]Gutkin, *supra* note 54, at 1501-03; Murphy, *supra* note 54, at 48, 50, 56.

(4) An express provision that the agreement may be specifically enforced in a court of equity, thereby preventing arguments by the Treasury Department that the valuation provisions are not effective because of the lack of specific enforceability.

Without the aid of any one of these elements, it is quite possible that the estate will run into a situation in which it is forced to sell the business interest for one value and yet have the same interest valued at a substantially higher figure in the estate tax return. As previously stated, and repeated here for emphasis, in extreme cases the tax resulting from such disproportionate valuations might consume the entire price received by the estate under an agreement that did not peg the estate tax value as equal to the purchase price.

Estate Liquidity Problem When Stock Retained

In cases in which it appears practical for the estate to retain the stock interest for the benefit of the family, the planner is once again faced with the question "Where will the estate of the owner of the business obtain funds to pay death taxes and other expense items?" It may develop that the testator will have sufficient liquid assets or has provided or must provide life insurance for this purpose. If not, and in many cases even if such solutions are available, the planner should not overlook an important tool provided him by section 303 of the 1954 code. If most of the client's assets are tied up in one corporation, or in several corporations in each of which he holds at least seventy-five per cent of the stock, this section allows the corporation to redeem as much of the decedent's stock as will provide a sum not greater than death taxes, funeral expenses, and expenses of administration; to this extent the funds received in redemption will not be considered a dividend from the corporation even if all the decedent's stock is not redeemed. This provision may be used only when the value of all of the corporation's stock included in the decedent's gross estate for tax purposes is either greater than thirty-five per cent of the gross estate or fifty per cent of the taxable estate.

If one of these two tests is met, the planner should seriously consider use of this section even though adequate liquidity is otherwise present in the estate, since in this manner he is allowed to siphon off accumulated corporate earnings without encountering an income tax on the distribution. This is an opportunity that will not again present itself to the heirs as stockholders.

The above discussion is much oversimplified and does not touch on many important aspects of planning under this section, such as the availability of corporate surplus to fund the redemption,[58] the permissibility of redemption in kind rather than in cash, the possibility of running afoul of section 531, which penalizes unreasonable accumulations of corporate earnings, and many other considerations that may arise in dealing with this problem. The procedure allowed may be very important, however, in the right situation; proper planning while the client is alive is necessary to be certain that the benefits will be available to his heirs after his death. It is therefore suggested that the reader with any such clients diligently study the articles cited.[59]

CONCLUSION

This article has been devoted to a generalized discussion of the broad problem of disposition of business interests. If a sale of the interest is deemed advisable, certain clauses to be included in the agreement have been suggested, but no actual check list or form is included for the attorney's guidance in preparation of his contract. These have been omitted because there is available a wealth of excellent material containing reference forms to assist him in the actual preparation of his agreement.[60] It will not even be necessary to purchase many of the cited works if the attorney does not already have them in his library. The many life insurance companies of the United States, in an effort to assist attorneys and trust companies and to promote the sale of their product, have produced voluminous literature on the subject of insurance-funded business purchase agreements, much of which consists of suggested forms.[61]

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[58]See FLA. STAT. §608.13 (9) (b) (1955).

[59]See 1 RABKIN and JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION §24.04 (1955); Dean and Leake, *supra* note 42; Love, *Redemptions of Stock for Payment of Death Taxes,* 29 TAXES 131 (1951).

[60]CASNER, ESTATE PLANNING 743-92 (2d ed. 1956); INSTITUTE FOR BUSINESS PLANNING, 7 TAX TESTED FORMS OF AGREEMENTS AND PLANS (1956); 7 RABKIN and JOHNSON, CURRENT LEGAL FORMS WITH TAX ANALYSIS (1955); SHATTUCK and FARR, AN ESTATE PLANNER'S HANDBOOK 470-517 (2d ed. 1931); STEPHENSON, DRAFTING WILLS AND TRUST AGREEMENTS 372-94 (1952).

[61]See Diamond Life Ins. Co. bulletins as well as publications of the company. Copies of such literature may be obtained by the attorney from the home offices of most insurance companies upon request, or by telephone call to some of his local friends in the insurance underwriting business.

In this brief discussion the reader with little or no previous experience in the field may have gained some insight into the estate planning facets involving business interests. If so, it is worthy of repetition to caution him again not to rely on a necessarily sketchy discussion such as this in attempting to solve his client's problems. Rather he must consult the authorities cited and do considerable research on his particular problem to be sure of serving his client well. It has been said in connection with these matters that "to rely upon chance can result in disaster for the family. To plan intelligently, with the best assistance and technical guidance available, is the part of wisdom."[62]

[62]Wormser, *Preserving the Family Enterprise for the Family*, THE PRACTICAL LAWYER, No. 8, 44, 54 (1956).