

# LEGAL ALERT

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## **BUY-SELL AGREEMENTS: *When was the last time that you reviewed the price under your Buy-Sell Agreement?***

**By George F. Bearup, Attorney**

It comes as a surprise to many that if they own an interest in a closely-held business that uses a Buy-Sell Agreement, which specifies what will be paid for their interest in the business at their death, that the agreement may not be binding with the IRS. The IRS is free to disregard for estate tax purposes a specified value for the decedent's interest in the business under a Buy-Sell Agreement, and revalue the business owner's interest.

What is important to keep in mind is that while the IRS is free to ignore the value established in a Buy-Sell Agreement for a person's business interest, IRC §2703 does *not* affect a contractual obligation that the decedent's estate carries to sell the business interest at the agreed upon price. It only affects the value of the business interest for transfer tax calculation purposes. This causes a situation where the decedent's estate could be obligated to sell the decedent's business interest for the price set in the Buy-Sell Agreement, and yet have to pay an estate tax based on a much higher "fair market value" for estate tax purposes. In some cases, the amount received under the agreement will not cover the estate tax due on the business interest.

IRC §2703 permits the IRS to disregard the value set in a Buy-Sell Agreement, or a similar agreement, for transfer tax purposes. IRC §2703 causes all rights, restrictions and other price provisions included in such an agreement, like a Buy-Sell Agreement, to be ignored for the purpose of determining the business interest's value for

transfer tax purposes. IRC §2703 was created to address perceived abuses in connection with Buy-Sell Agreements. Unfortunately, it is widely applied to all other types of business agreements, such as partnership agreements, LLC Operating Agreements, options, Articles of Incorporation, and Bylaws. The perceived abuse that IRC §2703 is intended to address is the presumption that a parent will set an artificially low buy-out price which, upon his death, will allow his child or the surviving business owners to purchase the parent's business interest for less than its fair market value. Without IRC §2703, the value that the child pays the deceased parent's estate for the parent's business interest would normally establish the value of the parent's business interest for federal estate tax purposes, because that is the price the estate is legally obligated to sell at.

There is, however, a *safe harbor* built into IRC §2703. For a Buy-Sell Agreement to be respected for federal transfer tax purposes, IRC §2703(b) sets forth a multi-step "safe harbor;" all steps must, however, be met. The steps include: (i) the offering price must be fixed and determined under the agreement; (ii) the agreement must be binding on the parties both during life and after death; (iii) the agreement must be entered into for a bona fide business reason; (iv) the agreement is a *bona fide* business arrangement; (v) the agreement is not intended as a device to transfer property to members of the decedent's family for full and adequate consideration in money and money's worth; and (vi) the agreement's terms are

comparable to similar arrangements entered into by individuals who are engaged in arms-length transactions. IRC §2703 places the burden of proof on the estate that the value as specified in the agreement is *bona fide*, is not a testamentary device, and that is *comparable* to other business transfer arrangements.

Since the primary abuse for which IRC §2703 was created was to prevent artificially low Buy-Sell Agreement values in transfers between parents and their children, IRC §2703 normally does *not* cover agreements between non-family members. As you might imagine, though, the scope of an “applicable family member” as defined by the Regulations is often much broader when the IRS is calling the shots. Consequently, it is possible for a non-family member to be considered a “family member” for purposes of IRC §2703 and its broad application and burden of proof that it imposes.

Many existing Buy-Sell Agreements provide that business owners will annually meet to establish a new value for their shares of stock or their partnership or LLC units. When the shareholders fail, year after year, to revisit and re-establish the value of a share of stock or other business interest as required under the terms of their Buy-Sell Agreement, that fact, standing alone, will be viewed by the IRS as a sign that the agreement was created primarily with a testamentary purpose in mind, thus failing the *safe harbor test*.

Recently the U.S Tax Court identified eight different facts by which a Buy-Sell Agreement

might trigger the “testamentary purpose” test: (i) the decedent’s poor health when he entered into the agreement; (ii) no negotiations of the agreement’s terms among family members; (iii) inconsistent enforcement of the agreement provisions; (iv) the failure to seek significant professional advice when selecting a formula price for the agreement; (v) the failure to obtain or rely on appraisals when selecting a formula price; (vi) the exclusion of significant assets from the formula price; (vii) the decedent’s business arrangements tend to fulfill his general testamentary intent, e.g., a stock is sold to the decedent’s children in shares of equal value; and (viii) ***there was no periodic review or modification of the formula price contained in the Agreement.***

The U.S. Tax Court has also suggested that a substantial modification to a Buy-Sell Agreement may also be the failure to update a right to set a more current price under the agreement that requires periodic updates to the buy-out price.

The message is clear. If you use a Buy-Sell Agreement that is intended to provide for the liquidity to your estate at the time of your death with a binding

obligation to purchase your business interest at a specified price, do as you promised under that agreement. Annually revisit that specified price and try to bring it as close to fair market value as you can.

*George is the chair of the Business and Individual Planning group at Smith Haughey. He can be reached directly at 231.486.4510 or [gbearup@shrr.com](mailto:gbearup@shrr.com).*

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