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Federal Taxation - Tax Aspects of Corporate Buy and Sell Agreement

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COMMENTS

FEDERAL TAXATION—TAX ASPECTS OF CORPORATE BUY AND SELL AGREEMENTS—One of the major problems faced by a closely-held corporation is that of providing for the orderly continuation of the corporation on the death of one of its shareholders. A common solution to the problem is the utilization of a buy and sell agreement in the form of either a stock purchase or cross purchase agreement. A stock purchase agreement, often called a stock redemption agreement, provides that the corporation will buy the deceased shareholder's stock upon his death.¹ A cross purchase agreement provides that a surviving shareholder,² as distinguished from the corporation, will buy the decedent's interest on his death. The funds for either type of purchase agreement can come from cash accumulated by the survivor or the corporation, but the most common source is the proceeds of a life insurance policy.³ Since the method of financing is fairly unimportant to this discussion,⁴ it will be assumed that the agreements are funded by insurance. If a different result would follow in a particular instance by financing through the accumulation of cash, specific reference will be made to that difference.

It is the purpose of this comment to consider the tax problems connected with both types of "conventional" corporate buy and sell agreements.⁵ It should be recognized, however, that there are

¹ Agreements of this sort have also been referred to as stock redemption agreements or survivor purchase agreements, but will be referred to herein solely as stock purchase agreements. Deceased shareholder will be used to refer to the party to the agreement who dies first.

² Surviving shareholder or survivor will be used herein to refer to the shareholder to the agreement who survives.

³ If a cross purchase agreement is used, each shareholder will purchase insurance on the life of the other shareholders and will name himself as beneficiary. Other methods, such as the purchase of insurance on one's own life with oneself as beneficiary and a provision in the agreement for the share to transfer automatically to the survivor, can be used but are dangerous. See part I-B-4 *infra*. If a stock purchase agreement is used, only one policy need be purchased by the corporation on the life of each shareholder and the corporation will name itself as beneficiary.

⁴ Most of the problems discussed will apply to both methods of financing.

⁵ "Conventional" is used here to mean a properly executed agreement with all of the necessary provisions. This agreement will be compared with the improperly drafted agreements that are presented by the cases. See Jones and Gleason, "Casale Reversed: Corporate Insurance Not Dividend to Controlling Stockholder," 7 J. TAXATION 258 at 262 (1957); Mannheimer and Friedman, "Stock-Retirement Agreements—The Prunier and Sanders Cases," 35 TAXES 567 (1957). Many of the problems of corporate buy and sell

many questions of local law and business necessity that also exert influence on the use of such agreements.⁶

I. STOCK PURCHASE AGREEMENTS

A. Operation of the Agreement Before the Death of One of the Parties

1. *Income Tax Liability of the Shareholders for Premium Payments.* When insurance is used to finance a stock purchase agreement, there is a possibility that the payment of premiums by the corporation will be considered a constructive dividend to the shareholders.⁷ Yet three recent cases, *Casale v. Commissioner*,⁸ *Sanders v. Fox*,⁹ and *Prunier v. Commissioner*,¹⁰ have considerably lessened this possibility. These cases make it fairly clear that the insurance premium will not be considered a dividend to the shareholders¹¹ if the corporation retains any property interest in the policy,¹² whether it is legal or equitable in nature. The

agreements apply equally to partnership buy and sell agreements. Generally see Samuels, "Funding Partnership Buy-and-Sell Agreements with Life Insurance," 35 TAXES 857 (1957); comment, 71 HARV. L. REV. 687 at 697 (1958); Willis and Fortser, "Partnership Buy-and-Sell Agreements," 96 TRUSTS AND ESTATES 337 (1957).

⁶ Local law problems include restrictions on redemptions from surplus, validity of restrictions on the alienation of stock, illusory agreements, testamentary intent, insurable interest and validity of option agreements. See O'Neal, "Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting," 65 HARV. L. REV. 773 (1952); comment, 71 HARV. L. REV. 687 at 711 (1958). The shareholders should analyze the facts of their individual situation to see if a buy and sell agreement is the best means of continuing the corporation on death. Option agreements, inter vivos gifts or inter vivos sale may be proper alternatives in some situations.

⁷ Constructive dividends are dividends that were not actually received, but since the shareholder benefits from the distribution it is treated as if he actually received the payment. See *Paramount-Richards Theatres v. Commissioner*, (5th Cir. 1946) 153 F. (2d) 602.

⁸ (2d Cir. 1957) 247 F. (2d) 440, revg. 26 T.C. 1020 (1956).

⁹ (10th Cir. 1958) 253 F. (2d) 855, revg. (D.C. Utah 1957) 149 F. Supp. 942.

¹⁰ (1st Cir. 1957) 248 F. (2d) 818, revg. 28 T.C. 19 (1957).

¹¹ Several earlier cases involving insurance, though not a stock purchase agreement, used this principle. *George Matthew Adams*, 18 B.T.A. 381 (1929); *N. Loring Danforth*, 18 B.T.A. 1221 (1930); *Lawthers*, "Prunier Offers No Threat to a Sound Buyout Plan," 7 J. TAXATION 2 (1957). However, some cases involving insurance have held the premiums taxable to the corporation even where the corporation has retained a property interest. *Paramount-Richards Theatres v. Commissioner*, (5th Cir. 1946) 153 F. (2d) 602. There may be a distinction between standard insurance and insurance for a stock purchase agreement when the beneficiary is the shareholder because a stock purchase agreement ties the insurance closer to the corporation.

¹² The reason for this is that the stock purchase agreement may never reach fruition and the shareholder would have been taxed for nothing. *MacNeill*, "Disposition of Business Interests," 87 TRUSTS AND ESTATES 398 at 403 (1918); *Mannheimer and Friedman*, "Stock-Retirement Agreements—The Prunier and Sanders Cases," 35 TAXES 567 (1957).

decisions are based on the distinction drawn between a shareholder and his corporation.¹³ Using the corporate entity theory, these cases rejected the argument that the premiums are constructive dividends merely because the shareholders benefit from the insurance policies.¹⁴

It appears that the shareholders can own the policies, select the beneficiaries and still avoid dividend treatment if they give the corporation some slight property interest. There is a warning in each of these cases, however, of possible constructive dividend treatment if the corporation's property interest becomes non-existent. For maximum safety and to avoid possible litigation, the best procedure would be to designate the corporation as owner and beneficiary of the insurance policies used to finance a stock purchase agreement.

2. *Income Tax Deduction to the Corporation for Premium Payments.* When life insurance is used by the corporation to finance a stock purchase agreement, the premiums are clearly not deductible as compensation to employees when the corporation is either directly or indirectly a beneficiary of the policy.¹⁵ Since the corporation should retain some interest in the insurance if the stockholder is to avoid constructive dividend treatment, the corporation would be either a direct or indirect beneficiary, and lose any possible deduction.

3. *Improper Accumulations of Surplus.* Accumulations of surplus to fund a stock purchase agreement, represented by liquid assets or the cash surrender value of an insurance policy, may subject the corporation to the accumulated earnings tax imposed by sections 531-537.¹⁶ The tax will be imposed only when there is an accumulation "for the purpose of avoiding the income tax with respect to its shareholders."¹⁷ But the intent to avoid income taxes will be presumed when there is an accumulation "beyond

¹³ I.R.C., §§1, 11.

¹⁴ The shareholder clearly benefits under these agreements from such things as an assured market for his stock, a definite fund with which to redeem the stock, and an assured minimum price. Lawthers, "Prunier Offers No Threat to a Sound Insured Buyout Plan," 7 J. TAXATION 2 at 5 (1957); *Sanders v. Fox*, (D.C. Utah 1957) 149 F. Supp. 942.

¹⁵ I.R.C., §264(a)(1); *Merrimac Hat Corp.*, 29 B.T.A. 690 (1934).

¹⁶ I.R.C., §§531-537. For a general explanation of this tax, see Cary, "Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)," 60 HARV. L. REV. 1282 (1949); Barker, "Penalty Tax on Corporations Improperly Accumulating Surplus," 35 TAXES 949 (1957).

¹⁷ I.R.C., §532(a).

the reasonable needs of the business,"¹⁸ unless the corporation can prove a contrary intent "by the preponderance of the evidence."¹⁹ Since proving a contrary intent is extremely difficult, this presumption is highly significant.²⁰

It is generally felt that the penalty tax should not be applied to funds used to finance a stock purchase agreement because such accumulations are clearly for a business purpose and are not for the purpose of avoiding the income tax on shareholders. The recently decided case of *Pelton Steel Casting Co. v. Commissioner*,²¹ however, casts some doubt upon this conclusion.²² In the *Pelton* case owners of 80 percent of the corporate stock devised a plan whereby the corporation would, following a recapitalization, purchase their entire common stock and half of their preferred stock interests for roughly \$800,000; in this manner the minority common stockholder would be permitted to obtain complete control of the corporation. To finance the plan the corporation borrowed \$500,000 and retained earnings during the taxable year of \$209,731. It was on this accumulation that the penalty tax was imposed. The Tax Court, which was affirmed by the Court of Appeals for the Seventh Circuit, reasoned that "where a closely held corporation adopts some plan (even having as its purpose the satisfaction of an otherwise bona fide business need)" by which its stockholders save substantial income taxes,²³ and "but for this tax saving, the same result could have been accom-

¹⁸ I.R.C., §533(a). Reasonably anticipated needs is included in the term reasonable needs of the business. I.R.C., §537.

¹⁹ For a case where there was an unreasonable accumulation but where there was no intent to avoid the tax, see *Gus Blass Co.*, 9 T.C. 15 at 37 (1947). Further discussion of burden of proof can be found in *Kopperud and Donaldson*, "The Burden of Proof in Accumulated Surplus Cases," 35 TAXES 827 (1957).

²⁰ If an unreasonable accumulation cannot be established, usually most courts will be reluctant to find an intent to avoid the income tax on the shareholders. But see *Whitney Chain & Mfg. Co.*, 3 T.C. 1109 (1944), *affd.* per curiam (2d Cir. 1945) 149 F. (2d) 936.

²¹ 28 T.C. 153 (1957), *affd.* (7th Cir. 1958) 251 F. (2d) 278.

²² There is no danger if the accumulated earnings and profits are below \$100,000 because §535(c) was amended to provide that no accumulated earnings tax will be applied to the first \$100,000 accumulated. It is doubtful if the accumulated earnings tax would apply to a corporation where substantial dividends were declared each year or where the shareholders were in a low income tax bracket because an intent to avoid taxation on the shareholders could not be established. *Mannheimer*, "Insurance to Fund Stock-Retirement and Buy-and-Sell Agreements," 9 N.Y.U. INST. ON FED. TAX. 77 at 96 (1951). The tax would clearly not apply to a publicly owned corporation because the intent to avoid the tax on a large number of shareholders could not be shown.

²³ The approximate amount of savings was \$70,000. See *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153 at 172 (1957).

plished . . . with the declaration and payment of a dividend," it is probable that there is an intent to avoid taxes within the meaning of section 531.²⁴

While this broad language appears applicable to stock purchase agreements of the type here under consideration, it can be argued that this reasoning will not extend to such agreements since they are essentially different from the transaction involved in the *Pelton* case. The *Pelton* case involved in substance an immediate transfer from the majority to the minority shareholder in a form dictated by tax avoidance. The majority shareholders set the price at which the corporation would redeem their shares. On the other hand a stock purchase agreement is a freely negotiated agreement to provide for the orderly redemption at some future time of a shareholder's interest at a price which reflects the true value of the corporation.

There is a further distinction in that, while the agreement in the *Pelton* case had the effect of injuring the corporation by reducing its immediate working capital by 60 percent and imposing a new \$500,000 obligation, a stock purchase agreement does in fact benefit the corporation. The benefits from such an agreement would include continuity of management, encouragement of creditors, improvement of employee morale, and avoidance of inexperienced ownership.²⁵ When life insurance is used to finance the stock purchase agreement, the corporation often derives the added benefit of financial protection against the loss received by the death of key employees.²⁶ If these distinctions are accepted, the reasoning of the *Pelton* case should not be extended to stock purchase agreements. That the Tax Court did not intend the language in its decision of that case to extend

²⁴ Id. at 174. See Sorden, "CA-7 Opinion in *Pelton Steel Clouds Rules on Surplus Accumulation, Redemption*," 8 J. TAXATION 254 (1958).

²⁵ *Prunier v. Commissioner*, (1st Cir. 1957) 248 F. (2d) 818; *Emeloid Co. v. Commissioner*, (3d Cir. 1951) 189 F. (2d) 230; *Edgar M. Docherty*, 47 B.T.A. 462 (1942); *Fred F. Fisher*, 6 CCH T.C.M. 520 (1947). *Mannheimer and Friedman*, "Stock-Retirement Agreements," 28 TAXES 423 (1950); *Kimbrough*, "Buy-Sell Agreements," 97 TRUSTS AND ESTATES 925 (1958).

²⁶ This is only of minor significance if it is remembered that the proceeds will be paid out on death for the decedent's stock and will not be used by the corporation. For cases involving key man insurance, see *General Smelting Co.*, 4 T.C. 313 (1944); *Bradford-Robinson Printing Co. v. United States*, 58-1 U.S.T.C. ¶9262 (1957). Some argue that the tax should not be imposed when insurance is involved. *Sneed*, "A Defense of the Tax Court's Result in *Prunier and Sanders*," 43 CORN. L.Q. 339 at 373 (1958); *Larkin*, "Survivor Purchase Agreements and Taxes," 97 TRUSTS AND ESTATES 881 (1958).

beyond the factual situation presented is illustrated by the fact that two similar cases were stated by the court to be inapplicable on the ground that a clear business purpose had existed in both.²⁷ There is also a recent case,²⁸ involving a 50 percent redemption, in which the court did not apply the *Pelton* test. Instead of looking only to see if the transaction could have been accomplished by a dividend and disregarding any business purpose, the court scrutinized the redemption to determine whether it was for a reasonable business purpose.

If it is accepted that a stock purchase agreement has a reasonable business purpose, which seems fairly clear, an accumulation of earnings and profits to effectuate the agreement would not be presumed to be for the purpose of avoiding income tax on shareholders. In seeking to invoke the penalty tax, however, the government could still rely on the argument made in the *Pelton* case that an intent to avoid the income tax is present if the "same result could have been accomplished . . . with the declaration and payment of a dividend." In the *Pelton* case, as indicated, the court was of the opinion that the redemption of the 80 percent interest could have as easily been effectuated through a dividend payment as through the accumulation of earnings, since dividend payments would reduce the value of the shareholders' interests in the corporation and correspondingly less cash would be needed to redeem their stock at the designated time. Yet it would seem doubtful that the "same result" could be accomplished when a 50 percent stock interest is to be redeemed. The difference might best be illustrated by an example. Assume a corporation worth \$400,000, with \$350,000 earnings and profits. The value of an 80 percent interest in this corporation is \$320,000. A straight cash redemption would cost the corporation \$320,000, and leave it with \$30,000 earnings and profits. If the corporation paid a dividend of \$100,000, the value of the 80 percent interest would

²⁷ Dill Mfg. Co., 39 B.T.A. 1023 (1939); *Gazette Publishing Co. v. Self*, (D.C. Ark. 1952) 103 F. Supp. 779.

²⁸ Penn. Needle Co., 17 CCH T.C.M. 504 (1958). Other cases where a reasonable business purpose was successfully argued: *Hedberg-Freidheim Contracting Co.*, 15 CCH T.C.M. 1433 (1956); *Fred F. Fisher*, 6 CCH T.C.M. 520 (1947); *W. H. Gunlocke Chair Co.*, 2 CCH T.C.M. 885 (1943). Cases where a reasonable business purpose was argued but the court held against the taxpayer: *Helvering v. Chicago Stock Yards Co.*, 318 U.S. 693 (1943); *Trico Products Corp. v. Commissioner*, 46 B.T.A. 346 (1942), *affd.* (2d Cir 1943) 137 F. (2d) 424. For a review of other cases in this area, see Altman, "Corporate Accumulation of Earnings," 36 TAXES 933 (1958).

be reduced to \$240,000, but the shareholder would have received \$80,000 in dividends. A redemption for \$240,000 would then leave the corporation with \$10,000 earnings and profits. Thus the difference to the corporation under the alternative plans is only \$20,000 in earnings and profits. In the case of a 50 percent redemption, the corporation without paying a dividend would have to spend \$200,000 to redeem the interest, and would be left with \$150,000 earnings and profits. If a dividend of \$100,000 were paid, the corporation could subsequently redeem the 50 percent interest for \$150,000. This would leave \$100,000 in earnings and profits. Here the corporation's earnings and profits have been reduced to the extent of \$50,000 in excess of what would have been needed for a straight cash redemption. The government, therefore, might find it quite difficult when a 50 percent redemption is involved, to argue that the "same result" could have been accomplished by the payment of a dividend. Since the courts were not disturbed by the 80-20 ownership ratio in the *Pelton* case, however, future cases in this area must be closely observed.

*B. Operation of the Agreement on the Death
of One of the Parties*

1. *Redemption Proceeds as Dividends to the Estate.* On the death of one of the parties to a stock purchase agreement, the decedent's estate surrenders its shares to the corporation for a predetermined price. The treatment of this transaction is governed by the redemption provision in section 302.²⁹ The question raised by this section is whether the redemption will be treated as a sale or exchange of stock, or as a dividend. If it is treated as a sale or exchange, the gain is measured by the difference between the fair market value at the decedent's death (the basis of the stock in the hands of the estate) and the amount realized from the redemption.³⁰ Normally, however, if the sale or exchange is pursuant to a conventional stock purchase agreement, there will be no difference between the amount realized from the redemption

²⁹ I.R.C., §302. See generally Rasman, "Stock Redemptions," 35 TAXES 355 (1957); Roeder, "Distributions in Redemption of Stock," 15 N.Y.U. INST. ON FED. TAX. 475 (1957); Waldo, "Liquidating a Shareholder's Interest in a Closely Held Corporation," 28 TAXES 1162 (1950). I.R.C., §691 clearly does not apply. See comment, 1958 UNIV. ILL. L. FORUM 135 at 150.

³⁰ I.R.C., §1001(a).

and the fair market value.³¹ Furthermore, if there were any gain it would be taxed at capital gains rates. If the redemption is treated as a dividend, the entire amount paid by the corporation for the stock would be taxed at ordinary rates without regard to basis.³²

When the stock of the corporation is owned by unrelated parties, the redemption will most likely be treated as a sale or exchange. Section 302(b) provides that a redemption shall be treated as a sale or exchange when the redemption is (1) "not essentially equivalent to a dividend,"³³ (2) "substantially disproportionate with respect to the shareholder" whose stock is redeemed,³⁴ or (3) a "termination of the shareholder's interest."³⁵ The last two are objective standards which, if met, would guarantee sale or exchange treatment. In the ordinary stock purchase agreement the deceased's interest in the corporation is completely terminated. Thus the redemption would be treated as a sale or exchange under section 302(b)(3) and the estate would not be liable for a heavy tax on a dividend. Even if the estate's interest were not completely terminated, it could qualify for sale or exchange treatment by meeting the specified conditions under the "substantially disproportionate" corridor of section 302(b)(2). These conditions are that after the redemption the shareholder must have less than 50 percent of the corporate voting power, and his proportionate interest must be less than 80 percent of his proportionate interest before redemption.

If the decedent's estate fails to meet either of the guaranteed standards which permit sale or exchange treatment, the estate may attempt to show that the redemption is "not essentially equivalent to a dividend." This would be difficult to show because it is doubtful whether a court would hold that a shareholder who cannot meet the two new objective standards established by Congress

³¹ I.R.C., §1014(a) provides that the estate's basis for the stock is the fair market value at death, and *Treas. Reg.*, §20.2031-2(d) (1944) provides that a valid stock redemption agreement will determine the fair market value of the stock if certain conditions are met. See part I-B-5 *infra*.

³² If a redemption does not meet one of the tests in I.R.C., §302(b) then the "amount distributed" as determined in §301 would be includible in income as a dividend to the extent of the corporation's earnings and profits, as set out in §316(a). This assumes that there is no question of partial liquidation (I.R.C., §346) or of "tainted" preferred stock (I.R.C., §306).

³³ I.R.C., §302(b)(1).

³⁴ I.R.C., §302(b)(2).

³⁵ I.R.C., §302(b)(3).

can still qualify under the old subjective test.³⁶ Actually this question is of little concern where the stock is owned by unrelated parties as most redemptions in such situations would qualify for sale or exchange treatment under one of the two objective standards of section 302.

When the corporation is owned by related parties, however, the constructive ownership rule presents a real danger.³⁷ In this situation the question is whether or not, on the death of one of the parties, the stock of one of the related survivors will be attributed to the decedent's estate and thereby cause the estate to lose the benefit of sale or exchange treatment. The constructive ownership rules provide that certain taxpayers are to be treated as if they owned the stock held by related taxpayers. Under section 318 an individual is treated as owning the stock of "his spouse, . . . children, grandchildren, and parents."³⁸ An estate is considered to own stock held by each beneficiary and the beneficiary is considered to own a proportionate part of the stock owned by the estate.³⁹ Since "stock constructively owned by a person . . . shall . . . be treated as actually owned by such person,"⁴⁰ there can be a series of stock attribution links so that the beneficiary of an estate may not directly own any stock, but may through a parent, grandchild, child, or spouse constructively own some stock which will then in turn be attributed to the estate.⁴¹ This gives the constructive ownership rules tremendous breadth which multiplies the risks in this area.⁴² There is one exception to the series of attribution links—no one chain can include more than one link due to family relationship.⁴³ Thus stock owned by a son can be attributed to his father but not through the father to the son's brother.⁴⁴ Apply-

³⁶ The only test for sale or exchange treatment before 1954 was "essentially equivalent to a dividend."

³⁷ I.R.C., §318. See generally Winton and Hoffman, "A Case Study of Stock Redemptions under Sections 302 and 318 of the New Code," 10 TAX L. REV. 363 (1955); Larkin, "Stock Redemption: Sections 302 and 318," 14 N.Y.U. INST. ON FED. TAX. 671 (1956); Hoffman, "1954 Code Can Turn Buy-Sell Agreements into Disastrous Tax Traps for Stockholders," 4 J. TAXATION 322 (1956).

³⁸ I.R.C., §318(a)(1).

³⁹ There are similar rules applicable for trusts and their beneficiaries, partnerships and partners, corporations and controlling shareholders. I.R.C., §318(a)(2).

⁴⁰ I.R.C., §318(a)(4)(A).

⁴¹ Treas. Reg., §1.318-3, Ex. 2 (1955); Treas. Reg., §1.318-2 (1955).

⁴² Some of the problems are discussed in 9 J. TAXATION 266 (1958); Winton and Hoffman, "A Case Study of Stock Redemptions under Sections 302 and 318 of the New Code," 10 TAX L. REV. 363 (1955).

⁴³ I.R.C., §318(a)(4)(B).

⁴⁴ Treas. Reg., §1.318-4 (1955).

ing these rules to a section 302 redemption where the beneficiaries of the estate own directly or indirectly any stock in the corporation, the danger of dividend instead of sale or exchange treatment can immediately be perceived. Although all the stock an estate directly owns may be redeemed, the objective standard of complete termination may not be met because of stock constructively owned by the estate. If the estate constructively owns a large number of shares, the other guaranteed standard of "substantially disproportionate redemption" will likewise not be met. Of course the estate may be able to satisfy the subjective test of "not essentially equivalent to a dividend," but this is particularly difficult to prove under section 302 as it is now written.

The constructive ownership rules can often be avoided by astute planning. When the constructive ownership problem stems from the situation where the beneficiary of any legacy in the estate directly owns stock which would be attributed to the estate, several schemes can be employed. First, the beneficiaries and the estate could sell all of their stock at the same time to meet the complete termination standard, or sell enough to meet the substantially disproportionate standard. Second, the estate can be so planned that anyone directly or constructively owning stock in the corporation would not be a beneficiary of the estate.⁴⁵ These solutions of course are somewhat limited because they would be possible only when the non-tax aspects of the arrangement are satisfactory to all the parties involved. A more general solution would be to delay the redemption of the stock held by the estate until distribution of the legacy to the stock-owning beneficiaries has taken place. Since under the regulations⁴⁶ a person is no longer a beneficiary of an estate when the legacy to which he is entitled has been distributed, the effect of delaying redemption would be to avoid the constructive ownership rules. There may be a practical difficulty, however, when the legacy is in cash because the principal source of cash in the estate is often the stock, and there would thus be nothing with which to pay the legacy until after the redemption. Even if the beneficiary could receive his legacy

⁴⁵ Greater use should be made of inter vivos gifts. A revocable trust could accomplish the same result as a will and the beneficiary of the trust would not be regarded as beneficiary of the estate. Other possible devices such as this could be used. For purposes of section 318 a person with a contingent remainder interest following another's life estate is not considered a beneficiary. *Treas. Reg.*, §1.318-2(c) (1955).

⁴⁶ *Treas. Reg.*, §1.318-3(a) (1955). See *Rev. Rul.* 58-111, 1958 *INT. REV. BUL.* No. 12, at 9.

before the redemption, there is still a danger that the Commissioner at a later time may seek to invoke the "step-transaction" doctrine.⁴⁷ Under this doctrine the two steps could be tied together so that the stock of the beneficiary should still be attributed to the estate.

If the problem is that the beneficiary of the estate owns no stock himself, but constructively owns the stock of his family which is attributed through him to the estate, then section 302(c)(2) provides a solution.⁴⁸ This section provides that if certain conditions are met the constructive ownership rules will not apply when there is a complete termination of the directly owned interests. These conditions are that the estate shall have no further direct interest in the corporation,⁴⁹ that no part of the stock redeemed was acquired under prescribed conditions within ten years of the redemption, and that no person owns stock attributable to the distributee which was acquired under the prescribed conditions within ten years.⁵⁰ For example, if a son and father owned corporation *Y* and the mother was the beneficiary of the father's estate, the constructive ownership rules, without section 302(c)(2), would apply. Thus the son's stock would be attributed through the mother to the estate, and thereby prevent an attempt to meet the objective standard of complete termination. If the conditions of section 302(c)(2) are met, however, the son's stock will not be attributed through the mother to the estate, and complete termination would result.

Several other methods of avoiding the constructive ownership rules need to be considered. First, the constructive ownership rules do not apply to a section 303 redemption.⁵¹ This section provides that a corporation can in certain situations redeem stock held by an estate to the extent of the estate tax, inheritance tax, and administrative costs and such redemption will be treated as a sale or exchange. The estate can thus at least partially avoid

⁴⁷ *American Bantam Car Co.*, 11 T.C. 397 (1948), *affd. per curiam* (3d Cir. 1949) 177 F. (2d) 513, *cert. den.* 339 U.S. 920 (1950); Mintz, "Step Transactions in Corporate Reorganizations," 12 N.Y.U. INST. ON FED. TAX. 247 (1954).

⁴⁸ I.R.C., §302(c)(2).

⁴⁹ I.R.C., §302(c)(2)(A)(i).

⁵⁰ I.R.C., §302(c)(2)(A)(ii). There may be a danger because the estate acquired the stock from the decedent within 10 years but it is doubtful that these qualifications were meant to include acquisition by operation of law.

⁵¹ I.R.C., §303. For a general discussion see Lanahan, "Redemptions To Pay Death Taxes: Redemptions Through the Use of Related Corporations," 15 N.Y.U. INST. ON FED. TAX. 493 (1957).

dividend consequences on the redemption. Even here there is a danger under the regulations⁵² that the amount paid for the shares covering taxes and administrative costs might be treated as a dividend. Finally, an attempt to qualify for sale or exchange treatment under the subjective test of "not essentially equivalent to a dividend" may prove worthwhile. The courts may use the subjective test as a convenient means of mitigating the harsh results of the constructive ownership rules.⁵³ The Commissioner has recently shown a disposition to use this type analysis when convinced there is no plan to avoid taxes.⁵⁴

2. *Redemption Proceeds as Dividends to the Surviving Shareholders.* It is possible that the proceeds paid to redeem stock of a deceased shareholder will be taxed as a constructive dividend to the surviving shareholders.⁵⁵ Several recent cases, however, have minimized this possibility by indicating that the surviving shareholder will not be deemed to have received a constructive dividend unless he has received "a direct pecuniary benefit." The most recent case supporting this view is *Holsey v. Commissioner*.⁵⁶ In this case the Greenville Auto Sales Co. owned all the outstanding shares of the Holsey Co. Joseph R. Holsey secured an option from Greenville to purchase 50 percent of the shares and a further option to purchase, within 10 years after the exercise of the first option, the other 50 percent. Holsey exercised the first option and several years later the second option was revised so that he or a corporation in which he owned 50 percent of the common stock could purchase the remaining shares. The option was then assigned to the Holsey Co. which redeemed the remaining shares. The Tax Court felt that the redemption was for the personal ben-

⁵² Treas. Reg., §1.303 (1955). For a possible although doubtful danger see Gelband, "Tax Trap Hidden in Sec. 303; Careful Timing of Redemptions Necessary," 8 J. TAXATION 244 (1958).

⁵³ There were no statutory constructive ownership rules under the 1939 code. Nonetheless, the courts did use the constructive ownership idea when they found that a redemption was essentially equivalent to a dividend because of family ownership of stock. *Commissioner v. Roberts*, (4th Cir. 1953) 203 F. (2d) 304. Even with the constructive ownership idea, they found that certain redemptions were not essentially equivalent to a dividend even though there was a family relationship. *Ada Murphy McFarlane*, 13 CCH T.C.M. 467 (1954).

⁵⁴ Rev. Rul. 56-183, 1956-1 CUM. BUL. 161; Rev. Rul. 56-556, 1956-2 CUM. BUL. 177; Rev. Rul. 56-584, 1956-2 CUM. BUL. 179.

⁵⁵ Generally see Hobbet, "The New Attack on Stock Redemptions," 35 TAXES 830 (1957); Pavenstedt, "Use of Corporate Funds To Buy Out a Stockholder—The Schmitt Case and Its Ramifications," 12 N.Y.U. INST. ON FED. TAX. 203 (1954).

⁵⁶ (3d Cir. 1958) 258 F. (2d) 865, revg. 28 T.C. 962 (1957).

efit of Holsey since he was in the same position as if he had personally purchased the shares. The argument that the redemption was for a corporate purpose because an adjustment in stock ownership was necessary to retain the corporation's automobile dealer franchise was rejected by the court on the belief that a realignment of stock ownership is a shareholder purpose. The Third Circuit reversed, one judge dissenting,⁵⁷ and ruled that "in the absence of a direct pecuniary benefit to the taxpayer the Tax Court erred in holding the distribution in question taxable to him."⁵⁸ The personal benefit theory of the Tax Court was refuted when the court said that even if there was an indirect benefit, it had not yet been "realized" within the meaning of the Sixteenth Amendment.⁵⁹ The court reasoned further that unless there was a direct pecuniary benefit, the redemption could not be treated as "essentially equivalent to a dividend" to the remaining shareholder, since there was a change in proportionate interest of the shareholders which would not have been accomplished by an ordinary dividend. The situation that would involve "a direct pecuniary benefit" to the shareholder would be where he *has a contractual obligation to purchase* the stock of another shareholder, and the corporation in redeeming the stock releases this obligation.⁶⁰

In the recent case of *Zipp v. Commissioner*⁶¹ the remaining shareholders received 46 of the 48 shares of the departing shareholder and instead of paying for them had the corporation redeem the other two shares at a price equal in value to all 48 shares. The payment for the two shares was considered a constructive dividend to the remaining shareholders. This case was cited in the *Holsey* case as involving a "direct pecuniary benefit" to these

⁵⁷ The dissent agreed with the Tax Court view. *Holsey v. Commissioner*, (3d Cir. 1958) 258 F. (2d) 865 at 869.

⁵⁸ *Id.* at 868-869.

⁵⁹ Realized in the sense of *Eisner v. Macomber*, 252 U.S. 189 (1920). Also see *Schmitt v. Commissioner*, (3d Cir. 1954) 208 F. (2d) 819. For a criticism of the need for realization, see Sneed, "A Defense of the Tax Court's Result in *Prunier and Casale*," 43 CORN. L.Q. 339 (1958). Cases consistent with this view are *Ray Edenfield*, 19 T.C. 13 (1952); *Joseph P. Schmitt*, 20 T.C. 352 (1953), revd. (3d Cir. 1954) 208 F. (2d) 819; *Fox v. Harrison*, (7th Cir. 1944) 145 F. (2d) 521; *Earl F. Tucker*, 23 T.C. 115 (1954), revd. (8th Cir. 1955) 226 F. (2d) 177. Cf. *Zenz v. Quinlivan*, (6th Cir. 1954) 213 F. (2d) 914.

⁶⁰ *Wall v. United States*, (4th Cir. 1947) 164 F. (2d) 462 (where the corporation assumed the obligation). *Eli R. Lowenthal*, 6 CCH T.C.M. 678 (1947), affd. (7th Cir. 1948) 169 F. (2d) 694; *Frank P. Holloway*, 10 CCH T.C.M. 1257 (1952), affd. per curiam (6th Cir. 1953) 203 F. (2d) 566; *Woodworth v. Commissioner*, (6th Cir. 1955) 218 F. (2d) 719. For a good review of all the cases in this area, see *Graham*, "Redemption Problems—The *Holsey* and *Zipp* Cases," 36 TAXES 925 (1958).

⁶¹ 28 T.C. 314 (1957), affd. per curiam (6th Cir. 1958) 259 F. (2d) 119.

shareholders. Yet neither the Tax Court nor the Sixth Circuit in the *Zipp* case felt that the case involved any direct pecuniary benefit. It was instead felt that the remaining shareholders had caused the redeeming corporation's "cash to be distributed for their benefit, i.e., to purchase all" of the departing shareholder's stock.⁶²

These cases should not endanger the normal stock purchase agreement redemption. The test of the *Holsey* case would be met as the surviving shareholders have received no direct pecuniary benefit. Even if they do receive an indirect benefit from the redemption, either because of increased control of the corporation or because the remaining assets in the corporation are of greater value than their proportionate share of the assets before redemption, such benefit has not yet been realized.⁶³ The *Holsey* case also suggested that there could be no constructive dividend if the proportionate interest of the surviving shareholder had changed, and this is of course true in all stock purchase agreement redemptions.⁶⁴

If the benefit test suggested in the *Zipp* case is interpreted to mean that there will be no constructive dividend to the survivor if any corporate purpose is shown, then this test does not endanger stock purchase agreement redemptions because of their inherent benefit to the corporation.⁶⁵ In light of a prior Sixth Circuit opinion, this would seem to be the proper interpretation of the *Zipp* case.⁶⁶ The language in the *Zipp* case might also be interpreted to mean that there will be a constructive dividend to the surviving stockholder when the survivor primarily benefits from the redemption, even though there is some corporate purpose. If this interpretation is accepted, stock purchase agreement redemptions might meet with some difficulties. It can be argued, however, that these redemptions primarily benefit the corporation

⁶² *Zipp v. Commissioner*, 28 T.C. 314 at 329 (1957).

⁶³ See note 59 *supra*.

⁶⁴ If this test is used in more cases, the government will have a difficult time attacking stock purchase agreements. However, there is some doubt if it will be applied. The test was originally used against shareholders who had their shares redeemed for cash and also against shareholders receiving stock dividends. In those areas the question was whether the proportionate interest of the shareholders had decreased and not as here if they had increased. In those cases the shareholder actually received something while here the remaining shareholder has received nothing. It is enough to say that most of the cases in this area have not adopted the proportionate interest test but have instead used a direct pecuniary benefit test. But see *Ferro v. Commissioner*, (3d Cir. 1957) 242 F. (2d) 838.

⁶⁵ Note 25 *supra*.

⁶⁶ *Ferro v. Commissioner*, (3d Cir. 1957) 242 F. (2d) 838.

rather than the shareholder. It might also be suggested that the case was improperly decided and should not be followed when considered in light of cases which hold that a shareholder may dispose of his stock by selling part to the corporation and part to another shareholder without constructive dividend treatment to the other shareholder,⁶⁷ and cases which hold that a direct pecuniary benefit is needed.⁶⁸ Another reason for not accepting the rationale of the *Zipp* case is that the holding undermines the usefulness of the redemption provision in section 302(b)(3),⁶⁹ which guarantees sale or exchange treatment to shareholders who completely terminate their interest through a redemption. Few shareholders would make use of this redemption provision if it would result in a constructive dividend to the remaining shareholders.

The Internal Revenue Service recently indicated that it did not intend to extend the constructive dividend reasoning to ordinary stock purchase agreements,⁷⁰ and it thus seems safe to assume that the redemption of a deceased shareholder's stock will not be treated as a constructive dividend to the surviving shareholder.

3. *Basis of the Stock Following Redemption.* If the redemption of the deceased shareholder's stock pursuant to the stock purchase agreement does not result in a constructive dividend to the surviving shareholder, it naturally follows that the basis of the surviving shareholder's stock will remain the same as before the redemption.⁷¹ On the other hand, if the surviving shareholder is deemed to have received a constructive dividend when the deceased shareholder's stock was redeemed, he should perhaps receive a basis for his stock equal to the redemption price of the decedent's stock plus the basis of his stock before redemption. The reason for this result would be that since he is treated as if he had received a dividend and had bought the decedent's shares, he should receive the advantage of the "stepped-up" basis.

The corporation has no basis for the stock even if the redemption is treated as a sale or exchange and not as a constructive dividend to the decedent's estate.⁷² This result is now dictated by

⁶⁷ Ray Edenfield, 19 T.C. 73 (1952); *Zenz v. Quinlivan*, (6th Cir. 1954) 213 F. (2d) 914.

⁶⁸ Note 60 *supra*.

⁶⁹ I.R.C., §302(b)(3).

⁷⁰ Comment, 9 J. TAXATION 221 (1958). T.I.R. 109, 58-6 CCH STAND. FED. TAX. REP. ¶6780 (1958).

⁷¹ I.R.C., §1012 provides for a cost basis.

⁷² The corporation should have no basis for the redeemed stock when the surviving shareholder received constructive dividend treatment because the distribution then is

section 1032(a),⁷³ which provides that a future sale of redeemed stock will result in no gain or loss to the corporation.⁷⁴ Thus it would be impossible to argue that the corporation after this redemption has any basis for the stock. In addition, good accounting principles provide that "any form of shares available for issue represents merely a means of raising capital, not actual, realized property."⁷⁵

4. *Insurance Proceeds Received by the Corporation.* The question whether the proceeds from a life insurance policy used to finance a stock purchase agreement are includible in the corporation's gross income for income tax purposes is answered by section 101(a)(1).⁷⁶ That provision states that "gross income does not include amounts received . . . under a life insurance contract, if such amounts are paid by reason of the death of the insured." This would apply to the ordinary stock purchase agreement where the corporation was purchaser, beneficiary, and owner of the insurance.⁷⁷ The only time that gain must be recognized on receipt of insurance proceeds is under section 101(a)(2),⁷⁸ when the policy has been transferred for a valuable consideration. However, even if an insurance policy is transferred to a corporation for valuable consideration, the gain from the proceeds is not subject to the income tax under a special exception to the "transfer for value" rule in section 101(a)(2)(B),⁷⁹ which provides that a transfer "to a corporation in which the insured is a shareholder or officer" will not cause the insurance proceeds to be subject to the income tax.

The proceeds of the insurance policy may cause an estate tax problem. If the decedent is beneficiary or has any of the incidents

not a sale or exchange but simply a dividend and a subsequent purchase between the shareholders.

⁷³ I.R.C., §1032(a).

⁷⁴ This was not always the rule. Before 1954 the basis of redeemed stock was recognized so that, in certain transactions, gain or loss would be recognized. Reg. 77, Art. 66 of the 1932 act provided that "if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another." See *Helvering v. Edison Bros. Stores, Inc.*, 45 B.T.A. 472 (1941), revd. (8th Cir. 1943) 133 F. (2d) 575, cert. den. 319 U.S. 752 (1943). But see *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

⁷⁵ PATON, *ESSENTIALS OF ACCOUNTING* 713 (1949).

⁷⁶ I.R.C., §101(a)(1). See generally RABKIN AND JOHNSON, *FEDERAL INCOME GIFT AND ESTATE TAXATION* §61.03 (1956).

⁷⁷ The section is even broader than this as it is doubtful if the proceeds would be includible even if the corporation was not owner of the policy.

⁷⁸ I.R.C., §101(a)(2).

⁷⁹ I.R.C., §101(a)(2)(B).

of ownership in the policy,⁸⁰ there is a possibility that both the insurance proceeds and the value of the decedent's interest in the corporation will be included in the decedent's gross estate.⁸¹ A proposed regulation provided that in cases where the shareholder retains any incidents of ownership, his estate would not include both the insurance proceeds and the decedent's interest in the corporation if the stock purchase agreement were made in good faith. However, if the agreement were made in bad faith, "both the value of the decedent's interest or shares (determined without regard to the agreement) and if otherwise includible, the proceeds of the insurance (except to the extent that the proceeds are included in the value of the interest or shares)"⁸² would be included in the decedent's gross estate. Although this treatment has been omitted from the final regulation,⁸³ this type of reasoning might be used by the government when the decedent instead of the corporation has the incidents of ownership in the life insurance policies used to finance the stock purchase agreement.

When the estate is beneficiary of the insurance both the proposed and final regulations are silent,⁸⁴ and the government may argue for full inclusion of both the stock and the insurance. There are cases which hold that only the larger amount will be included in the decedent's estate.⁸⁵ All the above estate tax problems concerning the insurance proceeds can be easily avoided by making the corporation beneficiary and owner of the policies.

5. *Valuation of Decedent's Stock for Estate Tax Purposes.* Section 2031(a)⁸⁶ provides that "The value of the gross estate of the decedent shall be determined by including . . . the value at the time of his death of all property."⁸⁷ Thus the value of a decedent's stock in the corporation will be included in his estate.⁸⁸ Only the

⁸⁰ This, of course, would not fall within the category of "conventional" agreements, note 5 supra. If the insurance is purchased properly so that the corporation is owner and beneficiary of the policy, this problem should not arise.

⁸¹ Insurance is generally included in a decedent's gross estate when the decedent retains any incidents of ownership. I.R.C., §2042.

⁸² Proposed Treas. Reg., §20.2042-1(c)(6), 21 Fed. Reg. 7885 (1956).

⁸³ Treas. Reg., §20.2042-1(c) (1958).

⁸⁴ Treas. Reg., §20.2042-1(b) (1958).

⁸⁵ Estate of John T. H. Mitchell, 37 B.T.A. 1 (1938); M. W. Dobrzensky, 34 B.T.A. 305 (1936).

⁸⁶ I.R.C., §2031(a).

⁸⁷ Value means fair market value. Treas. Reg., §20.2031-1(b) (1958).

⁸⁸ There is also a problem of inheritance tax which should be analyzed. Other than inheritance tax, local law can cause some real problems if the agreement is not binding. See Matter of Galewitz, 3 App. Div. (2d) 280, 160 N.Y.S. (2d) 564 (1957).

question whether the agreement is determinative of the value for estate tax purposes⁸⁹ will here be considered. An estate tax value established in this way is desirable in that it avoids the threat of the estate being taxed on a high valuation while being bound to sell at a lower price.⁹⁰ Equation of the value under the stock purchase agreement with the estate tax value also avoids future litigation and makes possible a precise calculation of the estate tax which will aid business planning. The regulations⁹¹ and the courts are not clear as to the efficacy of a stock purchase agreement in controlling the estate tax valuation,⁹² although certain minimum requirements may be set down which, if followed, should result in the agreement being given binding effect.⁹³ First, the agreement must be "a bona fide business arrangement,"⁹⁴ which is determined by the factors of family relationship, full and adequate consideration, and methods of evaluating the corporation. The purpose of this requirement is to prevent the parties, by setting a low price on the corporation, from effectuating a donative or testamentary intent without the payment of a gift or estate tax. When the deceased stockholder's relatives own the remaining shares of stock in the corporation, the agreement will be scrutinized closely for this testamentary or donative intent.⁹⁵ Although "a bona fide business

⁸⁹ For methods of valuing a small corporation, see *Treas. Reg.*, §20.2031-3, *Rev. Rul.* 54-77, 1954-1 *CUM. BUL.* 187; Rockefeller, "Valuation of Closely Held Stocks for Estate and Gift Tax Purposes," 36 *TAXES* 259 (1958); LOWNDES AND KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 488-499 (1956). For the binding effect of an agreement on estate tax value, see comment, 41 *MARQ. L. REV.* 48 (1957); Ness, "Federal Estate Tax Consequences of Agreements and Options To Purchase Stock on Death," 49 *COL. L. REV.* 796 (1949); Pavenstedt, "The Second Circuit Reaffirms Efficacy of Restrictive Stock Agreements To Control Estate Tax Valuation," 51 *MICH. L. REV.* 1 (1952); Bowe, "Options and Valuation of Property for Tax Purposes," 2 *VAND. L. REV.* 427 (1949). For cases involving the binding effect of a stock purchase agreement on gift tax liability, see *Commissioner v. McCann*, (2d Cir. 1944) 146 F. (2d) 385; *Raymond J. Moore*, 3 *T.C.* 1205 (1944).

⁹⁰ Of course if there are two truly adverse parties, the agreement price should almost equal the market value. In the case of related parties, there may be considerable difference between agreement price and market value.

⁹¹ The regulation says that the stock purchase agreement is only one factor in determining the estate tax value. *Treas. Reg.*, §20.2031-2(h) (1958).

⁹² The Supreme Court, in an income tax case, has recognized that such agreement could put a ceiling on the valuation of restricted property. *Helvering v. Salvage*, 297 *U.S.* 106 (1936).

⁹³ A stock purchase agreement should be given effect even if below the fair market value because value is at best a guess and thus the parties' guess, if made in good faith, should govern. Also a restriction on stock may itself diminish its value.

⁹⁴ *Treas. Reg.*, §20.2031-2(h) (1958).

⁹⁵ *Edith M. Bensel*, 36 *B.T.A.* 246 (1937), *affd.* (3d Cir. 1938) 100 F. (2d) 639; *Rev. Rul.* 54-77, 1954-1 *CUM. BUL.* 187.

arrangement" is difficult to prove when related parties own the rest of the corporate stock, it can still be shown if the two objective factors of adequate consideration and fair evaluation of the corporation are clearly shown.⁹⁶ The type of consideration required by the regulations is "money or money's worth."⁹⁷ Mutual promises, if equivalent to "money's worth," may provide the necessary consideration.⁹⁸ This equivalence is easily shown when the shareholders have equal interests and life expectancies, or when the agreement is made with a minority shareholder in order to keep him in the business. The most important factor in determining if the agreement is "bona fide" is the method of valuing the corporation.⁹⁹ The price must fairly reflect the value of the corporation when the agreement is executed.¹⁰⁰ Thus a disparity between the agreement value and market value at the date of death should be insignificant.¹⁰¹ However, a great disparity may show lack of good faith at the date of execution, and for this reason a clause providing for periodic re-evaluation should be inserted. This is especially true if related parties are involved. A problem considered by the proposed regulations was whether the contemplated insurance proceeds should be considered in the original valuation,¹⁰² but this was solved in the negative by the final regulations.¹⁰³ Second,¹⁰⁴ there should also be a restriction on the right of the owner to transfer his stock during life.¹⁰⁵ To be safe there should be an absolute provision against any transfers during life even though a right of

⁹⁶ *Brodrick v. Gore*, (10th Cir. 1955) 224 F. (2d) 892; *Rose Wasserman*, 24 T.C. 1141 (1955), dismissed by stipulation on appeal to the Court of Appeals for the Third Circuit. *May v. McGowan*, (W.D. N.Y. 1950) 97 F. Supp. 326, *affd.* (2d Cir. 1952) 194 F. (2d) 396. An attempt to show that the agreement was a transfer in contemplation of or to take effect on death was rejected. *Estate of Lionel Weil*, 22 T.C. 1267 (1954) (acq.).

⁹⁷ The adequacy of consideration is measured at the date of execution of the agreement.

⁹⁸ *Murphy v. Murphy*, 217 Mass. 233, 104 N.E. 466 (1914); *Matter of Fieux' Estate*, 241 N.Y. 277, 149 N.E. 857 (1925); *McKinnon v. McKinnon*, (8th Cir. 1893) 56 F. 409.

⁹⁹ Note 89 *supra*.

¹⁰⁰ *Edith M. Bense*, 36 B.T.A. 246 (1937), *affd.* (3d Cir. 1938) 100 F. (2d) 139.

¹⁰¹ *Estate of John Q. Strange*, P-H T.C.M. ¶42247 (1942).

¹⁰² Proposed Treas. Reg., §20.2042-1(c)(6), 21 Fed. Reg. 7885 (1956).

¹⁰³ Proposed Treas. Reg., §20.2042-1(c)(6) was dropped in the final regulations. Treas. Reg., §20.2042 (1958). See comment, 9 J. TAXATION 302 (1958).

¹⁰⁴ This can be considered a separate qualification or it can be argued that it is just another factor to be used to see if the agreement is bona fide.

¹⁰⁵ *Estate of James H. Matthews*, 3 T.C. 525 (1944) (acq.); *Baltimore National Bank v. United States*, (D.C. Md. 1955) 136 F. Supp. 642; Treas. Reg., §20.2031-2(h) ["Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his life time."].

first refusal in the corporation plus a price fixing provision has been upheld as a sufficient restriction.¹⁰⁶ The reason for this requirement is that if the decedent could dispose of his interest prior to death his failure to dispose would be in effect a transfer to the corporation and its remaining shareholders of the difference between the market value before his death and the price set by the stock purchase agreement.¹⁰⁷ The final requirement¹⁰⁸ is that the agreement should bind the corporation to buy and the estate to sell the interest of the deceased.¹⁰⁹ The rationale behind this requirement is that if the estate would be bound not by the price in the agreement, then the price should be the fair market value at date of death. An agreement has been held binding for valuation purposes even when the estate was bound to sell and the corporation had an option to buy.¹¹⁰ An option on the part of the estate to sell is probably not binding, although it might suitably serve as a minimum value. An option of first offer completely fails to meet the requirement of a binding agreement.¹¹¹ If the proper precautions are taken at the planning stage, the value set by the stock purchase agreement should be determinative of the stock value for estate tax purposes.

C. Operation of the Agreement After the Death of One of the Parties

1. *Insurance Policy on the Life of the Survivor.* What happens to the life insurance policies held on the surviving shareholder is not a significant problem in a stock purchase agreement.¹¹² The survivor could purchase the insurance on his life from the corporation. If this were done, the difference between the amount paid and the proceeds of the insurance on the survivor's death would not be subject to the income tax. Ordinarily a "transfer of value" would cause this difference to be taxed under section 101(a)(2),¹¹³

¹⁰⁶ *Brodrick v. Gore*, (10th Cir. 1955) 224 F. (2d) 892; *Estate of Albert L. Salt*, 17 T.C. 92 (1951) (acq.).

¹⁰⁷ This can be analogized to either a transfer with a reservation of a life estate or a revocable transfer. I.R.C., §§2036, 2038.

¹⁰⁸ Note 104 *supra*.

¹⁰⁹ *Rose Newman*, 31 B.T.A. 772 (1934); *John T. H. Mitchell*, 37 B.T.A. 1 (1938).

¹¹⁰ *Wilson v. Bowers*, (S.D. N.Y. 1931) 51 F. (2d) 261, *affd.* (2d Cir. 1932) 57 F. (2d) 682; *May v. McGowan*, (W.D. N.Y. 1950) 97 F. Supp. 326, *affd.* (2d Cir. 1952) 194 F. (2d) 396.

¹¹¹ *Estate of Ambrose Fry*, 9 T.C. 503 (1947).

¹¹² See part II *supra*.

¹¹³ Generally a transfer for value will be treated the same as an investment in stock and thus the appreciation in value would be taxed. I.R.C., §101(a)(2).

but an exception to the ordinary "transfer for value" rule was provided in section 101(a)(2)(B) when the transfer for value is to the insured.¹¹⁴ On the other hand, the insurance can be retained by the corporation as "key man" insurance,¹¹⁵ or to finance another stock purchase agreement, and the proceeds from the insurance will not be subject to any income tax.¹¹⁶

II. CROSS PURCHASE AGREEMENTS COMPARED WITH STOCK REDEMPTION AGREEMENTS

If a cross purchase agreement, where the surviving shareholder is to buy up the deceased shareholder's interest, is used instead of a stock purchase agreement, greater tax safety can often be obtained.¹¹⁷ Some of the non-tax disadvantages of a cross purchase agreement should be noted, however, before the tax aspects are discussed.¹¹⁸ First, if there are more than two shareholders involved, a cross purchase agreement is cumbersome.¹¹⁹ Each shareholder must purchase insurance on the lives of each of the other shareholders.¹²⁰ There will be confusion when one of the parties to the agreement dies, because in order to continue the agreement all of the policies owned by the deceased on the surviving shareholders will have to be purchased by the survivors.¹²¹ This problem might be solved by originally putting all the insurance in trust and having the agreement administered by a trustee. These problems do not arise in a stock purchase agreement, which is administered through the corporation. Secondly, there is the risk

¹¹⁴ I.R.C., §101(a)(2)(B).

¹¹⁵ Clapp, "Deduction of Premiums and Interest Paid To Carry Insurance; Taxation of Annuities; Keyman Insurance," 9 N.Y.U. INST. ON FED. TAX. 21 at 35 (1951).

¹¹⁶ I.R.C., §101(a)(1).

¹¹⁷ A cross purchase agreement is where the shareholder instead of the corporation agrees to buy the decedent's stock. If insurance is used, each shareholder should purchase insurance on the life of the other. If this is not done, serious tax consequences can result.

¹¹⁸ Generally see Krogue, "Funding Stock Purchase Plan with Life Insurance," ESTATE PLANNERS Q. 34 (March 1958); Redeker, "Business Insurance Agreements—Entity Purchase versus Cross Purchase," 12 N.Y.U. INST. ON FED. TAX. 675 (1954).

¹¹⁹ The same thing is true if it is contemplated that additional shareholders will join the agreement at a later time.

¹²⁰ This could result in 30 policies when 6 shareholders are involved as each shareholder owns the insurance on every other shareholder's life.

¹²¹ The agreement could be continued without the purchase of these policies from the decedent's estate by the purchase of new policies or cash financing but new policies may be unavailable because one of the survivors is uninsurable and the parties generally will not have enough free cash. Ordinarily additional funding is needed to cover the additional interest that each shareholder purchased from the decedent.

that an individual shareholder may fail to make the premium payment. Although this risk is present in the case of a corporation, there is less chance of its occurrence when the corporation is responsible for the premiums.¹²² Despite these disadvantages, a cross purchase agreement may from a non-tax viewpoint be preferable to a stock purchase agreement because of certain stringent restrictions placed on corporations by local law.¹²³

If the shareholders are satisfied with the non-tax aspects of a cross purchase agreement, the tax features should make the cross purchase agreement even more desirable. It has been argued that since the shareholders pay the insurance premiums in a cross purchase agreement, the corporation would have to pay a large enough dividend so that the amount remaining in the hands of the shareholders after taxes would cover the premium payments. What this argument overlooks is that the distribution for the premium payments may not be considered a dividend when the stockholders are also employees, but rather additional compensation and therefore deductible by the corporation.¹²⁴ If this is true, the value of the deduction to the corporation may more than offset the added tax to the shareholder,¹²⁵ and thus the cross purchase form could actually save taxes on the premium payments.¹²⁶

¹²² The reason for this is that both shareholders are continually in touch with the corporate affairs and they can be sure that the premiums are paid and that the corporation is financially able to redeem. It is also argued by some that there is a psychological difference when a corporation handles the agreement. Redeker, "Business Insurance Agreements—Entity Purchase versus Cross Purchase," 12 N.Y.U. INST. ON FED. TAX. 675 (1954).

¹²³ For problems of local law, see note 8 *supra*. There is an additional non-tax factor of inequity on premium payments. It can arise in a cross purchase agreement when both shareholders own the corporation equally but the younger shareholder must pay the greater premium. It can be argued that this is not inequitable because it is likely that he will have less payments to make before the older shareholder dies. Another inequity in the cross purchase is when the minority shareholder has to pay a large premium to cover the majority shareholder's interest but this can be refuted as the minority shareholder gets greater value when he buys out the majority. The argument of inequity in a stock purchase agreement is when there is a difference in interests and the majority shareholder will be bearing the larger part of the premium payment so the minority shareholder can buy him out. Davis, "Business Purchase Agreements," 94 TRUSTS AND ESTATES 284 (1955).

¹²⁴ I.R.C., §162. See *Casper Ranger Construction Co.*, 1 B.T.A. 942 (1925).

¹²⁵ BOWE, ESTATE PLANNING AND TAXATION, Stud. ed., §16.22 (1957).

¹²⁶ The savings for each case would have to be calculated but it can be generally stated that if the shareholder's marginal rate is less than the corporation's rate, there will be some tax savings. If the distribution is treated as a dividend, there would be no savings and the stock purchase agreement might be cheaper. On the other hand a stock purchase agreement always presents the danger that the premium payment will be treated as a constructive dividend. See part I-A-1 *supra*.

A cross purchase agreement is highly advantageous because there are no problems involving the accumulated earnings tax of section 531,¹²⁷ the constructive ownership rule of section 318,¹²⁸ or a constructive dividend to the surviving shareholder at the time of the "buy-out."¹²⁹ These problems do not arise because the corporation is in no way connected with the agreement.

When the basis of the survivor's stock in the cross purchase method is compared with the basis of the survivor's stock in the stock purchase method, the most important advantage of the cross purchase method is revealed. The basis of the survivor's stock, if a cross purchase agreement is used, is equal to the cost of his original stock plus the cost of the stock purchased from the decedent.¹³⁰ Under the stock purchase agreement the basis of the survivor's stock is only the cost of his original stock. His basis is not increased by the value of the decedent's stock,¹³¹ because the corporation rather than the survivor purchased the decedent's stock.¹³²

Estate and income tax problems in relation to the insurance proceeds on death of one of the parties are the same in both agreements. The discussion in the stock redemption area on this subject is fully applicable to a cross purchase agreement.¹³³ The final comparison between the two agreements deals with what happens to

¹²⁷ I.R.C., §531. See part I-A-3 *supra*.

¹²⁸ I.R.C., §318. See part I-B-1 *supra*.

¹²⁹ See part I-B-2 *supra*.

¹³⁰ I.R.C., §1012.

¹³¹ See part I-B-3 *supra*.

¹³² It can be argued that the basis difference is justified because of the difference in value of the corporations. Thus in a cross purchase agreement the survivor receives an increased basis because the value of the corporation remains the same while his interest increases. In a stock purchase agreement, the survivor's basis remains the same even though his interest increases because the value of the corporation has decreased. The fallacy in this reasoning is that during the life of cross purchase agreements part of the assets were paid out of the corporation to finance the agreement (at least enough to cover insurance premiums) while in a stock purchase agreement no assets are removed from the corporation. As a result of this, at the death of one of the parties the value of the corporation should be about the same under either agreement. Thus, the difference in basis is unjustified. Another possible argument to justify the basis difference is that the funds used by the survivor to purchase the decedent's stock in a cross purchase agreement were distributed from the corporation but were taxed to the survivor, and thus his basis should be increased. The funds used by the corporation to purchase the decedent's stock in a stock purchase agreement were distributed by the corporation but were never taxed to the survivor and thus his basis should remain the same. The fallacy here is that the survivor in the cross purchase agreement may have been receiving the payments as additional compensation and thus only paying one tax (individual) while the survivor under the stock purchase agreement was also paying one tax (corporation).

¹³³ I.R.C., §101(a). See part I-B-4 *supra*.

the insurance on the life of the survivors after the death of one of the parties. The insurance on the life of the survivors in a stock purchase agreement is owned by the corporation and, as was shown above,¹³⁴ no tax problems are presented. In a cross purchase agreement the insurance on the life of the survivors is in the decedent's estate,¹³⁵ which can cause a serious problem. The problem stems from the odd drafting in section 101(a)(2)(B),¹³⁶ and can best be shown by first analyzing section 101(a)(2).¹³⁷ This provision states that when life insurance is transferred for value, the proceeds on the death of the insured in excess of the cost will be subject to the income tax in the hands of the transferee.¹³⁸ Section 101(a)(2)(B) provides an exception to 101(a)(2) when the transfer for value is "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." However, for some unknown reason the provision fails to provide an exception for a transfer for value to fellow shareholders of the insured.¹³⁹ Thus, if the survivors in a cross purchase agreement wished to continue the agreement by purchasing the insurance on the life of the other survivors from the decedent's estate,¹⁴⁰ they would eventually be subject under section 101(a)(2) to an income tax liability on the proceeds of the insurance. Of course if there were only one survivor who purchased the insurance on his own life from the decedent's estate, there would be no income tax liability on the proceeds under section 101(a)(2) because section 101(a)(2)(B) clearly excepts transfers for value to the insured.

In the case of corporations with only two shareholders, the cross purchase agreement would be both the safer and cheaper form of "buy and sell" agreement. Since there is no problem of constructive ownership in the cross purchase arrangement,¹⁴¹ it would also be the safer form for related parties.

¹³⁴ See part I-C *supra*.

¹³⁵ Since in a cross purchase agreement the decedent owned insurance on the life of the other shareholders, his estate would have to include the value of these insurance policies. I.R.C., §2031(a).

¹³⁶ I.R.C., §101(a)(2)(B).

¹³⁷ I.R.C., §101(a)(2).

¹³⁸ See note 113 *supra*.

¹³⁹ The American Bar Association has requested that this provision be modified. H. Hearing before Committee on Ways and Means on H.R. 8381 (Technical Amendments Act of 1958), 85th Cong., 2d sess., p. 2832 (1958).

¹⁴⁰ Note 121 *supra*.

¹⁴¹ Constructive ownership applies when a corporation is redeeming and not when shareholders are purchasing. See part I-B-1 *supra*.

III. CONCLUSION

A general consideration of what the law should be may contribute to a fuller understanding of the problems involved when dealing with a stock purchase agreement. The basic problem in these agreements stems from the imposition of a corporate tax which in the case of a closely-held corporation is highly artificial. As a result of this distinction between corporation and individual, taxpayers are constantly attempting to avoid the tax on one entity or the other without regard for the business or personal nature of the transaction.

Congress has quite properly acted to prevent avoidance schemes.¹⁴² Section 531¹⁴³ was designed to prevent a corporation from accumulating earnings without a corporate purpose in order to avoid an ordinary income tax on its shareholders and then, at some future time, have the shareholders either liquidate or sell their interests in the corporation at capital gains benefits. When this section is invoked by the government against a stock purchase agreement, there is a conflict of policies. On the one hand the agreement accomplishes just what the statute attempts to prevent and should perhaps be subject to the penalty tax. However, it can be argued that the underlying policy behind the use of stock purchase agreements in general, to preserve small businesses,¹⁴⁴ outweighs the policy of section 531. Further congressional action can be found in section 318 which has the effect of making a redemption involving related parties taxable as a dividend because of the avoidance possibilities. This provision is undoubtedly too inclusive and should be modified.¹⁴⁵

¹⁴² There are several statutory provisions which modify the strict separate entity treatment, such as I.R.C., §§267(b)(2), 341, 541, 1371.

¹⁴³ I.R.C., §531.

¹⁴⁴ The recent hearings on the Technical Amendments Act showed innumerable instances where men had either merged their corporations or were thinking of merging them because of the serious tax consequences on death. H. Hearings before Committee on Ways and Means on H.R. 8381 (Technical Amendments Act of 1958), 85th Cong., 2d sess. (1958). Also see Brown, "How the Premium Payment Test Affects Small Business," 36 TAXES 295 (1958). The importance of this merger argument has been somewhat minimized by I.R.C., §6166 which allows the estate tax of "small business estates" to be paid over a 10-year period. The agreement also aids small business by the benefits provided during the existence of the Agreement. Note 25 *supra*.

¹⁴⁵ The recent hearings on the Technical Amendments Act uncovered a great deal of dissatisfaction with this provision. H. Hearings on H.R. 8381 (Technical Amendments Act of 1958), 85th Cong., 2d sess., pp. 2920, 2980, 3176 (1958). Also see comment, 9 J. TAXATION 266 (1958). See Ringel, Surrey and Warren, "Attribution of Stock Ownership in the Internal Revenue Code," 72 HARV. L. REV. 209 (1958).

The government has, through litigation, also attempted to prevent tax avoidance schemes. These attempts have come in a series of cases involving constructive dividends where taxpayers have used the corporate entity in an effort to minimize taxes. In *Holsey v. Commissioner*,¹⁴⁶ the taxpayer wished to purchase the shares of the remaining shareholder and, having insufficient funds or perhaps not wishing to spend after-tax dollars,¹⁴⁷ he had the corporation purchase the shares. No constructive dividend was found. In *Zipp v. Commissioner*,¹⁴⁸ a similar situation was presented except that neither the taxpayer nor the corporation had adequate funds to purchase the remaining shares. The corporation used borrowed funds which could be paid back with before-tax dollars, and redeemed the shares. A constructive dividend to the remaining shareholders was held to have been received. In *Prunier v. Commissioner*,¹⁴⁹ the principal shareholder was the owner and beneficiary of an insurance policy used to fund a stock purchase agreement, while the corporation paid the premiums. It was held that the payments did not constitute constructive dividends. It must be admitted that the factual situations here discussed, although related to the constructive dividend problems presented in the ordinary stock purchase agreement, represent extreme avoidance situations. It is doubtful if the government would extend its attack to a properly drawn stock purchase agreement.¹⁵⁰ Even if the government seeks to extend its theory to cases involving a properly drawn stock purchase agreement, the theory should be disputed. The government's argument is generally that the individual shareholder benefits from the transaction and should be taxed on the benefit received.¹⁵¹ The difficulty with this rationale is that anything which benefits the corporation will

¹⁴⁶ 28 T.C. 962 (1957), revd. (3d Cir. 1958) 258 F. (2d) 865.

¹⁴⁷ This has reference to income which was taxed to the corporation and distributed to the shareholders where it was again taxed. If the corporation does the purchasing, the income would only be taxed at the corporate level.

¹⁴⁸ 28 T.C. 314 (1957), affd. per curiam (6th Cir. 1958) 259 F. (2d) 119.

¹⁴⁹ 28 T.C. 19 (1957), revd. (1st Cir. 1957) 248 F. (2d) 818.

¹⁵⁰ See part I-A-1, I-B-2 supra. See note 147 supra. However, it must be recognized that in a father-son corporation the benefits of a stock purchase agreement are not so clear. The son would receive the corporation's stock through his father's estate even without an agreement and thus the continuity of ownership argument for a stock purchase agreement is quite weak.

¹⁵¹ See *Henry E. Prunier*, 28 T.C. 19 (1957); *Sanders v. Fox*, (D.C. Utah 1957) 149 F. Supp. 942; *Joseph R. Holsey*, 28 T.C. 962 (1957). See the discussion of the government's brief in *Lawthers*, "Prunier Reversed: No Income to Stockholders from Premiums Paid

at least in some degree benefit its shareholders,¹⁵² especially in a closed corporation. The use of this benefit theory places the separate entity distinction in a confusing and indefinite position which has caused a great deal of dissatisfaction.¹⁵³

The proper theory which should be applied to the separate entity problem has been suggested by a number of recent cases.¹⁵⁴ Since Congress has recognized separate entities, with modifications, the government and the courts should do likewise. The only deviation from this full recognition should be when the transaction itself has absolutely no business purpose.¹⁵⁵ Should avoidance increase, the problem would be squarely presented to Congress either to modify or repeal the separate entity treatment.¹⁵⁶ If avoidance does not increase, it is hoped that the law will begin to take a more definite and reassuring shape, which will lend itself to proper business planning.

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by Corporation," 8 J. TAXATION 12 (1958); Lawthers, "IRS Continuing Attack on Insured Redemptions Despite Court Setbacks; Sanders Reversed," 8 J. TAXATION 322 (1958).

¹⁵² For a discussion of the different "purposes" of a shareholder, see Sneed, "A Defense of the Tax Court's Result in *Prunier and Casale*," 43 CORN. L. Q. 339 (1958).

¹⁵³ Rabkin, "The Close Corporation—Through the Looking Glass," 8 N.Y.U. INST. ON FED. TAX. 664 (1950); Jones and Gleason, "Casale Reversed: Corporate Insurance Not Dividend to Controlling Stockholder," 7 J. TAXATION 258 (1957); comment, 71 HARV. L. REV. 687 (1958).

¹⁵⁴ See *Sanders v. Fox*, (10th Cir. 1958) 253 F. (2d) 855; *Casale v. Commissioner*, (2d Cir. 1957) 247 F. (2d) 440; *Holsey v. Commissioner*, (3d Cir. 1958) 258 F. (2d) 865.

¹⁵⁵ This test does not concern the benefit to the shareholder but only the benefit to the corporation. For this test the substance and not the form of the transaction should be closely scrutinized. An excellent example of this is a case where a shareholder was owner and beneficiary of a policy and the only connection the corporation had with the policy was that it paid the premium; the court still felt there was no constructive dividend. *Lewis v. O'Malley*, (8th Cir. 1944) 140 F. (2d) 735. If substance is to prevail, whether or not the insurance is mentioned in the agreement should be unimportant. Some courts have attempted to make this distinction. *Sanders v. Fox*, (10th Cir. 1958) 253 F. (2d) 855, held that since the insurance was to be used to purchase the stock as required in the agreement, the premium payments were not constructive dividends to the shareholder. On the other hand, *Casale v. Commissioner*, (2d Cir. 1957) 247 F. (2d) 440, stated that since the insurance was separate from the agreement, it would be subject to corporate creditors and therefore the premiums were not constructive dividends to the shareholders. This "no corporate benefit" test would not apply when a constructive dividend is invoked against a surviving shareholder. In this type of case there should be no dividend treatment unless there is a direct pecuniary benefit even though there is no corporate purpose. The reason for this liberal view is that a tax against the surviving shareholder undermines the realization doctrine and deprives §302(b)(2) of its effectiveness.

¹⁵⁶ To the extent that new sub-chapter S, of the Internal Revenue Code, which permits electing "small business corporations" to avoid the corporate tax, is applicable, Congress has made some strides in this direction.