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CORPORATE BUY-SELL AGREEMENTS: TAX PROBLEMS IN DRAFTING

RICHARD LLOYD STRECKER*

Since the relationship between the owners of a small business is essentially a close personal one, even though for legal and tax reasons the business may be operated in the corporate form, shareholders of such corporations are typically concerned to maintain ownership within a congenial group. Much is being written upon this subject at the present time.¹ The author hopes that lawyers called upon to draft arrangements designed to "keep a close corporation close"² may find aid in a paper whose purpose is not to canvass exhaustively the

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¹Hacker, *Corporate Distributions, Liquidations and Related Problems*, 30 Ohio Bar 749 (1955); Hobbet, *The New Attack on Stock Redemptions*, 35 Taxes 830 (1957); Jones and Gleason, *Casale Reversed: Corporate Insurance No Dividend to Stockholder—an Analysis*, 7 J. Taxation 258 (1957); Lawthers, *Prunier Reversed: No Income to Stockholders from Premiums Paid by Corporation*, 8 J. Taxation 12 (1958); Lawthers, *Prunier Offers No Threat to a Sound Insured Buyout Plan*, 7 J. Taxation 2 (1957); Lawthers, *The Fragile Bark of the Small Corporation*, 12 J. Am. Soc'y C.L.U. 4 (1957); Levine, *More on Casale: Decision Was Wrong Because There Was No Severance of Corporate Property*, 6 J. Taxation 289 (1957); Mannheimer and Friedman, *Stock-Retirement Agreements—The Prunier and Sanders Cases*, 35 Taxes 567 (1957); Pavenstedt, *The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation*, 51 Mich. L. Rev. 1 (1952); Rasman, *Stock Redemptions under Section 302 of the 1954 Code*, 35 Taxes 355 (1957); Steinberg, *Funding Stock-Redemption Agreements with Life Insurance*, 35 Taxes 669 (1957); Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*, 26 Fordham L. Rev. 189 (1957); Taylor and Maier, *Sanders Case Again Emphasizes Care Needed in Agreements Funded by Insurance*, 7 J. Taxation 68 (1957); Winton and Hoffman, *A Case Study of Stock Redemptions under Sections 302 and 318 of the New Code*, 10 Tax L. Rev. 363 (1955); Young, *Extreme Care Needed Today To Avoid Dividend Treatment of Stock Redemptions*, 7 J. Taxation 66 (1957); Note, *The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death*, 71 Harv. L. Rev. 687 (1958); Note, *Casale Reversal Clarifies Relation between Stockholder and Controlled Corporation*, 7 J. Taxation 271 (1957); Note, *Pelton Steel: Another Blow at Planning for Closely Held Corporation*, 7 J. Taxation 96 (1957); Note, *Could Casale Have Won If He Had Done It Slightly Differently?*, 6 J. Taxation 362 (1957); Note, *Stock Redemptions in Close Corporations: A Plan for Taxation*, 67 Yale L.J. 112 (1957).

Many worthwhile comments on this problem are also found in the proceedings of the various tax institutes. The list above is exhaustive only of comments in very recent legal periodicals.

²The phrase was suggested by Mr. Paul J. Bickel of the Cleveland Bar. See note 36 *infra*.

covey of recent cases but rather to guide the draftsman. The author's pedagogical predilections dispose him to the belief, supported by the brilliant success of the case and problem method in law school instruction, that any complex legal problem is better understood in reference to concrete facts, if not actual, then hypothetical. Therefore, our consideration of the problem will begin with a hypothetical case.

I. THE PROBLEM STATED

Dujaggets, Inc., is a corporation engaged in the manufacture and sale of chromium-plated dujaggets. The business was founded in 1920 by two men who had formerly been engaged in business as partners, Earl E. Dew and Cliff Jagget. Earl's son, Fogg E. Dew, is a vigorous and talented young executive in the firm, who is clearly competent to take over in a top management role. Earl has no other children. Cliff's only offspring, a daughter Garnet, is married to a successful young physician, Dr. Medico. Fogg and Garnet each have two small children.

The average net or taxable income of the corporation over the past ten years has been \$100,000. Before reaching this figure, there was deducted the amount of \$50,000 for salaries to executives: \$20,000 to Earl, who is president and general manager, \$20,000 to Cliff, secretary-treasurer and production manager, and \$10,000 to Fogg, who is not an officer of the corporation but who does have the responsibility of sales manager. The board of directors is composed of the following persons: Earl E. Dew, Mrs. Earl E. Dew, Cliff Jagget, Mrs. Cliff Jagget, and Attorney I. M. Abel, who is counsel for all the shareholders individually and for the corporation. It is an amicable group. Neither of the wives is an officer or employee of the corporation, although each receives the modest annual fee of \$500.00 for acting as director. They are faithful in their attendance at meetings.

The following is the corporation's balance sheet as of a recent date:

DUJAGGETS, INC.

ASSETS			LIABILITIES	
	<i>Fair Market Value</i>	<i>Book Value (same as adjusted tax basis)</i>		
Cash	\$100,000	\$100,000	Accounts Payable	\$ 50,000
Marketable Securities . . .	400,000	350,000		
Accounts Receivable . . .	50,000	50,000	Capital Stock, par value	
Inventory	100,000	75,000	\$100 per share, 5,000 shares...	500,000
Plants and Properties . . .	400,000	225,000	Earned Surplus (assumed to equal "earnings and profits").....	250,000
	<u>\$1,050,000</u>	<u>\$800,000</u>		<u>\$800,000</u>

Thus, the net book value of the corporation is \$750,000 and the book value of each share is \$150. The present net asset value of the corporation, based on fair market value of its assets is \$1,000,000, each share representing \$200 of net asset value.

The shares of stock of Dujaggets, Inc., are owned by the following persons in the amount set opposite each name:

	<i>No. of Shares</i>	<i>Percentage Ownership</i>
Earl E. Dew.....	1,500	30
Mrs. Earl E. Dew.....	500	10
Fogg E. Dew.....	500	10
Cliff Jagget.....	1,500	30
Mrs. Cliff Jagget.....	500	10
Garnet Jagget Medico.....	500	10
	<hr/> 5,000	<hr/> 100

Both Mrs. Dew and Mrs. Jagget received their shares as gifts from their husbands more than ten years ago. Fogg E. Dew and Garnet Jagget Medico received their shares as gifts from their fathers also more than ten years ago. Since the original cost of each of the shares was \$100, paid by Earl and Cliff at the time the corporation was formed in 1920, and since all other shareholders received their stock by inter vivos gift, the tax basis of the shares in the hands of each of the shareholders is \$100. At the present time, neither the articles of incorporation, the by-laws, nor any contract or agreement places restrictions upon the disposition which a shareholder of Dujaggets, Inc., may make of his stock, either during life or on the occasion of his death.

II. WHY HAVE A BUY-SELL?

Earl E. Dew, Cliff Jagget and Fogg E. Dew have been thinking a good deal about what will happen to the business when the founders die, or when the shares of any other shareholder, through death or otherwise, pass into the hands of persons outside the present harmonious group. Discussing this problem with other businessmen, their life insurance salesman, the trust officer at the local bank, and their accountant, they have concluded that it would be highly desirable to enter into some kind of "buy-sell agreement" whereby this problem would be solved. They have in mind that, in addition to the primary goal of maintaining ownership within a congenial group, such an arrangement might accomplish certain other important objectives: (1) the eventual transfer of control of the corporation from the found-

ers to young Fogg E. Dew, without whose continuing efforts the company's future appears bleak; (2) the provision of liquid funds to the estate of any shareholder for the payment of estate taxes; (3) the fixing of an upper limit upon the estate tax valuation of the shares, thus, at least, precluding expensive controversy and litigation and possibly avoiding disastrous overvaluation; (4) the minimizing of the separation of ownership from management by preventing the introduction of additional inactive shareholders against the will of the surviving active shareholders.³

III. WHO SHOULD BUY?

The fundamental question that must be answered before beginning the drafting of a buy-sell arrangement is: Who will buy the shares? In the event that a shareholder wishes to sell during life, or in case of a shareholder's death, should the remaining shareholders purchase the shares of the departing shareholder, or should his shares be purchased by the corporation? Perhaps the more common practice, and what is usually referred to as a "buy-sell agreement" in the narrow sense, is an arrangement whereby the surviving shareholders purchase. It is sometimes overlooked, however, that from the viewpoint of the ultimate percentage ownership and control of the corporation, either method accomplishes precisely the same result.⁴ For example, on the occasion of Earl E. Dew's death, the surviving shareholders, as a group, will own 100 per cent of the stock of the corporation whether Dew's shares are purchased by the corporation or purchased proportionately by each of the surviving shareholders. Of course, the percentage ownership and the voting power of each surviving shareholder will increase to exactly the same figure whether each buys a proportionately larger number of shares, or the total number of outstanding shares is reduced, increasing the proportionate interest. The present system of corporate income taxation, involving as it does what is frequently referred to as the double taxation of corporate business earnings, provides a powerful argument in favor of selecting the redemption route. Business income earned by a corporation is, to the extent paid out to shareholders in dividends, subject first to the corporate tax at a maximum rate of 52 per cent, and the remainder is subjected to a further tax as the indi-

³Mannheimer and Friedman, *Stock Retirement Agreements*, 28 *Taxes* 423, 425 (1950), citing White, *Business Insurance*, 406. See also 67 *Yale L. J.* 112, 119 (1957).

⁴From the viewpoint of the size and financial situation of the corporation after a shareholder has retired from the scene, the two methods differ drastically in result. This is discussed *infra* under the heading "Income Tax Consequences to Remaining Shareholder."

vidual income of the shareholder, at a maximum rate of 91 percent. "Double taxation" and high surtax rates combine to make it extremely difficult, if not impossible, for men of a moderately high income level, most of which is derived from a corporate business, to accumulate the amount of liquid funds which would be required to purchase a large block of stock from the estate of a deceased fellow shareholder. Double taxation of corporate business earnings is ameliorated to a limited extent by the accumulation of earnings until sale of shares converts the accumulation into capital gain⁵ or, indeed, until death, when the stepped-up basis⁶ in effect forgives the shareholder tax on the accumulation. However, the usefulness of these is sharply limited by the existence of the "accumulated earnings tax."⁷ Of course, the use of certain methods, such as the payment of salaries to active shareholders⁸ and interest on debt securities issued to shareholders,⁹ give limited relief from the corporate tax. To the extent these methods are successfully employed, the earnings are, because of the corporate deduction for these items, subjected only to a single shareholder tax. Unfortunately for Attorney Abel's clients, the doctrines concerning "reasonable compensation,"¹⁰ "hybrid securities,"¹¹ and "thin incorporation"¹² permit only limited escape. Thus, to a considerable extent in most companies, the business earnings are subjected to both corporate and individual taxation. To the extent that funds for redemption can be accumulated at the cost of only the corporate tax, it is financially much more feasible to have the corporation redeem shares than to have the remaining shareholders purchase them.

⁵Int. Rev. Code of 1954, §§ 1201-02. Hereafter, references to the Code will be made simply by section number.

⁶Section 1014 provides that the basis of property includible in the gross estate of a decedent shall, in the hands of the estate, legatee, or heir, be fair market value at the transferor's death.

⁷§§ 531-37.

⁸§ 162.

⁹§ 163.

¹⁰See, for example, *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115 (1930); *Long Island Drug Co. v. Comm'r*, 111 F.2d 593 (2d Cir. 1940); *Wright-Bernet, Inc. v. Comm'r*, 172 F.2d 343 (6th Cir. 1949).

¹¹*John Kelley Co. v. Comm'r*, 326 U.S. 521 (1946); *Kraft Foods Co. v. Comm'r*, 232 F.2d 118 (2d Cir. 1956); *Wetterau Grocer Co., Inc. v. Comm'r*, 179 F.2d 158 (8th Cir. 1950).

¹²*Gooding Amusement Co., Inc. v. Comm'r*, 236 F.2d 159 (6th Cir. 1956), cert. denied, 352 U.S. 1031 (1957); *Ruspyn Corp.*, 18 T.C. 769 (1952); *Swohy Corp.*, 9 T.C. 887 (1947). See Bittker, *Thin Capitalization: Some Current Questions*, 34 *Taxes* 830 (1956); Note, *Gooding Test "What Was Stockholder Debtor's Intent?" Is Unfair*, 7 *J. Taxation* 70 (1957). For an excellent early article see Schlesinger, "Thin" Incorporations: Income Tax Advantage and Pitfalls, 61 *Harv. L. Rev.* 50 (1947).

A. Income Tax Consequences to Remaining Shareholder.

If Earl E. Dew and Cliff Jagget, the founders of our corporation, had retained all the shares originally owned by them, they each would own 50 per cent of the stock of Dujaggets, Inc. If, at the death or withdrawal of Earl E. Dew, the corporation redeems all the shares formerly owned by him, it is apparent that the proportional interest of Cliff Jagget would increase from 50 to 100 per cent. To accomplish this redemption, using the figures of our hypothetical case, assume that the corporation makes a distribution to the estate of Earl E. Dew consisting of money and property in the total amount of \$500,000. This would represent the net asset value of the shares. Could it be that the surviving shareholder, Cliff Jagget, has realized dividend income in the amount of the \$500,000 distribution, since this corporate expenditure benefited him, a shareholder, by doubling his proportionate interest in the corporation? Several early cases held he did not.¹³ However, where the surviving shareholder was legally obligated to purchase the shares of the deceased or retiring shareholder, the corporate expenditure resulting in the discharge of the survivor's legal obligation has been held to be taxable income to him.¹⁴ Two recent decisions of the Tax Court, both of which are now on appeal, have reached the result that the surviving shareholder whose proportionate interest is increased does realize dividend income to the extent of the amount distributed to the deceased or retiring shareholder.¹⁵ These cases reached this result without regard to whether the surviving shareholder was legally

¹³Ray Edenfield, 19 T.C. 13 (1952); Fred Fischer, 6 CCH Tax Ct. Mem. 520, P-H 1947 T.C. Mem. Dec. par. 47,131 (1947). Though the issue was not raised, Jackson Howell, 26 T.C. 846 (1956), reached the same result on its facts. On principle, though the facts are somewhat different, *Tucker v. Comm'r*, 226 F.2d 177 (8th Cir. 1955), is in accord with Edenfield and Fischer.

¹⁴*Wall v. United States*, 164 F.2d 462 (4th Cir. 1947). But see Fred Fischer, note 13 *supra*, in which the remaining shareholder was legally obligated either to buy or to find another buyer for the retiring shareholder's stock. Redemption to eliminate a cantankerous minority shareholder was upheld as serving a valid corporate business purpose.

¹⁵*Louis H. Zipp*, 28 T.C. 314 (1957). An appeal taken on August 21, 1957 by the remaining shareholders, Monroe Zipp and Bernard Zipp, to the Court of Appeals for the Sixth Circuit is pending. The Commissioner has acquiesced in the conclusion that the departing shareholder, Louis H. Zipp, received capital gain on the occasion of the redemption of his shares. 1957 Int. Rev. Bull. No. 45, at 7. Presumably, the protective appeal taken by the Government to the Fifth Circuit in the case of the departing shareholder will not be prosecuted. The other case is *Joseph R. Holsey*, 28 T.C. 962 (1957), appeal to the Court of Appeals for the Third Circuit filed by taxpayer on December 13, 1957.

obligated to purchase the shares redeemed by the corporation, and in at least one of them, it was clear that he was not.¹⁶

In the hypothetical case posed immediately above, while it is clear that the proportionate interest of the surviving shareholder, Cliff Jagget, increases from 50 to 100 per cent, is it true that Cliff actually is benefited? These Tax Court decisions appear to have overlooked the fact that while Cliff's percentage has doubled, the total net asset value of the corporation has at the same time been cut in half. Whereas the net asset value had formerly been \$1,000,000 of which 50 per cent or \$500,000 was owned by Cliff, the net asset value of the corporation after the redemption is only \$500,000 of which 100 per cent is owned by Cliff.

Carrying this analysis one step further, suppose that a "buy-sell agreement" between Earl E. Dew and Cliff Jagget had required the corporation to redeem the shares of the first to die at a price of \$300 per share, or a total of \$750,000 for one-half of the shares. Had such an agreement been carried out, the Tax Court would presumably have held that Cliff had \$750,000 of dividend income.¹⁷ And yet, it would be more accurate to say that Cliff had suffered a loss of \$250,000 in the value of his shares.¹⁸

¹⁶Holsey, *supra* note 15. While the Zipp case is not based upon the theory that the corporation discharged a legal obligation of the surviving shareholder to buy, the facts strongly suggest that such an obligation was created by the negotiations prior to redemption. The court stresses that, "In effect, they [the surviving shareholders] caused Paramount's [the corporation's] cash to be distributed for their benefit, i.e., to purchase all of Louis' [the departing shareholder's] stock."

¹⁷Under § 316, a shareholder can be held to have dividend income only to the extent that the corporation has either current or accumulated "earnings and profits." A distribution, not in exchange for stock, in excess of the "earnings and profits" is treated as a tax-free return of capital up to the amount of the basis of the shares. § 301(c)(2). Once basis has been entirely recovered, any excess is treated as capital gain. § 301(c)(3). See *Comm'r v. Hirshon Trust*, 213 F.2d 523 (2d Cir. 1954), cert. denied, 348 U.S. 861, 862 (1954); *Comm'r v. Timken*, 141 F.2d 625 (6th Cir. 1944). As to distributions made after June 22, 1954, see U.S. Treas. Reg. § 1.316-1(a)(2) and (3) (1954).

"Earnings and profits" is a phrase of art in the tax law. It is not identical with taxable income or with earned surplus. E.g., tax-exempt municipal bond interest is included in "earnings and profits." U.S. Treas. Reg. 118, § 39.115(a)-2. A stock dividend, while reducing earned surplus, does not reduce earnings and profits. § 312(d)(1)(B). However, in most cases, earned surplus will be the same as accumulated earnings and profits.

¹⁸Whereas the net asset value of Cliff's shares was formerly \$500,000 it is now reduced to only \$250,000. For all that appears in the lengthy but incomplete statement of facts in Zipp, *supra* note 15, the survivors may actually have suffered a decline in the net asset value of their shares. The serious weakness in both Zipp and Holsey, *supra* note 15, lies in the failure to state, let alone discuss, the facts regarding value of the survivor's stock interest before and after the redemption. See note 19 *infra*.

Suppose, on the other hand, that a "buy-sell agreement" between Earl E. Dew and Cliff Jagget had required the corporation to redeem the shares of the first to die at a price of \$150 per share (book value) or a total of \$375,000. In this situation, it is at least arguable that Cliff Jagget, the surviving shareholder, has benefited by the redemption. The net asset value represented by his shares has increased from \$500,000 to \$625,000, a difference of \$125,000.¹⁹ Yet even here, it is clearly wrong to suggest that his benefit and tax liability is measured by the amount distributed in redemption of the decedent's shares. Such an approach would result in attributing \$375,000 income to a transaction which at the most benefited the survivor by \$125,000.

Thus it appears that whether a surviving shareholder actually benefits from the redemption of the shares of others will depend altogether on the redemption price and its relation to actual value. If redemption is made at a price equal to the fair market value of the shares,²⁰ it is hard to see how any measurable benefit has been conferred upon the surviving shareholder. If the redemption price is more than actual value, the curious result is that the survivor suffers an economic loss, though probably not sufficiently realized to permit its deduction for tax purposes.

Finally, if the redemption price is lower than actual value, it may be that the shareholder is benefited, although the amount of his benefit bears no necessary relationship to the actual amount distributed in redemption of the retiring shareholder's stock. Indeed, the extent

¹⁹This appears to have been the case in *Joseph R. Holsey*, *supra* note 15. While the court does not discuss the fair market value of the shares, or even their net asset value, the corporation had an earned surplus of approximately \$300,000 on the date of the redemption, and the redemption price of a 50 per cent stock interest was only \$80,000. If the value of the corporate assets was not substantially short of their net book value, then the earned surplus, plus a small \$11,000 capital stock account, represented the minimum net asset value of the company. Thus, the surviving shareholder may have acquired an additional interest worth approximately \$150,000. The cash outlay of the corporation, \$80,000, was the amount attempted to be taxed. In this case, the option price was higher than value at the time it was originally granted in 1946. The increase in value taking place after the grant of the option led to the result that the option price five years later was actually a bargain. This possibility exists in any case where a buy-sell agreement involves a fixed price.

²⁰The foregoing discussion was based upon net asset value rather than fair market value. The author realizes that net asset value does not necessarily correspond to fair market value. History and prospects with regard to earnings, whether favorable or unfavorable, will also influence value. In the case of most small closely held corporations, net asset value would closely approximate fair market value. It should be recognized, however, that a controlling interest may be worth more than the net asset value of that number of shares, and that a minority interest may be worth less than the net asset value of the shares. See note 21 *infra*.

of his benefit is so difficult to ascertain that it probably should not be regarded as realized for tax purposes, any more than would be a corresponding loss.²¹

The important drafting consideration suggested by these cases is this: To the extent that redemption at a price below actual value might result in realized income to the survivor, this threat can be minimized by a proper provision regarding the redemption price, which is probably dictated by fairness anyway. If the redemption price is set at fair market value of the shares, the attribution of income to the survivor is rendered extremely unlikely.

Another powerful argument against the attribution of income to the survivor, whatever the redemption price, has been stated by Professor Surrey and Dean Warren:

"Is the result of a dividend [to the surviving shareholder] intended by a Congress which went to extreme pains in section 302(b)(3) to make sure that the redemption would not fail of accomplishment because of the fear of a dividend [to the deceased or retiring shareholder]. But a dividend result for [the surviving shareholder] would equally block the redemption."²²

B. Income Tax Consequences to Departing Shareholder.

The income tax consequences to the retiring shareholder or to the estate of a deceased shareholder involve important problems. The biggest difficulty presented is to make sure that when the stock is redeemed or purchased by the corporation the transaction will not be treated as essentially equivalent to the distribution of a dividend to the departing shareholder or his personal representative.²³ Dividend

²¹The discrepancy between net asset value and fair market value of shares, discussed in note 20, is one of the reasons why it may be impracticable to consider income as arising from the mere unascertainable increase in value of the survivor's shares. Cf. *Eisner v. Macomber*, 252 U.S. 189 (1920), holding that a shareholder does not realize income, within the meaning of the sixteenth amendment, from the distribution of an ordinary stock dividend, since in essence such distribution represents a mere increase in value of the underlying shares. While *Koshland v. Helvering*, 298 U.S. 441 (1936) found realized income where the stock dividend increased the recipient's proportional interest, there the taxpayer actually received property whose value was ascertainable. Even so, § 305 has abandoned the imposition of tax largely because of difficulties similar to those encountered in the Zipp-Holsey situation. See also *Burnet v. Logan*, 283 U.S. 404 (1931) and *J. Darsie Lloyd*, 33 B.T.A. 903 (1936), Acq. (and Nonacq. withdrawn) 1950-2 Cum. Bull. 3, holding that income is not realized even upon a sale where the value of the consideration received has no ascertainable fair market value.

²²CCH, Surrey & Warren, *Federal Taxation—Current Law and Practice*, par. 1214, p. 371 (Dec. 1957).

²³§§ 302(d), 301(c).

treatment has two drawbacks: (1) the entire amount received, without any offset for cost-basis of the shares, is taxed;²⁴ and (2) this amount is treated as ordinary income. The desired consequence would be to obtain capital gain treatment. In the case of the share purchase, this would mean: (1) the cost-basis of the shares is offset against the amount received before any gain is computed;²⁵ and (2) the resulting gain is taxed at a maximum rate of 25 per cent.²⁶ Where shares are redeemed from an estate, a capital gain redemption will frequently not result in any tax. This is because the cost-basis of the shares in the hands of the estate is equal to fair market value at the time of death.²⁷ Thus, the proceeds of a redemption occurring shortly after death will frequently equal the tax cost-basis, with the result that the gain is zero.

The Internal Revenue Code of 1954 usually treats stock redemptions as dividends to the extent that the corporation has either current or accumulated "earnings or profits."²⁸ However, several clear exceptions are made which can, after proper analysis, form the basis for a favorable advance opinion to the effect that a given stock redemption will result in capital gain treatment. Three of these exceptions are of interest to us in the planning stage.

First, a distribution in redemption of all the shares, preferred and common, owned by a particular shareholder will be treated as a capital gain transaction. This is called "termination of interest."²⁹ Also, if such a large number of shares is redeemed that the percentage of voting power and ownership of the particular shareholder is sharply reduced (to less than 80 per cent of what it was prior to the redemption), again capital gain treatment will be given. This is referred to as a "disproportionate redemption."³⁰ One or the other of these rules will frequently suffice to assure that a stock redemption during life will qualify. It is to be noted, however, that in both cases, the "family ownership rules" of section 318 apply.³¹ The effect of that section is to attribute to a shareholder whose shares are being redeemed the ownership of shares nominally and actually owned by other persons, if those persons bear certain designated relationships to the departing

²⁴See Katcher, *The Case of the Forgotten Basis*, 48 Mich. L. Rev. 465 (1959); U.S. Treas. Reg. § 1.302-2(c) (1955).

²⁵§§ 302(a), 1001(a).

²⁶See note 5 *supra*.

²⁷See note 6 *supra*.

²⁸§§ 302(d), 301(c), and 316(a). See note 17 *supra*.

²⁹§ 302(b)(3).

³⁰§ 302(b)(2). In any event, the shareholder must hold less than 50 per cent of the voting stock after the redemption. § 302(b)(2)(B).

³¹§ 302(c)(1).

shareholder. For the purpose of the "termination of interest" rule, though not for purposes of the "disproportionate redemption" rule, some relief from these family ownership rules is available if the departing shareholder undertakes not to reacquire an interest in the corporation, other than as a creditor, for ten years following the redemption.³²

Careful analysis of the particular factual situation is necessary, with special attention being given to the effect of the ownership attribution rules upon any contemplated redemption. Such an examination will frequently lead to the conclusion that a contemplated redemption will come within the rule regarding termination of interest. This provision, sometimes aided by the disproportionate redemption rule, will frequently assure capital gain treatment for redemptions of stock that take place while the shareholder is still living.

Where the shares are redeemed at death, the effect is a purchase from the estate of the deceased shareholder rather than from the deceased shareholder himself. In such a case, the estate attribution rules set out in section 318 treat an estate as owning the shares owned by its beneficiaries. In this circumstance, an entirely independent analysis is necessary, applying different principles based upon the last will and testament of the shareholder whose stock is being redeemed. Numerous problems arise, a thorough discussion of which is found elsewhere.³³

In cases where shares of stock owned by an estate are redeemed, an additional exception from dividend treatment is provided to the extent that such a redemption is made for the purpose of raising funds to pay estate and inheritance taxes and the cost of administration of the decedent's estate.³⁴ This provision may have the advantage of applying to a situation in which only preferred or non-voting stock is redeemed, and in general is useful where only a part of the shares are sought to be redeemed. On the other hand, the provision is limited to cases in which the shares of the corporation whose stock is being redeemed form a large portion of the decedent's estate.³⁵ This section certainly does not replace the others referred to

³²§ 302(c)(2).

³³See especially the articles by Hacker and by Winton and Hoffman, cited in note 1 *supra*.

³⁴§ 303.

³⁵The stock of the corporation (whose shares are being redeemed) must comprise more than 35 per cent of the gross estate or more than 50 per cent of the taxable estate of the deceased. Where a decedent owned more than 75 per cent of the total stock of two or more corporations, these holdings may be added together for the purpose of the 35 per cent or 50 per cent rule.

above, which in some cases, particularly where a large redemption is contemplated, may be far more useful.

C. Conclusion: Who Should Buy?

Because of the double tax on corporate earnings, it is extremely difficult for a surviving shareholder to accumulate enough funds to enable him to purchase the shares of a retiring shareholder. Therefore, it is financially more feasible for a corporation to redeem the shares of a departing shareholder. If the redemption price is set at fair market value, no income should result to the surviving shareholder by reason of the redemption of the shares of the retiring or deceased shareholder. With a careful eye to the attribution of ownership rules set out in section 318, most stock redemptions in connection with buy-sell arrangements can be made to qualify for capital gain treatment to the departing shareholder or his estate.

IV. WHO SHOULD BE BOUND?

There are numerous types of stock restrictions that have been employed for various purposes. Absolute restrictions on transfer are invalid as restraints on alienation, while many reasonable contractual restrictions are upheld.³⁶ The types of provisions in most common use today include the following:

I. Where the corporation is to buy shares

A. During the shareholder's life:

1. First offer—If a shareholder wishes to sell, he must first offer (at a price fixed in the contract) to the corporation which has an option to buy.
2. First refusal—similar to "first offer," except that in "first offer" the price is fixed by contract, whereas in "first refusal" the price is fixed by the shareholder when he desires to sell. This is a much less stringent restriction.

B. At the shareholder's death:

1. First offer.
2. First refusal.
3. Option—Corporation has option to buy at fixed price, whether *or not* the estate wishes to sell.
4. Binding bilateral contract.

³⁶This paper makes no pretense of completeness on the corporate law aspects of this problem. For two excellent discussions see O'Neal, *Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting*, 64 Harv. L. Rev. 773 (1952); and Bickel, *Keeping a Close Corporation Close*, 23 Ohio Bar 537 (1950).

II. Where the remaining shareholder is to buy shares

A. During the shareholder's life:

1. First offer.
2. First refusal.

B. At the shareholder's death:

1. First offer.
2. First refusal.
3. Option.
4. Binding bilateral contract.

The selection among these twelve possibilities will, of course, be governed largely by the practical goals sought to be achieved. It was recommended above that purchase by the corporation is generally advantageous; however, one may wish to protect against a failure of this plan (due to corporation law, dissenting shareholders, or practical financial obstacles) by providing for alternative purchase by the remaining shareholders.

Redemption will present problems under the corporation law of many states. Sometimes these problems can be handled by appropriate provisions in the articles of incorporation;³⁷ research may be necessary to ascertain the law on this point with respect to any particular state.

It will be recalled that where the surviving shareholder is legally obligated to purchase the shares of the departing shareholder, and where the shares of the departing shareholder are redeemed by the corporation, it has been held that the survivor realizes dividend income by the disbursement of corporate funds in discharge of his legal obligation.³⁸ This consideration renders inadvisable any provision binding the survivor to purchase the shares of the departing person.

A. *Pegging Estate Tax Valuation.*

One of the goals frequently sought to be achieved through the use of a buy-sell arrangement is to fix an upper limit on the value which may be attributed to the shares for estate tax purposes. To the extent that this can be done, controversy with Internal Revenue Service authorities, litigation, and, most important, costly overvaluation may be avoided. Numerous cases have given conclusive ef-

³⁷Ohio Rev. Code Ann. § 1701.35(A) (Baldwin Supp. 1957) authorizes a corporation to purchase its own shares, "(7) When the articles in substance provide that the corporation shall have a right to repurchase if and when any shareholder desires to, or on the happening of any event is required to sell such shares.

³⁸See note 14 *supra*.

fect to contractual provisions which bound the deceased shareholder's executor or administrator to sell at a fixed price.³⁹ Proposed treasury regulations recognize that, at least where the agreement is entered into at arm's length, it will fix an upper limit on estate tax valuation.⁴⁰ However, these regulations deny effect to a mere "first refusal." That is, the option price must be fixed in the contract and not fixed by the selling shareholder when he decides to sell. Most important, the regulations provide that, "Ordinarily, no effect will be given to an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his life." This view, the soundness of which may be questioned, has some support in the decisions.⁴¹ While it may be argued that if the personal representative is absolutely bound to sell at the fixed price, and that the absence of restrictions during the deceased shareholder's life is irrelevant, prudence dictates that agreements be drafted to conform to the regulations. Only in this way can the agreement attain its goal of simplifying estate tax valuation. Therefore, it is recommended that all shareholders should be subject to at least "first offer" restrictions at a fixed price⁴² during life, and that their executor or administrator should be similarly obligated.

B. *All or Nothing at All.*

Some estates have been embarrassed by a buy-sell agreement that confers upon the corporation or the surviving shareholders an option to purchase at a favorable price, but which apparently permits them to exercise that option as to all *or any part* of the shares held by the decedent. The importance of control in a closely held corporation is so paramount in ascertaining value that frequently the estate is threatened with a partial exercise of the option leaving the estate holding an unmarketable minority interest whose value is uncertain. In order to guard against this situation, it seems advisable to require

³⁹May v. McGowan, 194 F.2d 396 (2d Cir. 1951); Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Comm'r v. Bensel, 100 F.2d 639 (3d Cir. 1938); Brodrick v. Gore, 224 F.2d 896 (10th Cir. 1955); Estate of Lionel Weil, 22 T.C. 1276 (1954).

⁴⁰Proposed Estate Tax Reg. § 20.2031-2(h) (1956).

⁴¹Robert R. Gannon, 21 T.C. 1073 (1954); Estate of George M. Trammell, 18 T.C. 662 (1952); Estate of James H. Matthews, 3 T.C. 525 (1944); Clare G. Hoffman, 2 T.C. 1160 (1943), aff'd on other issues, 148 F.2d 285 (9th Cir. 1945), cert. denied, 326 U.S. 730 (1945); Estate of Edward R. Armstrong, 3 CCH Tax Ct. Mem. 77 (1944), aff'd, 146 F.2d 457 (7th Cir. 1945).

⁴²The difficult problem of what to use for the option or contract price is discussed *infra* under the heading "Price."

the corporation or the surviving shareholders, as the case may be, to exercise their option as a whole or not at all. Of course, a binding contract obligating the corporation to buy all shares, or all shares offered by the estate, would protect against this hazard.⁴³ As mentioned above, a contract binding the surviving shareholders to buy is inadvisable since it may cause any redemption to give rise to dividend income to the surviving shareholders.

C. The Option Rule.

In determining whether a particular departing shareholder realizes ordinary dividend income or capital gain from the amounts paid in redemption of his shares, it will be recalled that the shares of stock owned by certain close relatives are treated as owned by the shareholder whose shares are redeemed. In addition, section 318 provides that any shareholder whose shares are redeemed shall be treated as owning any shares which he "has an option to acquire..." Buy-sell agreements frequently take the form of giving "options" or "rights to purchase" to surviving shareholders in the event that another shareholder either desires to sell during life or dies owning shares. The thought occurs: could these "options" given to surviving shareholders cause the holders to be treated as the owners of the shares subject to the option for the purpose of determining whether any redemption is to be treated as a dividend to the departing shareholder?⁴⁴

This problem can be illustrated by the following example based upon our hypothetical facts. Suppose that all the shareholders of Dujaggets, Inc., had entered into an agreement whereby each was given a right to a first offer to buy his proportionate part of the shares of any shareholder who might desire to sell. Suppose that Earl E. Dew desires to have some or all of his shares redeemed by Dujaggets, Inc. The family ownership rules of section 318 will attribute to Earl the ownership of the following shares: 1,500 shares owned by Earl E. Dew, 500 shares owned by his wife, and 500 shares owned by his son, or a total of 2,500 shares. If the buy-sell agreement is treated as conferring upon Earl an option to acquire his proportionate part (30 per cent) of the shares owned by the other shareholders, the result would be to attribute to Earl the ownership of the following addi-

⁴³A contract binding the corporation to redeem raises difficult corporate law problems. See note 37 *supra*. It may be wise to provide that, in any event, a shareholder shall not be bound to accept redemption of a smaller number of shares than would qualify for assured capital gain treatment under § 302.

⁴⁴Mr. Donald C. Alexander of the Cincinnati Bar called the problem to the writer's attention.

tional shares:⁴⁵ 450 shares, which is 30 per cent of the 1,500 shares owned by Cliff Jagget; 150 shares, which is 30 per cent of the 500 shares owned by Jagget's wife; and 150 shares, which is 30 per cent of the shares owned by Jagget's daughter, or a total of 750 additional shares. The total number of shares so attributed to Earl would be 3,250.

If this threat is real, the situation is even worse than would appear at first glance. This is because there is some relief from the *family* ownership rules if a shareholder completely and permanently terminates his own actual interest in the corporation.⁴⁶ Thus, were it not for the option rule, a redemption of all 1,500 of the shares owned by Earl in his own name would qualify for capital gain treatment. However, section 302(c) provides for relief from only the *family* ownership rules of section 318; the rules of constructive ownership based upon other factors, including holding an option, apply without exception. The Internal Revenue Service has not taken an official position on this question.

However, to regard the holder of a right to a "first offer" as the holder of an "option to acquire" within the meaning of the constructive ownership rules of section 318 seems unreasonable. The surviving shareholder really has no option at all until and unless another shareholder decides to sell his shares. It seems highly improbable that section 318 would apply to a right which is subject to an unpredictable condition precedent.

Suppose that in the event of the death of one of the other shareholders, Earl E. Dew would have an absolute "option to acquire" the shares from the estate of the deceased shareholder. As in the case of the first offer during life, the "option" ripens only upon a condition; here the death of one of the shareholders. While this condition is certain to occur at some time, it is not certain to occur during the life of any particular "surviving" shareholder. That is, while each of the other shareholders will certainly die at some time, there is no certainty that Earl will survive any one of them. The likelihood of his surviving all is probably very small. Therefore, it seems incorrect to regard Earl as the holder of an "option to acquire" within the meaning of section 318, at least while all other shareholders are living.

Nevertheless the possibility exists that the option rule applies to "first offers" and options (effective at death) conferred upon "surviv-

⁴⁵The exact percentage which any surviving shareholder is entitled to purchase can be ascertained only when it is known which other shareholder is departing. Absent such information, the 30 per cent figure is certainly not too high. The actual figure may be higher.

⁴⁶See note 32 supra.

ing" shareholders by possible future "departing" shareholders. The draftsman may regard this possibility as serious enough to justify efforts to preclude the untoward results which can be conjured up.

The drafting problem is twofold: (1) to safeguard a redemption during a particular shareholder's life, and (2) to protect a redemption of a deceased shareholder's stock.

In the case of a redemption of shares during the particular shareholder's life, it has been suggested⁴⁷ that if the "first offer" is drafted in such a manner that it will "run with the shares," the option rule will not seriously threaten the redemption. That is to say, if the first offer ceases to be available to a shareholder instantaneously upon his ceasing to be a shareholder, at least a complete termination of interest ought to be accomplished without difficulty. It is true that in the split second before the entire holding of shares would be redeemed, the departing shareholder might have held an "option" and hence owned some shares not redeemed. However, this seems insignificant in view of the fact that immediately after the redemption, the departing shareholder would hold no shares either outright or by virtue of the expired "option." Although this solution will suffice only in the case of a complete termination of interest, it seems to the writer to be reasonably satisfactory in this most common situation. Following is a clause which might be inserted in first offer arrangements dealing with restrictions on inter vivos transfer. The purpose is to make clear that the option runs with the shares.

The right to purchase conferred upon the remaining shareholders by this agreement is intended to run with the shares; a remaining shareholder's right to purchase shall cease instantaneously when he ceases to be a shareholder, whether by transfer to a third person (who shall then have the rights) or to the corporation.

The other drafting problem raised by the option rule is protecting the estate of a deceased shareholder from dividend treatment when the deceased's shares are redeemed. Buy-sell agreements frequently provide that their provisions will apply and inure to the benefit of the personal representative of any deceased shareholder. The problems raised by the option rule may call for a revision of this clause. While it is frequently desirable to have the estate of the deceased shareholder bound by first offer, option, or bilateral contract, practical necessity

⁴⁷The suggestion was made by Mr. Donald G. Rowlings of the Cincinnati Bar. It may well be that the operation of law would bring the same result as the draft proposed below.

would rarely require that the estate succeed to the "first offer" restrictions or to the option to buy in the event of the death of *another* shareholder. If the personal representative of the deceased shareholder is entitled to such rights, the option rule of section 318 may make him a constructive owner of a proportionate part of all stock owned by the surviving shareholders. Such a result might be catastrophic. A redemption of the estate's shares could never qualify as a complete termination of interest, and accomplishing a disproportionate redemption might be rendered exceedingly difficult, if not impossible.

The author offers a suggested solution to this problem, embodied in the following clause to be inserted in buy-sell agreements. Its purpose, obviously, is to prevent the estate of a deceased shareholder from succeeding to the first offer or option rights possessed by the deceased shareholder himself.

The executor or administrator, heirs, next of kin, devisees, legatees, or any other assignee or transferee of a shareholder shall be subject to all restrictions and duties herein provided. However, in the event of death of a shareholder, any right to purchase from other shareholders conferred by this agreement shall terminate instantaneously and the shareholder's personal representative shall have no right to purchase the shares of any other shareholder who may die or may wish to sell.

D. Conclusion: Who should be bound?

Many considerations, some of which have not been mentioned here, may enter into this decision. Speaking generally, the following conclusions seem advisable to the writer. Most objectives will be accomplished by first offer restrictions, at a fixed price, during life, coupled with a binding contract or option at death. Any option at death should be exercisable only as a whole, and not in part. Agreements binding the surviving shareholders to purchase should be avoided. Agreements binding the corporation to purchase may be desirable if corporate law and practical financial obstacles can be overcome. In drafting first offer and option restrictions, it may be advisable to attempt to avoid the problems posed by the option rule of section 318. This can be accomplished by making the option "run with the shares," and not permitting the personal representative of a shareholder to succeed to the decedent's rights to purchase.

V. PRICE

Perhaps the most frequently used method of setting the price is to refer to book value of the shares as shown by a financial statement prepared reasonably near the date of sale under the contract. The

advantages of book value are principally two: (a) it is ascertainable with reasonable accuracy and ease, and (b) its use in times of inflation, when actual value frequently exceeds book (based on historic cost), can sometimes result in substantial estate tax savings. Two notes of warning must be sounded. If the buyer under a favorable book value contract is the natural object of the seller's bounty, as in the case of a father-son sale, the Internal Revenue Service holds that the restrictions are not conclusive in establishing estate tax value.⁴⁸ While some cases reach different results,⁴⁹ the persuasive force of the Treasury's position casts considerable doubt on the effectiveness of any scheme to mask a legacy with a buy-sell arrangement. If the buyer is not the natural object of the seller's bounty, a sale at book value when such value is far short of actual value has the effect of diverting a substantial amount of the seller's property and estate into the hands of persons not dependent on him and away from his own family.

In times of inflation, and in times of depression as well, the only fair price is fair market value at the time of sale. Furthermore, as seen above, such a price will minimize the risk of the realization of income by the surviving shareholders from the distribution of corporate funds in redemption of the retiring shareholder's stock.

If fair market value is not immediately ascertainable from any convenient source, probably the most satisfactory way of determining the value is through the use of arbitration. The typical tripartite arbitration body can be established, one member to be appointed by the selling shareholder, one member to be appointed by the corporation or the purchasing shareholder, as the case may be, and these two to appoint a third. One important caveat: courts sometimes regard contractual provisions for the ascertainment of value of property as intending something less binding than arbitration.⁵⁰ It is therefore a wise precaution to state expressly that:

The arbitrators' determination of fair market value shall be absolutely binding and conclusive on all parties and their successors in interest and may not be questioned in any subsequent proceedings.

⁴⁸See note 40 *supra*.

⁴⁹For example, *Brodrick v. Gore*, note 39 *supra*.

⁵⁰The Ohio cases support arbitration to fix price. *Brennan v. Brennan*, 164 Ohio St. 29, 128 N.E.2d 89 (1955). Cf. *Fitzgerald v. Continental Ins. Co.*, 275 App. Div. 453, 90 N.Y.S.2d 430 (3d Dep't 1949). The author is indebted to Professor Carl H. Fulda, College of Law, The Ohio State University, for help on the arbitration question.

While vast estate tax savings may not be possible under a buy-sell agreement providing for sale at actual or fair market value, one may rest assured that arbitrators, one of whom represents the buyer, are not likely to overvalue stock of a closely held corporation, frequently an almost unmarketable asset. The cases giving conclusive effect for estate tax purposes to a fixed price restriction should apply as well to a price fixed at fair market value as determined by arbitration. Since the arbitration will be binding on the parties it should be as determinative for estate tax purposes as a fixed price stated in the contract in terms of dollars.

VI. TO FUND OR NOT TO FUND?

That is the question. The practical advantage is obvious of providing funds to finance: (1) the redemption of shares, or (2) the purchase of shares by surviving shareholders. Persons entering into such an agreement do so with greater confidence and willingness if they are assured that all other parties will be able to meet the financial obligations which eventually will arise. Life insurance has been used for this purpose for many years. This form of funding possesses the unique advantage that the full amount of the needed funds can be assured no matter how early the need may arise. Unfortunately, funding, by life insurance or otherwise, presents numerous possibilities of very adverse tax consequences, whether the plan contemplates a redemption or a purchase by the surviving shareholders. Every draftsman must at least be familiar with the problems involved. While space does not permit exhaustive consideration of these problems, many of which are thoroughly discussed in other articles,⁵¹ an attempt will be made to highlight the trouble spots and briefly indicate the state of the present case law with regard to each.

A. Reciprocal Insurance: Double Estate Tax Inclusion?

Sometimes shareholders will enter into an agreement whereby each takes out life insurance on his own life. This life insurance is then transferred to a trustee who holds all policies. Premiums are paid reciprocally, each shareholder paying his proportion of the premiums on the insurance on the lives of the others. In the event of death of any shareholder, the trustee is to apply the proceeds of insurance on the deceased shareholder's life to pay the purchase price of the decedent's shares, which are then acquired by the survivors.

⁵¹See note 1 *supra*, especially Lawthers.

As recently as 1951, the Internal Revenue Service has maintained that *both* the stock and the life insurance are subject to estate tax in the estate of the deceased shareholder. Of course, the stock is taxable as property owned by the decedent at the time of his death, even though it is subject to option or contract to buy in favor of the surviving shareholders. The theory for including the life insurance proceeds is that the decedent, indirectly through the reciprocal arrangement, possessed the incidents of ownership of the policy on his life and hence was taxable under section 2042. However, the proceeds of the life insurance are, under the agreement, in effect allowed to the survivors as a reduction of their purchase price of the stock. Therefore, say the courts, it would be inequitable to tax both the life insurance and the full value of the stock.⁵² The deceased shareholder's estate has only the insurance or the stock at full value, not both.

B. Payment of Premiums by the Corporation: Income to Shareholders?

The Courts of Appeals of two circuits have recently completed work on the deactivation of two Tax Court bombshells called *Casale*⁵³ and *Prunier*.⁵⁴ A third case is presently receiving the attention of the Court of Appeals for the Tenth Circuit.⁵⁵ Meanwhile, the Ninth Circuit, while giving judgment for the taxpayers, occasions speculation over menacing negative implications.⁵⁶ Troubled as the waters are, we must venture forth upon them in the hope of salvaging "the fragile bark"⁵⁷ called Closely Held Corporation.

⁵²Estate of Ray E. Tompkins, 13 T.C. 1054 (1949), acq. 1950-1 Cum. Bull. 5; Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938), acq. 1938-1 Cum. Bull. 20; M. W. Dobezensky, 34 B.T.A. 305 (1936) (NA); Boston Safe Deposit & Trust Co., 30 B.T.A. 679 (1934); Estate of G. C. Ealy, 10 CCH Tax Ct. Mem. 431 (1951); Stuetzer, Some Business Life Insurance Income Tax Problems, 11 N.Y.U. Institute on Federal Taxation 109, 124 (1953).

In order to avoid the reciprocal transfer problem, it might be advisable (though perhaps impracticable) for each shareholder to take out a policy on the life of each other shareholder, the proceeds payable to the owner of the policy. This course has the blessing of the Treasury Department. Rev. Rul. 56-397, 1956-2 Cum. Bull. 599.

⁵³*Casale v. Comm'r*, 247 F.2d 440 (2d Cir. 1957). The Government will not seek Supreme Court review. Note, 26 U. Cin. L. Rev. 642 (1957). Many of the articles cited in note 1 *supra* are devoted to this case and to *Prunier*, *infra* note 54.

⁵⁴*Prunier v. Comm'r*, 248 F.2d 818 (1st Cir. 1957). The Government will not seek Supreme Court review.

⁵⁵*Sanders v. Fox*, 149 F. Supp. 942 (D.C. Utah, 1957), appeal to Tenth Circuit filed by taxpayer June 14, 1957.

⁵⁶*Doran v. Comm'r*, 246 F.2d 934 (9th Cir. 1957). The Government will not seek Supreme Court review. As to the negative implications, see Lawthers, *The Fragile Bark of the Small Corporation*, 12 J. Am. Soc'y C.L.U. 4, 17 (1957).

⁵⁷Lawthers, cited in note 56 *supra*, credits the phrase to Judge Staley in *Emeloid, Co., Inc. v. Comm'r*, 189 F.2d 230 (3rd Cir. 1951).

The present cases seem to justify the following tentative conclusions: 1. Where the corporation pays the premiums on life insurance purchased to fund a buy-sell agreement, premium payments will not constitute realized dividend income to the shareholders if the life insurance is an asset of the corporation alone in every respect. This means that the corporation should have all incidents of ownership, both nominally and equitably, and that the insurance policy must be available to creditors of the corporation in the event of bankruptcy. 2. If life insurance is owned by a trustee for the shareholders, who possesses the incidents of ownership, and if the policy is not available to creditors of the corporation in the event of insolvency, then the proceeds, when received by the trustee and applied in payment for the decedent's shares, will be exempt from tax as life insurance proceeds under section 101. It has been suggested that in this instance there is a negative implication that the premiums paid by the corporation are properly taxable as realized dividends to the shareholders at the time the premiums are paid.

In conclusion it appears probable that a shareholder will not be taxed on the premiums paid by the corporation if the policy is in every sense a corporate, and not a shareholder, asset.

C. *Accumulated Earnings Tax.*

To this writer, the threat of the imposition of the accumulated earnings tax on earnings set aside to fund the redemption of stock presents the most serious menace of all to funded stock redemption plans. The Seventh Circuit's recent unhesitating affirmance of the Tax Court's strong medicine in the *Pelton Steel* case⁵⁸ shows the gravity of this danger.

Sections 531-37 impose a penalty tax, in addition to the ordinary corporate tax, on a corporation which is "formed or availed of" to prevent the imposition of income tax on its shareholders. The measure of the annual tax is from 27½ to 38½ per cent of the "accumulated taxable income" of the corporation. In order to arrive at the "accumulated taxable income" on which the annual tax is imposed, two major items are subtracted from "taxable income." The first is the federal income tax. The second is an "accumulated earnings credit" which is generally equal to "such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business. . .,"⁵⁹

⁵⁸*Pelton Steel Casting Co. v. Comm'r*, 251 F.2d 278 (7th Cir. 1958). The note in 7 J. Taxation 96 (1957) discusses the case in the Tax Court.

⁵⁹§ 535(c)(1).

including the "reasonably anticipated needs of the business."⁶⁰ The accumulation of earnings "beyond the reasonable needs of the business" is "determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."⁶¹ The 1954 Code shifts the burden of proof on the question of reasonable needs of the business to the Government if the taxpayer, in a deficiency case, submits a timely statement "of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business."⁶²

In *Pelton Steel Casting Co. v. Commissioner*,⁶³ three persons owned all the common stock. A owned 60 per cent and B and C each owned 20 per cent. A and B wished to dispose of their interest in Pelton Steel, but C desired to avert an outside sale. C, who had made the business of Pelton Steel his life's work, was very concerned that Pelton might become a "captive foundry," engaged solely in filling the requirements of a large steel company. C did not like the idea of Pelton Steel becoming a subsidiary of some out-of-town corporation, with possible harmful effects on employee relations and the status of key men in the organization. It was finally agreed in 1946 that the corporation would buy up and redeem 80 per cent of the common stock, all that was held by A and B. The redemption price was placed at 80 per cent of the selling price of the corporation's assets when offered to outsiders.

The following quotation from the opinion of the Court of Appeals is clearly indicative of the principal basis for the decision:

"Financiers planning Pelton's purchase of the common stock advised against a declaration and payment of dividends during 1946."

Both courts held that the accumulated earnings tax was properly imposed for the year 1946. The Court of Appeals rejected, for reasons that are not entirely clear, the taxpayer's assertion that maintaining the existence of Pelton Steel as an independent corporation constituted a valid corporate business purpose. In part this conclusion appears to have been based on an affirmance of the Tax Court's "ultimate finding of fact" which did not appear to the Court of Appeals to be "clearly erroneous." One sees here the ghost of the *Dobson*

⁶⁰§ 537.

⁶¹§ 533(a).

⁶²§ 534.

⁶³See note 58 supra.

rule,⁶⁴ which tax lawyers and Congress thought was interred by a 1948 statutory amendment.⁶⁵ The court distinguished two similar cases that had been decided favorably to the taxpayers on the ground that they had involved redemption of shares representing a minority interest, whereas in *Pelton* the majority stock interest was redeemed. The terseness of the court's discussion of this point leaves doubt as to the relevance of this distinction. It may be germane, however, since buying out a disagreeable minority shareholder frequently is justified as serving to maintain harmony in the conduct of the corporation's affairs, and in corporation-shareholder relations. However, it seems hard to conceive of a clearer corporate business purpose than buying out the majority interest in order to make possible the continued corporate existence and independence of the corporation.

Unfortunately, the Supreme Court reviews an extremely small number of tax cases each year, and review of this decision is statistically improbable. The fact that no dividends were paid, a fact exceptionally favorable to the Government, makes the case distinguishable from many that will arise involving similar issues. The weakness in the court's reasoning, coupled with the existence of authority favoring the taxpayer,⁶⁶ makes a taxpayer victory in another circuit not improbable.

Meantime, however, the case on its reasoning appears to block deliberate funding of corporate redemption plans. Depending upon the circumstances, the accumulated earnings tax will either put the shareholders in the same overall position as though they had pur-

⁶⁴*Dobson v. Comm'r*, 320 U.S. 489 (1943) held that if the question decided by the Tax Court involved less than a clear-cut question "of law," appellate courts should not substitute their judgment for that of the highly expert Tax Court.

⁶⁵In 1948, § 1141(a), Int. Rev. Code of 1939, was amended so as to provide that the courts of appeals should have the same power to review Tax Court decisions as they have to review decisions of district courts sitting without a jury. 62 Stat. 991. The provision is now to be found in Int. Rev. Code of 1954, § 7482(a). Rule 52(a) of the Federal Rules of Civil Procedure provides that such findings of fact are to be set aside only if "clearly erroneous." The intention was clearly to change the effect of the *Dobson* decision, note 64 *supra*.

⁶⁶*Dill Manufacturing Co.*, 39 B.T.A. 1023 (1939); *Gazette Publishing Co. v. Self*, 103 F. Supp. 779 (D. Ark. 1952). The authority of the *Gazette* case is weakened by the fact that apparently the idea of buying out a shareholder arose after the taxable year as to which the earnings tax was sought to be imposed. In *Emeloid Co. v. Comm'r*, 189 F.2d 230 (3rd Cir. 1951), the agreement to use life insurance proceeds to redeem stock was executed after the taxable year in question, and the court expressed doubt as to its relevance. The case did not involve the accumulated earnings tax, but the borrowed capital credit for purposes of excess profits tax. It was held that the "key man" life insurance served a valid corporate business purpose. Some of the court's language is certainly in conflict with the viewpoint of the Seventh Circuit in *Pelton Steel*, note 58 *supra*.

chased the shares out of their own double-taxed income, or perhaps in an even worse position. The great advantage of redemption plans over shareholder stock purchase plans may be completely lost or even overbalanced by the additional cost of the accumulated earnings tax. Until this case is either reversed or counterbalanced by similarly weighty authority favoring the taxpayer, it is this writer's view that a funded redemption plan, at least for a majority interest, involves an unreasonable risk. Perhaps one solution to the funding problem would lie in having the corporation borrow money to finance the redemption when the necessity arises.⁶⁷

Taxpayers' counsel can hope that the depressing effect of the *Pelton* case will be weakened in the not too distant future, perhaps opening the way for the resumption of funding of this reasonable business need before the immediate financial requirements are encountered.

D. Conclusion: To Fund or Not to Fund?

While double estate tax inclusion is not a serious threat, insurance funding of shareholder-purchase plans can be accomplished only at the cost of the double tax. That is, either the premiums must be paid by the shareholders out of double-taxed income, or, if the corporation pays the premiums for a trust fund available to the shareholders, dividend income will probably arise with each premium payment.⁶⁸ On the other hand, funding within the corporation involves a serious threat of the accumulated earnings tax if the debatable reasoning of the *Pelton* case is rigorously followed. Some taxpayers' counsel may dismiss *Pelton* because no dividends were declared during the period in question, and because the reasoning does not strongly commend it as an authority in the decision of other cases. However, until its force is weakened, many will feel that deliberate funding of a stock redemption plan cannot be recommended. While the decision stands, a redemption plan may have to be carried into effect by borrowing, which might include the issuance of secured long term negotiable notes to shareholders in exchange for the redeemed stock.⁶⁹

⁶⁷Query whether the use of earnings *subsequent* to redemption to discharge debt incurred to finance the redemption, is immune to attack under § 531. Where corporation notes are issued to former shareholders in exchange for their stock, the debt would be an integral part of the redemption transaction. Is this latter transaction safer under § 531 than borrowing from outsiders? The departing shareholder may not be satisfied to accept corporate notes, although in many cases there may be no real alternative.

⁶⁸See note 56 *supra*.

⁶⁹See note 67 *supra*.

VII. CONCLUSION

A corporation-life-insurance-funded redemption plan accompanied by first offer restrictions during life and an option at death is perhaps the most desirable arrangement. Until the *Sanders* case⁷⁰ is decided on appeal, and *Pelton Steel*⁷¹ is somehow weakened or counteracted, such funding involves tax hazards so serious that, at least for the time being, funding is hazardous.

A feasible alternative that can be immediately employed is an agreement that provides: (1) during the life of the shareholder his first offer must be made to the corporation, and if the corporation declines, an offer of a proportionate number of shares must be made to remaining shareholders; (2) a binding option entitles the corporation to purchase from the estate of a deceased shareholder, and the surviving shareholders to purchase a proportionate number of shares if the corporation declines. Appropriate safety valve provisions should be inserted to protect selling shareholders and estates from fragment purchases and from being required to redeem a smaller or larger number of shares than would qualify for assured capital gain treatment under sections 302 and 303. The possible shareholder purchase could be partially funded by shareholder-owned life insurance paid for by shareholders with no tax risk to the corporation and with shareholders getting the full benefit of the insurance for which they might be taxed (under *Sanders*) even if corporation-owned.

⁷⁰See note 55 supra.

⁷¹See note 58 supra.