

PLANNING OPPORTUNITIES WITH
BUY-SELL AGREEMENTS

VALUATION AND FUNDING PROVISIONS

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A. Valuation Issues

1. Historically, the purchase price established by a Shareholders Agreement with respect to the purchase of shares from a deceased Shareholder's estate established the market value for Federal Estate Tax purposes if certain conditions were met.

a. If the Agreement restricted the sale of stock during lifetime and at death and was between unrelated individuals, purchase price was normally binding on Internal Revenue Service. See Broderick v. Gore (55-2 USTC ¶ 11, 555).

b. Treasury Regulations (§ 20.2031-2(h)) also provide that the agreement must be a bona fide business arrangement and not a device for passing the decedent's shares to the natural object of his bounty for less than adequate and full consideration.

c. In St Louis County Bank v. U.S., (82-1 USTC 13,459) the shares of a closely held corporation were owned by Mr. Sloan (265 shares) and his children (201 shares). The agreement provided for a right of first refusal in the event of a voluntary lifetime transfer as well as an option to purchase the shares of a deceased Shareholder at a formula price equal to ten times the average annual net earnings for the previous five years.

At the date of Mr. Sloan's death, the average annual net earnings for the prior five years was \$0. The Corporation exercised its option to repurchase the Shares for \$0. Although the District Court held that the Agreement had a valid business purpose and provided for a reasonable price, the Court of Appeals held that under the circumstances presented, including the health of the testator at the time of the agreement and the discrepancy between the purchase price and book value, "a reasonable inference could be drawn that the agreement was testamentary in nature and a device for the avoidance of estate taxes." The decision was, therefore, reversed and remanded.

2. Applicability of IRC Section 2703.

a. Purpose of this provision was to prevent a business owner from creating an artificially low value for estate tax purposes by providing for a purchase price in the Shareholders Agreement that was lower than the actual value.

b. Section 2703 will apply (and buy-sell value will be disregarded) unless the agreement:

(i) is a bona fide business arrangement;

(ii) is not simply a device to transfer stock to natural objects of bounty for less than full and adequate consideration;

(iii) its terms (including valuation determination) are comparable to similar arrangements entered into by persons in an arms-length transaction.

c. A right or restriction is treated as comparable to similar arms-length transactions if “the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arms length.” Treas. Reg. §25.2703-1(b)(4). Whether the agreement is comparable requires consideration of such factors as the term of the agreement, market value, and adequacy of any consideration given in exchange for the rights.

d. Where Shareholders are not related, the terms of a buy-sell agreement can be presumed to constitute a bona fide business arrangement and to be the result of arms-length negotiations.

B. Approaches for Determining Purchase Price.

1. No one valuation formula is equally appropriate for all businesses.

2. Appraised Value (as of the triggering event).

a. This approach may eliminate future disagreement regarding the methodology for determining value but lacks predictability. Therefore, it is difficult to prefund the purchase price.

b. If this approach is utilized, it is important to carefully set forth the parameters for determining value; i.e.: how many appraisers, qualifications, what factors to consider, etc.

3. Agreed Value.

- a. Shareholders agree on a set price and agree to meet periodically to redetermine value of shares.
 - b. This approach allows for a meeting of the minds, provided that parties actually review the value on a periodic basis.
 - c. Main problem is when owners either don't meet or fail to agree on a new value. If there is no fall-back position, then most recent value applies.
4. Formula Approach. This is most practical approach if the formula used is realistic.
- a. Book Value
 - (i) Book value per share is determined by dividing the entity's net worth (assets less liabilities) into the number of outstanding shares or units;
 - (ii) Book value has limited value unless assets are adjusted to current value (e.g. marketable securities and real estate should be adjusted to actual value);
 - (iii) Also, book value normally does not take into consideration goodwill;
 - (iv) Book value is normally not a realistic approach for S corporations and limited liability companies since earnings may be distributed to owners and book value remain static.
 - b. Capitalized Earnings or Cash Flow.
 - (i) Determined by multiplying the average earnings or cash flow for a given period by a specified capitalization rate;
 - (ii) adjustments to earnings are necessary for extraordinary items and excess compensation to owners;
 - (iii) formula is usually based on a weighted average of cash flow to take into account trend of increased or decreased earnings;
 - (iv) abnormal or non-recurring items such as changes in accounting methods, unusual gains and losses, or heavy retirement plan contributions must be considered.
 - (v) the capitalization rate is the most important aspect of this approach. It is based on the rate of return a hypothetical investor would expect. Typically, the best guide to determining a cap rate is the sales price for comparable companies. This may be difficult to determine.

5. Combination Approach.

a. one alternative is to use the last agreed value, unless there has been no agreement for given period of time (e.g.: 12 months), then use last value plus or minus any change in Company's net worth since the last valuation date as fall-back to formula approach.

b. another possibility is a hybrid of the above methods, such as book value plus X times average cash flow for the prior five years.

C. Importance of Periodic Appraisals.

1. The owner of a business typically does not have adequate information to provide realistic value. Typically, his or her concept of the value is based either on past history or on an unrealistic guess as to future worth.
2. If shareholders are unrelated and they can agree on a valuation approach, appraisal may not be necessary, although appraisal provides an objective approach to fixing the purchase price in the future or setting the formula.
3. Appraisal need not be done every year . . . 3-5 years usually more realistic.
4. Use of periodic appraisal may help satisfy the requirements of Sec 2703 (b)(1).

D. Funding of Purchase Price.

1. Purchaser(s) of shares from selling shareholder may be either company (entity buyout) or other owners (cross purchase agreement). In either event, parties must develop a strategy for funding the purchase from the deceased shareholder's estate.
2. Purchase of Shares can be funded by one or more of following methods:
 - a. Sinking Fund (prefunding of purchase price) is sometimes difficult to accomplish if client is not disciplined to maintain the fund and if funds are needed for other purposes. Further, if the remaining Shareholders are purchasing the shares, the funds utilized are after-tax dollars.
 - b. Lump sum payment of purchase price may require borrowing of funds from bank or other source. Parties need to consider the possibility of unfavorable interest rates.

c. Extended payout of purchase price is a frequently used alternative. The major problem with this method to Seller is the risk of non-payment. How can Seller be protected?

(i) Seller may be given a security interest in the assets of the Company. This is unlikely in most situations, since the new owners may need to grant security interests to lenders who provide funds for ongoing operations;

(ii) Seller can take back a pledge of the securities that are sold. This approach may not offer much help since the Seller probably does not want to be in the same position as before the sale; otherwise, he wouldn't have sold in the first place.

(iii) Also, if the Seller retains a security interest, this may preclude capital gain treatment under IRC Section 302;

(iv) Restrictions are typically placed on the new owner's ability to operate the Company, such as limits on compensation, investment in capital assets, liquidations and mergers.

d. Consideration should be given to purchasing life insurance to fund buyout of shares from a deceased shareholder. This may be costly if shareholders are old or have health problems.

3. If life insurance is contemplated the question arises as to the amount of insurance; that is, should more insurance be purchased than current value to factor in growth in value of the company. If so, should purchase price be increased by the excess?
4. Shareholders must consider the type of insurance that is appropriate: i.e., term, whole life or universal life. Although term may be cheaper in the short run, whole life is more appropriate if the need will extend beyond 15-20 years.
5. Each shareholder should have the option to purchase the policy or policies on his/her life from the Company or other shareholders if the Agreement is terminated or the policy is not needed.