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TAX CONSIDERATIONS IN DESIGNING STOCK TRANSFER AGREEMENTS

JOSEPH W. BLACKBURN*

I. IMPORTANCE OF STOCK TRANSFER (BUY-SELL) AGREEMENTS IN CLOSELY HELD CORPORATIONS

Stock transfer agreements are vital for both the formation and ultimate operation of closely-held corporations.¹ The importance and ultimate goals of stock transfer agreements include the following:

A. Insure Retention or Orderly Transfer of Control

Stock may not only be owned by the founding principals, but may perhaps have been given or sold to key employees. The stock transfer agreement can insure retention and/or orderly transfer of control upon death or termination of employment of shareholders.

B. Provide A Market for Stock

A stock transfer agreement can assure shareholders in a closely-held corporation of having a market for their shares. A market is needed upon the occurrence of events such as death, disability, termination of employment, deadlock or other triggering events.

C. Retain Key Employee Shareholders

Key employees can be rewarded based upon their continued employment with the corporation. Providing different buy-back prices upon termination of employment versus death, disability or retirement can help accomplish this goal.

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1. For a general discussion, see SHANNON P. PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 501, 517 (2d ed. 1989); HAROLD I. APOLINSKY ET AL., TAX PLANNING FOR PROFESSIONALS, ¶ 3.05[1][a][i] (1986).

D. Plan Estates

Stock transfer agreements play a vital role in estate planning by providing a source of liquidity for the decedent's family. If properly structured,² such agreements can also fix the valuation of the stock for estate tax purposes.³

*E. Other*1. *S* Corporation Protection

The stock transfer agreement can be utilized to insure that there is no sale or other transfer which would affect an *S* corporation's status.⁴

2. Shareholder Dispute Resolution

Shareholder deadlock can be a triggering event⁵ under a stock transfer agreement. Also, Put/Call⁶ types of agreements are an interesting technique for buy-outs between feuding shareholders.

3. Protection Against Shareholder Creditors

An insolvent shareholder's credit problems may, but for a stock transfer agreement, impair corporate operation and confuse corporate stock ownership.⁷

The purpose of this article is to discuss the myriad of personal, corporate and income⁸ tax considerations which must be balanced carefully in designing stock transfer agreements. The article will also address the unique concerns of *S* Corporations and employee-owned stock.

2. This article does not address estate planning and estate tax considerations in designing stock transfer agreements.

3. See APOLINSKY, *supra* note 1, at ¶ 5.01[3][a] n.7. Technically, a value set by a stock transfer agreement is not necessarily binding on the Internal Revenue Service, but such valuations are a major factor considered by the Service and "may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes." Rev. Rul. 59-60, 1959-1 C.B. 237. The value set by a stock transfer agreement has, under certain circumstances, been found by the courts to be binding on the Service. See, e.g., Estate of John Frederick Davis v. Commissioner, 37 T.C.M. (CCH) 341 (1978); Estate of Bischoff v. Commissioner, 69 T.C. 32, 48 (1977).

4. *S* Corporation stock may not be held by corporations, partnerships and certain trusts. Transfers to such entities would terminate the selection. I.R.C. § 1361(b)(1)(B) (Supp. 1992).

5. See *infra* Section II.A.

6. In a Put/Call, the offeror specifies the price at which he must either buy or sell.

7. For example, creditors may get a security interest in and take the stock.

8. Estate tax planning and implications are beyond the scope of this article.

II. STRUCTURAL OVERVIEW OF STOCK TRANSFER AGREEMENT

Normally the Corporation and/or other Shareholders have either an obligation or an opportunity to purchase all (not part) of the stock of a selling shareholder upon certain triggering events. The sale is made at prices specified in or calculable according to provisions of the agreement. Provisions for a corporation's purchase of its own stock from a shareholder create a "redemption" agreement. Provisions for purchase and sale between shareholders create a "cross purchase" agreement. Terms of payment are of utmost importance. Restrictions on transferability imposed by the agreement should be evidenced on each affected certificate.

A. Triggering Events

The nature of the triggering event⁹ is frequently the principal factor controlling price and other terms of the stock transfer. For example, a key employee might receive a low price upon termination of employment and a high price upon retirement. Pricing can be used to create a disincentive to leave and an incentive to remain with the Corporation. Furthermore, upon a lifetime sale, the purchaser may have a first right of refusal to acquire stock of the departing shareholder (*i.e.*, an option). Upon the death of a shareholder,¹⁰ the purchaser would more likely have a fixed obligation to acquire the stock.¹¹ Typical triggering events include lifetime voluntary sale, termination of employment, retirement, disability,¹² death, shareholder dispute, call, and shareholder bankruptcy.¹³

B. Corporate Redemption versus Shareholder Cross-Purchase Agreements

An unfunded stock transfer agreement¹⁴ frequently contains both Redemption and Cross-Purchase provisions within a single agreement.¹⁵

9. A triggering event is that which causes the terms of the agreement to become operable.

10. A shareholder agreement triggered at death is generally far more complicated and must be integrated with a shareholder's estate plans.

11. Such a fixed obligation assures the shareholder that his heirs will receive a fair price and will not be squeezed out as minority shareholders.

12. Lump sum disability insurance, similar to life insurance, can be acquired at a reasonable price. Proceeds can be used to provide buy-out funds. Generally, benefits received are tax free, I.R.C. § 104(a)(3) (Supp. 1992), though the alternative minimum tax may apply. I.R.C. § 56(g)(4)(B)(ii) (Supp. 1992).

13. See *Joseph v. Dever*, No. C840628, 1986 W.L. 9340 (Ohio App. August 20, 1986), for a well reasoned analysis and explanation of triggering events.

14. Generally, the agreement provides for the source of funds from which the purchaser may pay for the shares of stock, including insurance on the life of a deceased shareholder or a special reserve fund. See APOLINSKY, *supra* note 1, at ¶ 5.02[7].

15. If nonselling shareholders have an obligation to acquire the shares, but such shareholders shift the obligation to the corporation, the corporation's purchase of the shares may result in a constructive dividend to the nonselling shareholders. See *infra* Section III.

Frequently the corporation has the first option to acquire the stock. A second option (or obligation) would arise among the nonselling shareholders to acquire all the shares in the event the corporation failed to exercise its option. However, when the purchaser's obligation is funded with life insurance,¹⁶ a choice between a Redemption Agreement and a Cross-Purchase Agreement must be made.¹⁷ A choice is necessary in order to determine where the insurance will be acquired.¹⁸

C. Pricing

Pricing techniques vary widely and a single agreement may contain different pricing formulas for different triggering events. Pricing techniques may include a fixed price,¹⁹ a formula,²⁰ *bona fide* offer,²¹ original purchase price,²² appraisal²³ or a put/call.

D. Payment Terms

Payment arrangements will likely vary substantially, depending upon the nature of the triggering event, the existence of a funding mechanism such as life insurance, the credit worthiness of the corporation, the remaining shareholders and other similar variables.

E. Corporate Approval

Unless voting rights or other terms of stock are affected, provisions of stock transfer agreements are not required to appear in the corporation's Articles of Incorporation or By-laws. If stock transfer provisions are included in the Articles of Incorporation or Bylaws, then formalities for amending Articles and Bylaws must be followed in order to amend the agreement.

F. Noncompete/Nondisclosure

Inclusion of noncompete/nondisclosure provisions in the stock transfer agreement can be effective in preventing disclosure and the competitor's use

16. *See infra* Section VII.C.

17. *See infra* Section III.

18. One must determine who will have the obligation so that party can purchase the insurance.

19. Specified Price per share to be redetermined annually or set at the amount of insurance purchased for funding of the purchase.

20. E.g., book-value increased by appraised fair market value of real estate.

21. *Bona fide* offer for third party sales.

22. Original cost may be appropriate upon termination of employment.

23. *See infra* Section IV.B.

of trade secrets.²⁴

G. Permitted Transfers

Often, a stock transfer agreement permits intra-family gifts of restricted stock. The stock and each donee will continue to be subject to provisions of the agreement. Similar provisions may be established for pledging of shares to creditors.

III. REDEMPTION VERSUS CROSS-PURCHASE

A. Tax Treatment of Redemptions

Sale of stock back to the issuing corporation will be treated as either a dividend or a sale. Sale or exchange treatment applies only if the sale qualifies as a "redemption" under Section 302 or 303 of the Internal Revenue Code.²⁵ General rules applicable to all redemptions under Section 302 apply in the context of a redemption pursuant to a stock transfer agreement.²⁶ Unless a redemption qualifies under either Section 302 or Section 303, the distribution will be taxed to the selling Shareholder as a dividend under Section 301.²⁷

The principal difference between dividend treatment and "sale or exchange" treatment is the utilization of the selling shareholder's basis to

24. Such a nondisclosure/noncompete provision should be considered even if a similar arrangement is in effect under an Employment Agreement. Courts seem to more readily enforce these restrictions in the context of the sale of a business. *See, e.g., Standard-Crescent City Surgical Supplies, Inc. v. Mouton*, 535 So. 2d 1301 (La. Ct. App. 1988) (while an employment noncompete contract would be invalid under Louisiana statute, a sales agreement binding a shareholder under a non-compete clause may be valid); *Shearson Lehman Bros. Holdings v. Schmertzler*, 116 A.D.2d 216 (1986) (explaining the distinction between such covenants when incident to the sale of a business and to an employment contract); *Reiman Assoc., Inc. v. R/A Advertising, Inc.*, 306 N.W.2d 292 (Wis. Ct. App. 1981) (holding that such covenants, incidental to the sale of a business, are not subject to exacting scrutiny).

25. I.R.C. § 302(a) (1988) (Corporate redemption of its stock "shall be treated as a distribution in part or full payment in exchange for the stock"); I.R.C. § 303(a) (1988) ("A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which . . . is included in determining the gross estate of a decedent [and subject to the limitations of § 303(a)(1) and (a)(2)] . . . shall be treated as a distribution in full payment in exchange for the stock so redeemed").

26. I.R.C. § 302(a) (1988).

27. *See* I.R.C. § 301(a), (c) (1988). The Tax Reform Act of 1986, Pub. L. No. 99-513, 301 Stat. 2085 (1986), repealed the rate differential favoring capital transactions, and The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990), created a maximum 3% rate differential between Net Capital Gain and ordinary income. Unless a more substantial long-term capital gains preference is reenacted, there may be little difference between the treatment of a dividend and the gain on a sale.

reduce gain on a sale.²⁸ This is a vital distinction in the context of a post-death redemption where basis is increased to fair market value at death.²⁹

“Sale or exchange” treatment can also qualify the gain as Net Capital Gain subject to a maximum 28% tax rate. Dividend treatment can result in tax rates as high as 39.6%. The purpose of Section 302 is to distinguish between redemptions which, economically, are “essentially equivalent to a dividend” and those which are economically equivalent to a “sale or exchange.” In order to qualify for “sale or exchange” treatment, the redemption must comply with one of the provisions of subsections 302(b)(1), (2) or (3).³⁰

Section 302(b)(1) is a subjective provision which incorporates old common law principles established by the courts prior to the enactment of the more objective provisions of (b)(2) and (b)(3) discussed below. Usually, Section 302(b)(1) is relied upon only as a last resort, when a redemption fails to qualify under the clearer and more objective requirements of (b)(2) or (b)(3).

Under Section 302, a substantially disproportionate redemption of stock will receive redemption, *i.e.*, “sale or exchange,” treatment.³¹ This test is satisfied if prescribed mathematical requirements have been met. The component parts of the tests are as follows: (1) the shareholder must, immediately after the redemption, own less than 50% of the combined voting power of all classes of stock of the corporation; (2) the shareholder’s proportionate voting power must have been reduced by at least 20% as a result of the redemption;³² and (3) the shareholder’s interest in all *common stock* (whether voting or nonvoting) must be reduced by at least 20%.³³

The complete termination of a shareholder’s interests in a corporation also receives redemption treatment.³⁴ The importance of the complete

28. See I.R.C. §§ 301(c) (Supp. 1992), 302(b) (1988). If redemption is treated as a dividend, earnings and profits are reduced by the sum of the cash, the principal amount of any obligation, and the greater of the adjusted basis or fair market value of any other property distributed. Brian J. Simmons, *Tax Planning for Stock Redemption Agreements*, 68 MICH. BAR J. 272, 273 (1989).

29. I.R.C. § 1014(a) (1988) (The basis of “property in the hands of a person acquiring the property from a decedent” is generally fair market value at the time of death).

30. See I.R.C. § 302(b)(4) (1988) (dealing with partial liquidations).

31. I.R.C. § 302(b)(2) (1988).

32. These disproportionate redemption rules *cannot* apply to redemptions of solely nonvoting shares. Treas. Reg. § 1.302-3(a)(3) (1978); *but see* Rev. Rul. 77-426, 1977-2 C.B. 87 (stock was nonvoting, nonconvertible, limited and preferred as to dividends and in liquidation):

33. See Treas. Reg. § 1.302-3(b) (1978) (setting forth examples); *see also* I.R.C. § 302(b)(2) (1988). The rule can apply to disproportionate redemptions consisting solely of voting preferred stock if the shareholder owns no common stock. Rev. Rul. 81-41, 1981-1 C.B. 121.

34. I.R.C. § 302(b)(3) (1988). Recently, the Service reviewed a situation where a man, his mother, and a qualified subchapter S trust (QSST) held all of the S corporation’s stock. The Service determined that a redemption by the S corporation of all of the mother’s and QSST’s stock will be treated under I.R.C. § 302 (1988) as a distribution of property to which I.R.C. § 301 (Supp. 1992) applies. Moreover, the Service found that any distribution will not be

termination rule lies primarily in the redemption of nonvoting shares or in the waiver of family attribution rules governing constructive stock ownership under Section 302(c)(2).

In determining the applicability of the exemptions provided by Section 302(b)(1), (b)(2), and (b)(3), constructive ownership rules of Section 318 apply. Under Section 318 there is attribution of stock³⁵ ownership (1) among family members;³⁶ (2) from entities back to individuals,³⁷ and (3) from individuals to entities.³⁸ Importantly, Section 318(a)(1), pertaining to family attribution, *does not* apply to a redemption otherwise qualifying as a complete termination of interest under Section 302(b)(3).³⁹ Notice that this waiver *only* applies to *family* attribution and does not apply to entity attribution under subsections 318(a)(2) or (3).⁴⁰ Thus, a complete termination of interest of a living parent may qualify as a redemption. However, a complete termination of that parent's estate's interest in the corporation may fail to qualify under Section 302(b)(3), because estate/beneficiary attribution rules are not waived under Section 318(a)(2).⁴¹

Redemptions from estates are automatically treated as sales or exchanges, and not as dividends, if they meet the requirements of Section 303. For redemption treatment, the value of the corporation's stock included in determining the value of the deceased stockholder's gross estate must exceed 35% of the excess of (1) the value of the gross estate of such decedent, over (2) the sum of the amounts allowable as a deduction to the estate under Section 2053 or 2054.⁴² If Section 303 applies, the maximum amount which can be redeemed is the sum of the estate tax, administrative expenses and funeral expenses payable by the estate.⁴³

included in the mother's gross income to the extent that the total distribution during the taxable year is less than the corporation's accumulated adjustments account and the mother's basis in the stock. Pub. Ltr. Rul. 92-30-016 (July 24, 1992).

35. This means that stock is deemed to be owned by persons and/or entities closely-related to the actual owner.

36. I.R.C. § 318(a)(1) (1988).

37. I.R.C. § 318(a)(2) (1988). For example, from a controlled corporation to a shareholder.

38. I.R.C. § 318(a)(3) (1988). For example, from beneficiary to estate or trust.

39. I.R.C. § 302(c) (1988); see Treas. Reg. § 1.302-3(a)(3) (1978).

40. See I.R.C. §§ 302(c), 318(a)(2), (3) (1988). A complete termination requires termination of all employment and similar relationships. Although there is conflict over the appropriate interpretation of what employment relationships are within the prohibition, the appellate court has strictly interpreted the statutory construction to include all employment relationships. *Lynch v. Commissioner of Internal Revenue*, 801 F.2d 1176 (9th Cir. 1986), *rev'g* 83 T.C. 597 (1984).

41. In drafting a stock transfer agreement among family members, avoid mandatory redemption provisions which are triggered by death. I.R.C. § 302(b)(3) (1988) will not apply if other stockholding family members are beneficiaries of the estate. Consider terminating the family member's status as a beneficiary if caught in this trap. In some estates, I.R.C. § 303 (1988) may apply and thus redemption treatment will not be dependent upon waiver of the constructive ownership rules. Section 303 grants automatic redemption treatment if you otherwise qualify.

42. I.R.C. § 303(b)(2) (1988).

43. I.R.C. § 303(a) (1988).

Note, that in order to substantially benefit from Section 303, an estate must owe estate taxes and/or have other expenses of the estate. Thus, the most important application of Section 303 is where the estate owes substantial taxes. This usually occurs only upon the death of the last survivor of stockholder spouses.

B. Tax Treatment of Cross-Purchase Agreements

Other than funding considerations,⁴⁴ the principal tax advantage of a cross-purchase over a redemption is a higher basis for the acquired stock. When one shareholder buys the stock of another shareholder, the purchaser receives a cost basis in the shares acquired.⁴⁵ By contrast, in the context of a redemption, the corporation acquires shares which are either treated as Treasury shares or are cancelled, and the basis of those shares becomes irrelevant.⁴⁶

IV. BASIC APPROACHES TO SETTING THE PURCHASE PRICE

There are three basic approaches for determining fair market value in stock transfer agreements: (1) negotiation and agreement among the parties; (2) formal appraisal by an outside, independent appraiser; and (3) the formula approach based on some measure of the firm's financial performance, as reflected in the financial statements.

Unfortunately, none of the above approaches give an exact statement of the "true value" of shares of stock in a close corporation.⁴⁷ Perhaps no one formula will give the closest approximation of the true fair market value of shares of stock in closely held corporations under all circumstances. In noting the tenuous nature of the evaluation process, the Internal Revenue Service has stated: "Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science."⁴⁸ Yet, the Service has set forth a beginning point in the valuation analysis. Fair market value is defined as "The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to

44. See *infra* Section VII.

45. I.R.C. § 1012 (1988).

46. Corporations do not recognize gain or loss on dealings in their own stock. I.R.C. § 1032 (1988).

47. See EDWIN T. HOOD ET AL., 2 CLOSELY HELD CORPORATIONS IN BUSINESS AND ESTATE PLANNING 104 (1982); Solk & Grant, *Valuation Techniques for the Closely-Held Enterprise*, 92 COMM. L.J. 254, 255 (1987).

48. See Rev. Rul. 59-60, 1959-1 C.B. 237; see also *South Carolina Nat'l Bank v. McCleod*, 256 F. Supp. 913 (D.S.C. 1966).

sell and both having reasonable knowledge of relevant facts.”⁴⁹

Following is a discussion of the three basic valuation approaches outlined above.

A. *Negotiation and Agreement Among the Parties*

Business owners and other parties to the agreement will be most knowledgeable about the business, especially in matters that do not appear in the firm's financial statements. They may be able to agree on a valuation to be specified as the purchase price. Because business conditions and the circumstances of the shareholders will vary over time, the agreement should contain a provision calling for periodic redetermination of the specified purchase price.

The disadvantages may, however, outweigh any advantages to be gained by this approach. For example, after an initial price is set, the parties may not subsequently be able to agree on a price redetermination. Also, the parties may simply neglect to periodically redetermine the price as specified in the agreement.⁵⁰ Constant reevaluations may create friction among the shareholders. Therefore, the agreement needs to provide for an alternative means of valuation, such as arbitration, formula or outside appraisal.

There are other potential problems with this approach. One of the parties may take unfair advantage of the others. For example, suppose at the time for price redetermination, one of the shareholders, who also happens to be a key employee, is terminally ill. The other shareholders could agree on a very low price, perhaps citing the potential loss of a shareholder or key employee as a *bona fide* business purpose for the low figure.⁵¹

B. *Independent Outside Appraisal*

Where the appraisal method is chosen, the agreement should provide a method for selecting an independent, knowledgeable and experienced appraiser of close corporations.⁵² The appraiser should be given a clear set of guidelines in determining the value of the stock. Finally, all parties to the agreement should agree to be bound by the appraiser's determination.⁵³ Courts have tended to place heavy emphasis on the findings and conclusions of expert appraisers.⁵⁴ Parties who anticipate any Internal Revenue Service

49. Treas. Reg. § 20.2031-1(b) (as amended in 1992).

50. See HOOD, *supra* note 47, at 506-07.

51. See Orville B. Lefko, *Buy-Sell Agreements and Appraisals*, 55 MICH. ST. B.J. 116, 120-21 (1976).

52. See W. ROTHENBERG, *TAX AND ESTATE PLANNING WITH CLOSELY HELD CORPORATIONS* 608 (1981).

53. See *id.*

54. For example, 67 valuation cases were decided in Tax Court during the period June 1966 through June 1974; 30 of which involved expert testimony on the valuation as a factor in the courts' decisions. Lefko, *supra* note 51, at 121.

challenge, should select as their appraiser a potential expert witness for subsequent tax litigation.

C. Valuation by Use of Formula

1. Book Value

Book value is the total of a firm's assets minus the total of its liabilities. The amount of such assets and liabilities are as recorded on the firm's financial statements.⁵⁵ To determine book value per share, the book value of the firm is divided by the total number of shares outstanding. Though this formula is one of the easiest to use, it nearly always fails to yield an accurate reflection of fair market value.⁵⁶

2. Net Asset or Adjusted Book Value

As contrasted with book value, the net asset approach values assets at their current fair market value.⁵⁷ This method produces a more accurate estimate of asset fair market value than book value. The net asset method likewise fails to consider the going concern value of the business, but may be useful in establishing a minimum value, i.e., a floor.⁵⁸

3. Replacement Value

Replacement value is simply the hypothetical dollar amount that would be required to replace a firm's total assets at present prices.⁵⁹ This method will normally yield a higher valuation figure than either book or net asset

55. The value of assets as stated in any firm's financial sheets are based on historical cost, not present value. In addition, the book value of a company fails to take into account the "going concern" value of a business. At most, the book value should be used only as a starting point or when other approaches fail to yield a meaningful result.

56. Judith F. Todd & Roy F. King, *Valuation of Publicly Traded Securities: Blockage and Related Matters*, 248 TAX MANAGEMENT A-1, A-1 (1992).

57. Solk & Grant, *supra* note 47, at 265; HOOD, ET AL., *supra* note 47, at 113-14.

58. See R. RADCLIFFE, INVESTMENT CONCEPTS, ANALYSIS, AND STRATEGY 284-85 (1982); Solk & Grant, *supra* note 47, at 265. Net asset value may be fairly accurate when applied to firms whose principal business is the holding of assets (i.e., trusts, investment companies, personal holding companies).

59. RADCLIFFE, *supra* note 58, at 285; Solk & Grant, *supra* note 47, at 265.

value.⁶⁰

4. Liquidation Value

The liquidation value of a firm is represented by the number of dollars available to shareholders if a firm discontinued its business operations, subjected its assets to a quick or forced sale, and distributed the proceeds to creditors and security holders in order of legal priority.⁶¹

5. Comparable Company or Substitution Value

The value of comparable publicly traded corporations “engaged in the same or a similar line of business” may be highly relevant.⁶² Even where the other firms are not entirely similar to the firm being appraised, the inquiry may still be useful. For example the method could help in determining a proper capitalization rate for the firm being appraised. It must be recognized that a downward adjustment in the value of the close corporation’s shares may be required to reflect lack of marketability.⁶³

6. Capitalization of Earnings

Capitalization of earnings involves applying a capitalization rate⁶⁴ to the corporation’s past or projected earnings.⁶⁵ The riskier the investment, or the higher the market rate of return, the higher should be the rate of return required on the shares being evaluated.

When applying this method of valuation, the appraiser should make any adjustments necessary to accurately reflect the firm’s earnings. For example, the appraiser should adjust for excessive management salaries, extraordinary or nonrecurring income and expense entries, and any personal or extravagant expenses being paid by the corporation.

The disadvantage of this approach is the difficulty involved in determining the appropriate earnings and selecting a fair capitalization rate. An advantage of this approach is that it takes into account the going concern

60. See generally Solk & Grant, *supra* note 47, at 265-66. The operating value of a business will likely be totally unrelated to the replacement cost of the firm’s assets.

61. See *supra* RADCLIFFE, note 58, at 284-85; Solk & Grant, *supra* note 47, at 265. Liquidation value reflects the absolute minimum value of the firm’s stock. This approach should be used only where the business is in bankruptcy or extreme financial difficulty with little chance for a turnaround.

62. See I.R.C. § 2031(b) (1988); Rev. Rul. 59-60, 1959-1 C.B. 237; Solk & Grant, *supra* note 47, at 266-67.

63. See *infra* note 69 and accompanying text.

64. The capitalization rate, *i.e.*, appropriate rate of return, reflects the risks inherent within the corporation, including the likelihood of consistent future earnings. This figure is applied to the percentage of ownership represented by the stock sold.

65. Because the term “earnings” is subject to interpretation, it should be defined in the buy-sell agreement. APOLINSKY, *supra* note 1, at ¶ 5.06[2][b].

value of the corporation.

7. Discounted Future Earnings/Cash Flow

This approach entails estimating the firm's earnings or cash flow over some period of years⁶⁶ into the future. The earnings or cash flow figures are then discounted back to their present value. The method is designed to calculate the corporation's future earning power in terms of today's dollars. The disadvantage lies in trying to accurately estimate the firm's future earnings or cash flow and determining an appropriate discount rate. The method also requires determination of present value for the residual,⁶⁷ future value of the business.

8. Capitalization of Dividends

This method entails estimating expected dividends per share to be paid out by a firm over some period of future years. An appropriate capitalization rate based on perceived risk and desired rate of return is applied to such dividend income.⁶⁸ This is a common approach to stock valuation among publicly held companies.

9. Discount for Lack of Marketability

Closely-held corporations ordinarily do not have a ready market for their stock. This lack of marketability leads to a discount from its valuation.⁶⁹ As one court has recognized, "an unlisted closely held stock of a corporation . . . in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public."⁷⁰

The Tax Court has denied the lack of marketability discount, however, in at least one case involving valuation of the shares of two close corporations.⁷¹ The lack of a discount was based on the presence of the following

66. Ten years is a common period over which to project earnings or cash flow.

67. Residual value is the value upon expiration of the ten-year cash flow projection period.

68. RADCLIFFE, *supra* note 58, at 287. Typically, a five-year history of the company's earnings is converted into present fair market value by using a multiplier factor, which is often the price/earnings ratio of comparable companies in the public sector. Todd & King, *supra* note 56, at A-3.

69. See, e.g., Ross v. Ross, 600 A.2d 891 (Md. Ct. Spec. App. 1992); *In re Seagratt Floral Co.*, 583 N.E.2d 287 (N.Y. 1991); Fechtor v. Fetchor, 534 N.E.2d 1 (Mass. App. Ct. 1989); Bosserman v. Bosserman, 384 S.E.2d 104 (Va. Ct. App. 1989); Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill App. Ct. 1988); Kalisch v. Kalisch, 585 N.Y.S.2d 476 (N.E. 2d 1992); King v. FTJ, Inc., 765 S.W.2d 301 (Mo. 1988) *reh'g denied* (1989); Bors and Bors, 839 P.2d 272 (Or. Ct. App. 1992); Charland v. County View Golf Club, 588 A.2d 609 (R.I. 1991); Goodrich v. Goodrich, 613 A.2d 203 (Vt. 1992).

70. Central Trust Co. v. United States, 305 F.2d 393, 405 (Ct. Cl. 1962).

71. See Estate of Jephson v. Commissioner, 87 T.C. 297 (1986).

factors: (1) all assets of the company were liquid; (2) neither company had significant liabilities; and (3) the decedent's 100% ownership of the companies gave her the right to liquidate them at any time.⁷² Although no set rule exists for estimating the size of the discount, courts have sanctioned discounts of between 10% and 33 1/3%.⁷³

10. Majority and Minority Interest Block Discount

The lack of marketability discount can apply to either majority or minority interests.⁷⁴ Either the majority or minority shareholder may attempt to sell a large block of publicly traded stock, create a buyer's market, and force the price down.⁷⁵ Consequently, the courts sometimes allow the selling shareholder to claim a block discount and reduce the stated value of the stock for tax purposes. The attorney who is considering the possibility of claiming a block discount should remember the possibility of increased scrutiny by the IRS, penalties due to undervaluation, and estate tax implications resulting from any additional gains.⁷⁶

A minority interest is generally less valuable than the majority interest; therefore, it should receive an additional discount.⁷⁷ However, courts tend to disallow block discounts for shareholders whose ownership represents only a small portion of the outstanding shares.⁷⁸ Some courts are persuaded and the Service has recognized the need to allow such a discount for those who hold a proportionally small number of shares, when many of the remaining shares are closely held and not traded.⁷⁹ In determining whether to allow a blockage discount, courts weigh the facts and circumstances of the particular case to determine whether the shares could be disposed of over a reasonable period of time without depressing the market, thus making a discount inappropriate.⁸⁰ Because of the difficulty in substantiating block discounts, courts allow and the attorney should consult experts who can provide relevant evidence.⁸¹ The expert must be able to determine the appropriate discount and prove that the size of the block and the prevailing

72. *Jephson v. Commissioner*, 87 T.C. 297, 303 (1986).

73. *See generally* *Jephson v. Commissioner*, 87 T.C. 297 (1986).

74. A significant premium for a block sale of the majority interest, however, is uncommon even in closely held corporations. *Todd & King*, *supra* note 56, at A-15. State corporate laws do not alleviate all of the problems faced by the minority shareholder. A minority shareholder in a closely-held corporation is often at the mercy of the majority shareholders as to managerial decisions and "freeze-out" techniques. *See HOOD*, *supra* note 47, at 135-36.

75. *Todd & King*, *supra* note 56, at A-1.

76. *Id.* at A-1, A-2.

77. *Id.* at A-7.

78. *Id.*

79. *Id.*; *see* Treas. Reg. § 20.2031-2(f) (as amended in 1992); Rev. Rul. 59-60, 1959-1 C.B. 237.

80. *Todd & King*, *supra* note 56, at A-8, A-9.

81. *Id.* at A-4.

market *justify* the discount.⁸²

Although there is no set formula for determining the appropriate discount, several courts consider the cost of selling the stock in a secondary distribution (*i.e.*, special offering), while those and others find that the liquidation valuation theory is the appropriate method.⁸³

V. TAX ISSUES WITH EMPLOYMENT RELATED STOCK TRANSFER AGREEMENTS

Many business organizations use diverse employee compensation schemes. A prevalent non-salary method is to substitute shares of the corporation's stock for cash compensation. As the corporation's business succeeds, the value of the employee's stock rises. Stock compensation agreements, however, normally include limitations on the holder's right to transfer or to retain his shares. These restrictions may be imposed by a stock transfer agreement, articles of incorporation or the corporate bylaws. The sale of stock to an employee coupled with stock transfer restrictions raises numerous income tax questions.

A. Section 83

Pursuant to Section 83,⁸⁴ an employee will realize ordinary income upon receipt of stock unless such stock is substantially nonvested,⁸⁵ *i.e.*, unless it is subject to a substantial risk of forfeiture. Unfortunately, the Section 83 definition lacks substantive objective guidelines as to when a

82. *Id.* at A-5 (citing *Dellacroce v. Commissioner*, 83 T.C. 269 (1984)).

83. *Id.* at A-15; *see also supra* Section IV.C.4.

84. 26 U.S.C. § 83 (Supp. 1992) was enacted by Congress in 1954, and revised by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969). The purpose of Section 83 is to prevent an employee from avoiding the imposition of a tax on noncash compensation from stock and options. Prior to section 83, no tax was imposed until the restrictions on the agreements lapsed or the stock was sold. Even when a tax was imposed, only the difference between the reduced price of the stock and the lesser of the (1) fair market value at the time of acquisition, or (2) the fair market value on the date the restriction on the stock lapsed was subject to taxation. Thus, the employee could avoid any tax on the appreciation of the stock shares during the period of possession.

Section 83 taxes this appreciation to the employee as ordinary income. I.R.C. § 83(a) (Supp. 1992). If Section 83 applies to a transaction, the employer-corporation will receive a tax deduction, just as if it had paid a regular cash salary. I.R.C. § 83(h) (Supp. 1992). The employee will recognize the gain as ordinary income.

85. Section 83 will apply if property is transferred in connection with the performance of services, the property is not subject to a substantial risk of forfeiture, and the property is not disposed of in an arm's length transaction prior to becoming transferable, *i.e.*, when the risk of forfeiture no longer applies. *See* I.R.C. § 83(a), (c) (Supp. 1992).

“substantial risk” exists.⁸⁶ The Regulations merely state that “for purposes of Section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances.”⁸⁷

The amount of ordinary income an employee recognizes is the difference between the value of the stock and the amount paid by the employee. Such income is deemed paid in connection with the employee’s performance of services. Thus, the employee has income and the employer corporation has a corresponding deduction.

If the stock received is subject to a substantial risk of forfeiture⁸⁸ and is nontransferable, the employee’s recognition of income will be postponed. In such a case, the income will be recognized only when the substantial risk of forfeiture is eliminated.

Frequently the provisions of a stock transfer agreement impose substantial risks of forfeiture in these situations. For example, a stock transfer agreement may require that the employee sell the stock back to the corporation at the same price paid by the employee upon termination of employment.⁸⁹

The foregoing rules apply even when the employee acquires stock at a discount from another stockholder. The selling stockholder’s discount is treated as a contribution to the corporation followed by a transfer of the discounted amount by the corporation to the employee.⁹⁰

There is no bright line test to determine existence of substantial risk of forfeiture under section 83(c)(1). The subsection is deliberately vague and grants wide latitude to courts. For the client, the question is not whether he

86. Section 83(c)(1) defines a “substantial risk of forfeiture” as follows:

(c) Special rules. - For purposes of this section -

(1) Substantial risk of forfeiture. -

The rights of a person in property are subject to a substantial risk of forfeiture if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.”

I.R.C. § 83(c)(1) (Supp. 1992).

87. Treas. Reg. § 1.83-3(c) (as amended in 1985). Several cases have elaborated on the definition. *See, e.g.,* *Montelepre Systemed, Inc. v. Commissioner of Internal Revenue*, 956 F.2d 496 (5th Cir. 1992) (the facts and circumstances test will be unnecessary when retention of the right of first refusal is conditioned upon the continued performance of substantial services under contract); *MacNaughton v. United States*, 888 F.2d 418 (6th Cir. 1989) (stock subject to a restrictive agreement may be classified as restricted under § 83(a) and thus may be subject to substantial risk of forfeiture); *Quantz v. Commissioner*, 53 T.C.M. (CCH) 1402 (1987) (finding no forfeiture where nothing suggests anything other than immediate full dominion and control over the stock). *See generally* *Gresham, Inc. v. Commissioner of Internal Revenue*, 752 F.2d 518 (1985); *Pagel v. Commissioner*, 91 T.C. 200 (1988).

88. I.R.C. § 83(c)(1) (Supp. 1992).

89. *See* Treas. Reg. § 1.83-5(a) (as amended in 1985). For examples of “substantial risk of forfeiture,” *see* Treas. Reg. § 1.83-3(c)(2), 3(c)(4) (as amended in 1985) (examples 1, 3 and 4).

90. Treas. Reg. § 1.83-6(d) (as amended in 1985).

will pay tax on the value of the stock received, but when he will be forced to pay it. To insure deferral of income recognition, Taxpayer must show a conspicuous and intentional risk of forfeiture with a discernible business purpose.

In *Burnetta, O.D., P.A. v. Commissioner*,⁹¹ the taxpayer's compensation agreement stated: "If any participant shall be discharged for theft of company property or embezzlement, and convicted therefore [sic] in a court of competent jurisdiction, his proportionate interest . . . shall thereupon be forfeited by him. . . ."⁹² The court held that "the possibility that a Burnetta corporation employee would be discharged and convicted for theft or embezzlement of corporation property was too remote to present any substantial risk that the amounts contributed on his behalf would be forfeited."⁹³ Therefore, the amounts contributed to the employee's plan were to be immediately included in gross income.

*Richardson v. Commissioner*⁹⁴ involved a compensation agreement which required the employee, a doctor, to render advice and counsel to a hospital even after his official retirement date.⁹⁵ Taxpayer maintained that this arrangement required him to provide substantial post-retirement services, and if he failed to do so, he would forfeit his rights to the trust.⁹⁶ In holding that the compensation in trust was not subject to a substantial risk of forfeiture, the court determined that the compensation was in fact for past and current services, not future services.⁹⁷

In *Robinson v. Commissioner*,⁹⁸ a stock option contained a clause which obligated the Taxpayer to hold the shares for one year after exercising the purchase option.⁹⁹ Taxpayer exercised his option, but contended that the sellback provision, stop transfer order, and absence of registration with the Securities and Exchange Commission combined to create a substantial risk of forfeiture.¹⁰⁰ The First Circuit agreed, and held that Centronics had a fiduciary duty to the other shareholders to enforce the sellback provision.¹⁰¹

91. 68 T.C. 387 (1977).

92. *Id.* at 390-91.

93. *Id.* at 405. Under the pre-1969 rule, the mere possibility of employee misconduct was sufficient to forfeit an employee's rights under such plans (which would result in the income not being included). *Id.* (citing *Pollnow v. Commissioner*, 35 T.C. 715 (1961); *Liberty Machine Works v. Commissioner*, 62 T.C. 621 (1974); *Comprehensive Designers Int'l, Ltd. v. Commissioner of Internal Revenue*, 66 T.C. 348 (1976)).

94. 64 T.C. 621 (1975).

95. *Richardson*, 64 T.C. at 623.

96. *Id.* at 625-26.

97. *See Id.* The agreement also contained a provision which allowed the doctor to receive his benefits in one lump sum payment upon retirement and thereby avoid any risk of forfeiture. *Id.* at 628-29.

98. 805 F.2d 38 (1st Cir. 1986), *rev'g* 50 T.C.M. (CCH) 89 (1985).

99. *Robinson*, 805 F.2d at 39.

100. *Id.*

101. *Id.* at 40.

The court stated, "the use of the modifier 'substantial' indicates that the risk must be real; it must serve a significant business purpose apart from the tax laws."¹⁰²

Securities law restrictions were specifically addressed in *Pledger v. Commissioner of Internal Revenue*.¹⁰³ Taxpayer acquired company shares through an employment stock option.¹⁰⁴ The shares were transferred to Pledger without a substantial risk of forfeiture specified in the agreements.¹⁰⁵ The shares, however, were not registered with the S.E.C.¹⁰⁶ If Pledger had sold them within six months, their value would have been reduced 35%, due to securities restrictions. Though the limitation was not imposed by the agreement, the securities laws were held to create a substantial risk of forfeiture.¹⁰⁷

B. Gain Upon Elimination of the Risk of Forfeiture

When the substantial risk of forfeiture is eliminated, the employee will have income. The income is the difference between the amount paid and the fair market value of the stock at such time.

Thus, income may be triggered even upon a stockholder employee's death. The employee stockholder's death may be the event which eliminates the substantial risk of forfeiture. According to Section 83, gain is measured at such time by the difference between the stock's fair market value and the "amount paid." The "amount paid" would apparently not be the same as the new stepped-up basis¹⁰⁸ received by the estate.

C. Election Out

A shareholder employee may elect to presently recognize any purchase discount as income. The election under Section 83(b) must be filed within thirty (30) days following acquisition of the stock. This election will avoid triggering additional income in the future as a result of appreciation between date of purchase and that future date when substantial risk of forfeiture is

102. The business purpose of the sellback provision was to prevent Taxpayer from engaging in insider trading. See also *MacNaughton v. U.S.*, 888 F.2d 418 (1989) ("Transferability under § 83(a) depends on standard practices and assumed observance of contract, not hypothetical sub rosa violations.")

103. 641 F.2d 287 (5th Cir. 1981), *aff'g* 71 T.C. 618 (1979).

104. *Pledger*, 641 F.2d at 288.

105. See *id.* at 291, 293-94.

106. *Id.* at 288. The shares were not registered under the Securities Act of 1933, 15 U.S.C. § 77(f) (1988), and could not be sold without a "no action letter" or until they were registered. *Id.* A "no action letter" is written by a government attorney advising the agency that no prosecution will occur on the facts.

107. See *Pledger*, 641 F.2d at 291. In *Koss v. Commissioner*, 57 T.C.M. (CCH) 882 (1989), lack of registration was held not to constitute a substantial risk of forfeiture.

108. I.R.C. § 1014 (1988).

eliminated.¹⁰⁹

D. Cautions to S Corporations

The impact of Section 83 on S corporations is unclear. Treasury Regulation Section 1.83-1(a)(1) provides that stock which is substantially nonvested shall be regarded as owned by the employer-corporation, not by the employee.¹¹⁰ The regulation further states that any income received by the employee attributable to the stock is treated as additional compensation income.¹¹¹

If this approach applies to the stock of an S corporation, items of income, deduction, loss and credit of the S corporation would not be allocated to the employee. Likewise, there would be no basis adjustments under Section 1367.

VI. IMPACT OF STOCK TRANSFER AGREEMENT ON NET OPERATING LOSS CARRYFORWARDS

Section 382 imposes limitations on a corporation's utilization of its net operating loss carryforwards when there has been an "ownership change."¹¹² Such an "ownership change" occurs if shareholders of a loss corporation have increased their ownership by more than fifty percentage points (based on value) during the preceding three-year test period.¹¹³ Section 382 provides that, in determining whether or not an ownership change has taken place, options shall be deemed to have been exercised.¹¹⁴ Furthermore, a stock transfer agreement is specifically treated as an option in applying the "deemed exercise" rule.¹¹⁵ Agreements which may grant rights of first refusal for lifetime purchase and sale of stock would possibly fall within an exception to such rules.¹¹⁶ Thus, mere execution of a stock

109. This election must be filed even if the stockholder employee initially paid full fair market value and received no discount. *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984), *aff'd* 79 T.C. 865 (1983).

110. Treas. Reg. § 1.83-1(a)(1) (as amended in 1985); *See also* Treas. Reg. § 1.83-3(b), (c) (as amended in 1985).

111. Treas. Reg. § 1.83-1(a)(1) (as amended in 1985); *See also* Rev. Proc. 80-11, 1980-1 C.B. 616.

112. I.R.C. § 382(g) (1988).

113. I.R.C. § 382(g)(1) (1988).

114. Conference Committee page ¶ 26,088 note 6. *See also* I.R.C. § 382 (1988).

115. *See* Treas. Reg. § 1.382-2T(h)(4)(v) (as amended in 1992).

116. Purchase options granted in the event of death, disability or incompetence are excluded from the foregoing "deemed exercise" rule. There are four requirements to fall within this exception: a) the options are held by noncorporate shareholders; b) such noncorporate shareholders actively participate in corporate management; c) the option was granted prior to the corporation's becoming a loss corporation; and d) the option must be exercisable *only* in the event of death, disability or incompetency.

transfer agreement may trigger an ownership change and, thereby result in loss or limitation on the use of net operating loss carryforwards.

VII. FUNDING THE STOCK TRANSFER AGREEMENT

Whether the stock transfer agreement is a redemption agreement or a cross-purchase agreement, prospective purchasers must consider the source of funds for the purchase. This is vital when the purchase is mandatory. Typically, sources include reserved savings (accumulated profits), incurrence of debt (including seller financed purchasing), and life or disability insurance. If there is no source of funding, dissolution may be the only remaining option.

A. Funding From Accumulated Earnings and Profits

If a corporation undertakes to accumulate after-tax earnings and profits to fund a future redemption, it may be confronted with accumulated earnings tax problems.¹¹⁷ Usually, the accumulation of earnings and profits for the purpose of funding an anticipated redemption of stock is not treated as a reasonable need of the business.¹¹⁸ However, an accumulation can be justified as a reasonable need of the business if the redemption is to eliminate a dissenting, minority shareholder.¹¹⁹ Accumulations of earnings and profits for the purpose of retiring debt issued to finance a redemption is also a reasonable need of the business.¹²⁰

Accumulations made to fund a redemption on the death of the shareholder under Section 303 will also avoid the accumulated earnings tax.¹²¹ The statute does provide a fairly generous time frame for the corporation to make qualifying distributions. Section 303(b) covers distributions made within ninety days of the expiration of the statute of limitations for estate taxes, within sixty days of a deficiency determination by the Tax Court, or within the time allowed under Section 6166¹²² for installment estate tax pay-

117. I.R.C. § 531 (Supp. 1992). Accumulated earnings subject to the tax are taxed at a rate up to 39.6% of the accumulated taxable income. This problem only applies to "C" corporations, because "S" corporation shareholders are taxed on all the firm's income annually and, therefore, are exempt from the accumulated earnings tax under I.R.C. § 532 (1988).

118. See *Lamark Shipping Agency, Inc. v. Commissioner*, 42 T.C.M. (CCH) 38 (1981); *Ted Bates & Co., Inc.*, 24 T.C.M. (CCH) 1346, 1367 (1965).

119. *Dickman Lumber Co. v. Commissioner*, 355 F.2d 670 (9th Cir. 1966); *Lamark Shipping Agency, Inc.*, 42 T.C.M. (CCH) 38 (1981).

120. See I.R.C. § 537(a)(2) (1988).

121. I.R.C. § 537(b)(1) (1988); I.R.C. § 303(a) (1988). See *supra* note 41 and accompanying text.

122. Section 6166 allows qualifying initial estate tax payments to be deferred for up to five years and then paid with up to nine annual installment payments resulting in a fourteen year payout period. I.R.C. § 6166(a)(3) (1988). Only that portion of the estate tax attributable to closely-held business interests qualifies for the deferral. I.R.C. § 6166(a)(1) (1988).

ments.¹²³ The stock transfer agreement could further provide that additional distributions would be accumulated and paid out to a widow or heir in installments or in a lump sum at the end of the period as provided by Section 303.

However, any shareholder entering a buy/sell agreement providing for repayment in installments should consider *Mountain State Steel Foundries v. Commissioner of Internal Revenue*.¹²⁴ *Mountain State* held that the agreement was only intended to apply if the corporation had enough money to fund the buyout.¹²⁵

If accumulated earnings and profits are distributed to shareholders to allow shareholders to save such distributions in anticipation of a cross-purchase, the distribution will result in double taxation as a dividend.

B. Debt Financed Redemptions and Cross Purchases

Use of installment notes to redeem stock is permissible under Section 302, including the provisions for complete termination of interests.¹²⁶ However, the Service will not issue private letter rulings on the issue.

Depending on the estate's immediate liquidity needs, the ability to obtain life insurance and the credit risk which the seller is willing to assume, combinations of life insurance funding and seller credit can work well.

The purchaser may utilize installment payments to help finance the acquisition. Pursuant to Section 453, the seller can defer recognizing income until the payments are received.¹²⁷

One case, *Maher v. Commissioner of Internal Revenue*,¹²⁸ held that, although the corporation's assumption of its shareholder's liability to a third person constituted a dividend, no dividend income was recognized until and as installment payments were actually made by the corporation.¹²⁹

The stockholder may choose to avoid Section 453 and contend instead that his redemption be treated as an "open transaction."¹³⁰ The primary benefit of "open transaction" treatment is the ability to completely recover

123. IRC § 303(b) (1988).

124. 284 F.2d 737 (4th Cir. 1960).

125. See *Mountain State*, 284 F.2d at 742-43. The case, which found an executory agreement instead of a contract, was later reversed by statute. See DEL. GEN. CORP. LAW. § 160(a) (1991).

126. See I.R.C. §§ 302(c)(2), 303(b) (1988); Rev. Proc. 81-62, 1981-2 C.B. 684. Section 6166 affords the decedent's estate up to 14 years to pay the estate tax. I.R.C. § 6166(a) (1988).

127. I.R.C. § 453 (1988). See *Estate of Mathis v. Commissioner of Internal Revenue*, 47 T.C. 248, 257 (1966). Installment treatment has been expressly recognized on the sale of closely-held stock. *Weaver v. Commissioner*, 647 F.2d 690 (6th Cir. 1981); *Roberts v. Commissioner*, 647 F.2d 690 (9th Cir. 1981). See also *Sprague v. United States*, 627 F.2d 1044 (10th Cir. 1980) (installment treatment for similar transaction examined in detail).

128. 55 T.C. 441 (1970), supplemental opinion, 56 T.C. 763 (1971), *rev'd and remanded in part*, 469 F.2d 225 (8th Cir. 1972).

129. *Id.* at 288. See also *Ornholt v. Commissioner*, 60 T.C. 541 (1973) acq. 1974 2 C.B. 4.

130. *Burnet v. Logan*, 283 U.S. 404, 51 S.Ct. 550, 75 L.Ed 1143 (1931).

the stock's basis prior to recognizing any gain. An "open transaction" is disfavored by the Service and by Congress and will only be allowed in extraordinary circumstances where the amount to be paid is unknown and unable to be reasonably estimated.¹³¹

The Tax Court did allow open transaction treatment in a stock redemption, where consideration for the redemption was a certificate entitling the redeemer to dividends on that stock for the next ten years.¹³² Because there was no ascertainable fair market value to the certificate, the court allowed the shareholder to recover his basis before recognizing any gain.¹³³

C. Funding With Life Insurance

Utilization of life insurance to fund a testamentary purchase requirement is quite common. Normally the principle question is whether to buy the insurance at the corporate level to fund a redemption or to buy the insurance at the shareholder level to fund a cross purchase. Issues regarding life insurance funding include the number of policies needed, the source and amount of funds needed to pay the insurance premium and taxation of the proceeds.¹³⁴

The insurance windfall—who will win the lottery? Where insurance is used as a funding vehicle in a redemption arrangement, all shareholders split the cost in proportion to their stock ownership. Essentially this creates a lottery whereby the winner is the last survivor. The estate of a decedent frequently will receive a fixed price for the corporate stock. No consideration may be given to the increase in value of the corporate stock as a result of receipt of the insurance proceeds. Thus, the estate of the decedent receives only part of the actual value of the corporation. The surviving lottery winner has paid only a part of the cost of the insurance, yet has benefited totally from the receipt of the insurance proceeds. The survivor will own the corporation as a result of having paid out only a part of the insurance premiums. In addition, the corporation will still own the policy which was acquired on the life of the surviving shareholder.¹³⁵ This policy on the life of the surviving shareholder was paid for in part by the deceased shareholder, yet the deceased shareholder again receives no benefit from the asset generated.

If a cross-purchase arrangement is used, the estate of the deceased

131. Treas. Reg. § 15A.453-1(d)(2) (1981). One such example is a contingent purchase, because price is based on future performance.

132. Estate of Marshall v. Commissioner, 20 T.C. 979 (1953).

133. *Id.* at 983.

134. Premium payments will not be deductible in any event. I.R.C. § 265(1); Rev. Rul. 66-262, 1966-2 C.B. 105.

135. A joint, first to die policy will alleviate some of these inequities and will likely cost less than two full policies.

shareholder will not only receive the value for the stock, but will also continue to own the insurance policy on the surviving shareholder. Depending on the nature of the policy, this may be a substantial asset in itself.

Practical concerns regarding policy ownership impact the choice of redemptions versus cross-purchases. Only one policy needs to be acquired for each shareholder under a redemption agreement. Verification of and control over current premium payments and borrowing against cash surrender value (CSV) are also easier if policies are owned at the corporate level.¹³⁶

With a cross-purchase arrangement, each shareholder must acquire a policy on every other shareholder, thereby resulting in the purchase of multiple policies. For example, if there are four shareholders, twelve separate insurance policies must be acquired.

A possible solution to multiple policies is the insurance trust.¹³⁷ Under such an arrangement, a trustee would own a single policy on each shareholder. The trust arrangement would also help solve administrative headaches of insuring that, in fact, each shareholder kept necessary policies current and did not borrow against CSV.

Where share ownership is not proportional, a cross-purchase agreement places the burden of ownership more appropriately on the ultimate beneficiary. For example, if ownership is 25% in A and 75% in B, A must pay the premiums necessary to fund A's buy-out of B's 75% of the premium cost.

D. Dissolution

One final option of the owners of a business lacking the ability to fund a buyout is to dissolve the corporation. Upon dissolution, the corporation may sell its assets, including the accumulated goodwill of the firm, and divide the proceeds. The corporation may also attempt to divide the corporation into separate operating entities.

Prior to dividing a "C" corporation¹³⁸ in this manner, consideration should be given to minimizing the newly imposed corporate level tax on liquidation.¹³⁹ Liquidation results in a deemed sale of assets at their fair market value,¹⁴⁰ triggering the new corporate-level tax. Distribution of

136. Premiums are not a tax deductible business expense under I.R.C. § 264(a)(1) (1988). Edward A. Stoeber, *Corporate Ownership of Life Insurance—Complexities Abound*, 45 J. AMER. SOC'Y CLU & CHFC 57, 57 (1991).

137. See *infra* Section VII.E.

138. This tax is not imposed on an "S" corporation which has never been a "C" corporation or which converted to subchapter "S" soon after the enactment of the 1986 Tax Reform Act. I.R.C. § 336 (Supp. 1992); Rev. Rul. 86-141, 1986-2 C.B. 151.

139. The tax is burdensome. When the corporate tax is coupled with the shareholder's tax, the rate can exceed 50%. Hence, from a practical perspective, where both taxes will apply, corporate dissolution should only be used as a last alternative for a "C" corporation.

140. I.R.C. § 336 (Supp. 1992).

after-tax assets triggers a second tax to the shareholders.¹⁴¹ This corporate level tax coupled with the shareholder tax might be avoided if the corporation can be split into two corporations. Once the assets are divided, each shareholder¹⁴² is distributed all the shares of one of the two subsidiaries.¹⁴³ Thereafter, the shareholders will each own all the shares of one of the two companies.

VIII. CHANGE FROM REDEMPTION TO CROSS-PURCHASE

A. *The Corporate Alternative Minimum Tax*¹⁴⁴

Since the Tax Reform Act of 1986, internal buildup of the cash surrender value and net death benefits under insurance policies have created corporate Alternative Minimum Tax (AMT) problems. The 1986 Act added a new preference item which will subject many corporations with redemption agreements to the AMT. Under the 1986 Act, as amended by the 1989 Tax Act, the corporation's AMTI includes 75% of the amount by which the adjusted corporate earnings of the corporation exceed the AMTI before adjustments.¹⁴⁵

Thus, life insurance proceeds can create a preference item. Assume a corporation with no income and no prior inside build-up on the policy receives \$100,000 in life insurance proceeds. The corporation plans to use these proceeds to redeem the stock of a deceased shareholder. Under these circumstances, 75% or \$75,000 is an item of tax preference and will be subject to the AMT.¹⁴⁶ Prior to 1990, the maximum effective corporate alternative minimum tax rate on such preferences was only 10%.¹⁴⁷ In

141. I.R.C. § 332 (1988).

142. Or each group of shareholders; for example, one or more withdrawing shareholders in one group and the continuing shareholders in another.

143. I.R.C. § 355 (1988). When a corporation distributes stock or securities to a shareholder, the shareholder will recognize no gain or loss if: 1) the transaction is not used principally as a device for the distribution of the earnings and profits of either the distributing corporation or the controlled corporation; 2) both corporations meet the requirements of an active business under §355(b); 3) the corporation distributes all of the stock in the controlled corporation held by it immediately before the distribution or an amount of stock in the controlled corporation constituting control within the meaning of I.R.C. § 368(a) (1988); and 4) retention of the stock was not an attempt to avoid Federal income tax. I.R.C. § 355(a)(1) (1988).

144. See I.R.C. §§ 55 to 59 (Supp. 1992). The corporate AMT is determined by taking 20% of the Alternative Minimum Taxable Income (AMTI). I.R.C. § 55(b)(1) (Supp. 1992). If the AMT is greater than the tax which would normally be imposed on the corporation, the AMT will apply. The AMTI is calculated by taking the corporation's regular taxable income and adding back to it "preference items." I.R.C. § 55 (Supp. 1992).

145. Tax Reform Act 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2329 (1986); Apfel & Wolfe, *AMT Increases Advantages of Cross-Purchase Arrangements Over Redemption Agreements*, 43 TAX'N FOR ACCT., Dec. 1989, at 364.

146. For more detailed practical examples, see Treas. Reg. § 1.56(g)-1 (as amended in 1991).

147. Prior to 1990, the Alternative minimum tax rate was determined by multiplying the 20% alternative tax rate by one-half (only one-half of these items constituted a tax preference). See *supra* Stoeber note 136, at 61.

1990 and thereafter, a 20% rate applicable to 75% of these tax preference items will result in a maximum effective tax rate of 15%.¹⁴⁸ This aspect of the corporate alternative minimum tax (*i.e.*, taxation of the excess of a corporation's adjusted corporate earnings over its AMTI as a tax preference) does not apply to S Corporations.¹⁴⁹

Because corporate owned life insurance policies held to fund redemptions will cause many corporations to be subject to the AMT,¹⁵⁰ shareholders of newly formed corporations should consider framing buy-sell agreements as cross-purchase agreements. Moreover, shareholders with redemption agreements already in place should consider switching to the cross-purchase alternative.

If the decision is made to convert to a cross-purchase agreement, it will be necessary for each shareholder to own a policy on the life of every other shareholder. The corporation has two alternatives; replace the existing insurance policies owned by the corporation with new policies owned by individual shareholders¹⁵¹ or transfer the existing corporate owned policies to the shareholders.¹⁵²

B. Problems of Insurance Conversion

1. Cancellation

The easiest way to convert from a redemption arrangement to a cross-purchase arrangement is to cancel the insurance policies owned by the corporation.¹⁵³ Each shareholder could then purchase a policy insuring the life of the other shareholders.¹⁵⁴ Cancellation of the policies will be a viable option if the policies are relatively new and if the shareholders can

148. See Stoeber, *supra* note 136, at 61-62. See also I.R.C. §§ 53, 56(g)(4)(B)(i)(I) (Supp. 1992).

149. Note, however, that when an S corporation distributes tax exempt death proceeds under I.R.C. § 1368(e)(1)(A) (Supp. 1992), the shareholder may be taxed when the distribution exceeds the accumulated adjustments account. Stoeber, *supra* note 136, at 60-61.

150. However, the Tax Court has held that even when the corporation owns life insurance on a shareholder-key employee, the federal estate value of the stock at the shareholder's death should be reduced. See *Estate of Feldmar v. Commissioner*, 56 T.C.M. (CCH) 1414 (1989). Consequently, insurance on key employees may provide economic and tax benefits and financially strengthen the business. See Stoeber, *supra* note 136, at 63.

151. Existing policies could be cancelled or retained as key-man policies. If cancelled, any gain would be recognized.

152. William T. Harrison III, *Entity Redemption vs. Cross-Purchase Agreements*, Sept. 1987, *THE TAX TIMES*, 4, at 23.

153. Robert M. Wolf, *The Effects of the Tax Reform Act of 1986 on Corporate Buy-Out Agreements Funded with Life Insurance*, 62 FLA. B.J. 72, 73 (Nov. 1988).

154. *Id.*

obtain new policies without difficulty.¹⁵⁵ If the policies owned by the corporation are old, the corporation would probably collect a large cash surrender value upon cancellation of the policies.¹⁵⁶ The cash surrender value may cause a book tax preference¹⁵⁷ to arise and the corporation may find itself in AMT posture once again.¹⁵⁸ Furthermore, cancelling the old policies may be costly to the shareholders. If the shareholders have aged, acquiring new policies on their lives will require the payment of higher premiums. Moreover, some shareholders may no longer be insurable.¹⁵⁹

If cancellation of the corporate owned policies is an alternative, the cash surrender value collected could be distributed to the shareholders to help pay the costs associated with acquiring new policies. The shareholders would have to include the amount received in their gross incomes.

2. *Transfer of Existing Policies*

If cancellation of the insurance policies owned by the corporation is not an option due to the age of the shareholders or the AMT posture of the corporation, the corporation could attempt to transfer the existing policies to the shareholders. The corporation could distribute the policies to the shareholders as a dividend or sell the policies to the shareholders. Significant tax pitfalls could arise upon either method of transfer.¹⁶⁰

a. **Dividend Treatment.** If the corporation distributes the policies to the shareholders, the distribution would probably be taxed to the shareholders as a dividend.¹⁶¹ As such, the fair market value of the policies would be includible in the shareholders' gross income.¹⁶² The corporation could reduce the value of the dividend by borrowing against the policy. However, the limitations on the deductibility of interest makes this alternative less attractive.¹⁶³

b. **Sale of Policies to the Shareholders.** Another method of transferring

155. The corporation must remember that the transfer of ownership of policies into a trust may cause the policies to become "new" according to the tax transfer laws and make them subject to certain deduction limits and loan caps which are enforced against policies purchased after June 12, 1986. Stoeber, *supra* note 136, at 57; *see also infra* note 163 and accompanying text.

156. *Id.*

157. *See supra* Section VIII.A.

158. Wolf, *supra* note 153, at 73.

159. Apfel & Wolfe, *supra* note 145, at 365.

160. Harrison, *supra* note 152, at 23; Wolf, *supra* note 153, at 73.

161. "Dividend means any distribution of property made by a corporation to its shareholders . . . [made out of its] earnings and profits." I.R.C. § 316(a) (1988). In addition, distribution of the policy would cause recognition of gain to the corporation if the policy had a value in excess of its basis. I.R.C. § 311(b) (Supp. 1992).

162. I.R.C. § 301(c)(1) (Supp. 1992).

163. I.R.C. § 264(a)(4) (1988); Harrison, *supra* note 152, at 24; *see also* Stoeber, *supra* note 136, at 58.

existing corporate owned life insurance policies to the shareholders is to allow the shareholders to purchase the policies from the corporation. A cross-purchase arrangement requires a shareholder to own the policies insuring the lives of his co-shareholders, the insured is not the owner of the policy insuring his own life. Thus, a "transfer for value" problem arises when attempting to get the policies into the hands of the shareholders.

Life insurance proceeds payable by reason of the death of an insured are generally not includible in the gross income of the recipient.¹⁶⁴ However, if the policies are transferred for valuable consideration, the proceeds received by death of the insured may be included in the recipient's gross income. The recipient may only reduce the includible amount by the consideration paid plus all subsequent premiums paid on the policy.¹⁶⁵ Thus, if a corporation transfers the existing corporate owned policies for consideration to the other shareholders, an insured shareholder's subsequent death would require the surviving shareholders to include the proceeds in their gross incomes.

There are exceptions to the "transfer for value" rule that may be utilized to allow the shareholders to avoid including the insurance proceeds in their gross incomes.¹⁶⁶ The "transfer for value rule" does not apply if the transfer is to the insured, a partner of the insured or a partnership in which the insured is a partner.¹⁶⁷ Thus, the "transfer for value" rule may be avoided if the corporation transfers the policies to a partner of a shareholder or a partnership in which the shareholder is a partner.

If the shareholders are not partners in a partnership, one may be formed to effect the transfer of the insurance policies. The partnership may not be formed solely for tax avoidance purposes, because the I.R.S. may consider it a sham.¹⁶⁸ The partnership must have a business purpose, though apparently the purpose need not relate to the corporation's business.¹⁶⁹ For example, the partnership could acquire equipment and lease it to the corporation or may engage in a separate real estate venture.

Another less attractive alternative is to have each shareholder purchase from the corporation the policy insuring his own life. This arrangement would also fall within an exception to the transfer for value rule.¹⁷⁰ As mentioned, a cross-purchase agreement requires each shareholder to own a policy on the lives of the other shareholders. The insured is normally not the owner of the policy insuring his own life. Thus, if the corporation transferred to a shareholder the policy insuring his own life, the shareholder

164. I.R.C. § 101(a)(1) (1988).

165. I.R.C. § 101(a)(2) (1988).

166. I.R.C. § 101(a)(2)(B) (1988).

167. *Id.*

168. *Swanson v. Commissioner*, 33 T.C.M. (CCH) 296 (1974), *aff'd* 518 F.2d 59 (1975).

169. *Apfel & Wolfe*, *supra* note 145, at 366.

170. *See* I.R.C. § 101(a)(2)(B) (1988).

may still have to make a subsequent transfer to his co-shareholders.¹⁷¹ Furthermore, the corporation usually owns only one policy on the life of each shareholder. If the corporation has more than two shareholders the only way acquiring new policies may be avoided is if the insurance company is willing to split the policies.¹⁷² If splitting the policies is an option, each shareholder could make a transfer of the policies to the other shareholders. The gift of a policy is not subject to the "transfer for value" rule.¹⁷³ However, if the shareholders were to make mutual gifts to each other, the Service would likely recharacterize the transaction as a transfer for value.¹⁷⁴

When a shareholder dies, the policies insuring the lives of the surviving shareholders must be transferred out of the deceased shareholder's estate. Two options are available to effect the transfer and avoid the "transfer for value" rule. Each shareholder could purchase the policy insuring his own life from the estate or the corporation could purchase the policies. Each of these alternatives falls within an exception to the "transfer for value" rule.¹⁷⁵

IX. USE OF A TRUSTEE TO LESSEN THE COMPLEXITY OF CROSS-PURCHASE ARRANGEMENT

In any situation in which new policies must be acquired, the use of a trustee can help to lessen the complexity inherent in cross-purchase agreements funded with life insurance.¹⁷⁶ As mentioned, cross-purchase agreements require each shareholder to own an insurance policy on the life of every other shareholder. Thus, many more policies are required to fund a cross-purchase agreement than are required to fund a redemption agreement. Where N is the number of shareholders, the number of policies required to fund a cross-purchase agreement is $N \times (N - 1)$.¹⁷⁷ For example, if a corporation had ten shareholders each shareholder would have to own nine policies, one policy on the life of each other shareholder. Therefore, ninety insurance policies would be necessary to fund a cross-purchase agreement.¹⁷⁸

To lessen the complexity of the cross purchase agreement funded by life insurance, many such agreements use trustees to acquire and hold the

171. As an alternative, the shareholder/insured may be beneficiary of his own policy to provide wealth to his family. The shareholder may then be willing to negotiate a mutual reduction in the share price under the Stock Transfer Agreement.

172. Harrison, *supra* note 152, at 23.

173. See I.R.C. § 101(a)(2)(B) (1988).

174. Harrison, *supra* note 152, at 23.

175. I.R.C. § 101(a)(2)(B) (1988).

176. See *supra* note 155.

177. Grassi, *Shareholder Agreements and the Tax Reform Act of 1986*, 67 MICH. B.J. 279, 280 (1988).

178. Simmons, *supra* note 28, at 275.

policies. The trust could be created by the cross-purchase agreement itself, or it could be created by separate documents. However, if the trust is created by separate documentation, the cross-purchase agreement should specifically refer to the trust and should bind the shareholders to adhere to the terms of the trust.¹⁷⁹ A corporate trustee is preferable. Although any disinterested individual may be named as trustee, the use of the corporate trustee will avoid the problem of the individual dying before a shareholder does.¹⁸⁰

The trustee should be directed by the terms of the trust to initially acquire and pay the premiums on the life insurance policies. The trustee should acquire only one policy on the life of each shareholder. This substantially reduces the number of policies that would otherwise be required to fund a cross-purchase agreement. The trust agreement should provide that the funds required to pay the premiums will be collected from the shareholders by the trustee in proportion to the shareholders' individual interests in the policies. This apportionment alleviates the inequitable result of younger shareholders paying higher premiums than the older shareholders.

The possibility that a shareholder will allow a policy to lapse is lessened by the use of the trust arrangement.¹⁸¹ A problem arises if one or more shareholders refuse or is unable to provide the trustee with the funds to pay the premiums. This problem may be solved by providing in the cross-purchase agreement that, in such an event, the corporation will deliver the funds to the trustee. This will, of course, be treated as a dividend to the shareholder and will be taxable to him as ordinary income. The agreement could also provide that any later distributions made to the shareholders by the corporation, will be reduced by the earlier payment to the trustee. Stronger penalties, including forfeiture of stock, could also be provided.

The trustee should be made the beneficiary of the policies. The trust *must* be in existence before naming the trustee or the beneficiary.¹⁸² The trust agreement should provide that the insurance proceeds will be payable to the trustee.¹⁸³ Upon the death of a shareholder, the trustee will deliver the proceeds of the policy to the estate of the deceased shareholder. The agreement should require the estate of the deceased shareholder to deliver the deceased's stock to the surviving shareholders.¹⁸⁴ Another option would be to allow the trustee to take legal title to the shares. If this option is

179. See generally 1 W. WALTON & S. WALTERS, CLOSELY HELD CORPORATIONS 10-55 (George Brode, Jr. ed. 1977).

180. CLOSELY HELD BUSINESS (P-H) ¶ 7741.2 (1985).

181. WALTON & WALTERS, *supra* note 179, at 10-56.

182. CLOSELY HELD BUSINESS (P-H) ¶ 7741.2 (1985). "[T]he agreement should be executed, the trust created and the trustee designated. The 'trustee' does not exist prior to the trust; so if you name the beneficiary before you set up the trust, a non-existing person would be named and the beneficiary designation would have no effect." *Id.*

183. See WALTON & WALTERS, *supra* note 179, at 10-55.

184. *Id.*

preferred, the trust agreement should establish a method for voting the shares. For example, the agreement should provide that the beneficiaries under the trust are to designate how the trustee should vote the shares that represent the shareholders' proportionate interests.¹⁸⁵

X. SPECIAL S CORPORATION CONSIDERATIONS

As already noted, there are unique aspects of S corporations. A stock transfer agreement provides an opportunity to provide additional protection to S corporation status. An agreement can also create additional concerns.

The agreement can contain restrictions on the corporation and agreements among shareholders that additional classes of stock will not be issued. In such a situation, any corporate debt to a shareholder must be "straight debt,"¹⁸⁶ no transfers can be made to nonqualifying shareholders,¹⁸⁷ and the cooperation must be required to obtain reinstatement in the event of inadvertent terminations.¹⁸⁸

Under final Treasury Regulation Section 1.1361-1, a corporation making an S election may issue only one class of stock.¹⁸⁹ If a principal purpose of the buy-sell or redemption agreement is to circumvent the one class of stock requirement *and* the agreement establishes a purchase price significantly above or below the fair market value of the stock at the time that the agreement is entered into the Service may consider the agreement in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights.¹⁹⁰ Otherwise, buy-sell agreements among shareholders and redemption agreements are disregarded.¹⁹¹ Moreover, certain restrictions on employee shareholders' option shares do not create a second class of stock.¹⁹²

Stock issued in connection with the performance of services that is substantially nonvested is not treated as outstanding stock of the corporation and the holder of the stock is not treated as a shareholder, unless he makes

185. One commentator suggests that instead of using a trustee, an escrow form could be utilized. The escrow form would eliminate complicated trust provisions and would not require the escrowee to take title to the shares. The shares would remain in the hands of the individual shareholders and the dividends would also be paid to them. WALTON & WALTERS, *supra* note 179, at 10-55.

186. I.R.C. § 1361(c)(5)(A) (Supp. 1992). Straight debt is a written unconditional promise to pay a fixed amount on demand or on a specified date, where the interest rate is not contingent on profits, the borrower's discretion, or similar factors; where there is no convertibility into stock; and the creditor is an individual, estate, or trust, as defined in the section. I.R.C. § 1361(c)(5)(B) (Supp. 1992).

187. I.R.C. § 1361 (Supp. 1992).

188. I.R.C. § 1362(f) (Supp. 1992).

189. Treas. Reg. § 1.1361-1(l)(1) (1992).

190. Treas. Reg. § 1.1361-1(l)(2)(iii)(A)(1), (2) (1992).

191. Treas. Reg. § 1.1361-1(l)(2)(iii)(A) (1992).

192. Treas. Reg. § 1.1361-1(l)(2)(iii)(A) (1992); Priv. Ltr. Rul. 88-19-041 (Feb. 11, 1988).

an election under Section 83(b).¹⁹³ Also, uniform stock transfer restrictions do not constitute a second class of stock.¹⁹⁴ Nonuniform stock transfer provisions affecting the stock of an S corporation may result in shares having varying interests or rights to participate in the profits or liquidation proceeds of the corporation. Such provisions would violate the one class of stock requirement.¹⁹⁵ Using stock appreciation rights plans for S corporations, instead of restricted stock options, may help resolve some of these problems.¹⁹⁶

Under certain circumstances, *bona fide* agreements to redeem or purchase stock will be disregarded in determining whether all shares confer identical rights.¹⁹⁷ If the agreement is triggered by any event not specifically listed in the Regulations, the Service may argue that the agreement created a second class of stock.¹⁹⁸ Those triggering events specifically exempted are death, disability, termination of employment, and divorce.¹⁹⁹ Agreements triggered, for example, by insolvency of the shareholder, conviction of a crime, or loss of a business license are not exempted.²⁰⁰

Another important consideration is the election to close the books upon sale of stock. With approval of all of its then shareholders, a corporation may elect during its taxable year to have income and losses for the year treated as if the corporation's books had been closed on the effective date of a sale.²⁰¹ This election causes the corporation to allocate its income and loss as if there were two short taxable years within its normal taxable year.

In the absence of an election, income and loss of the corporation is allocated on a pro rata, per share, per day basis.²⁰² If the election is made, income or loss is allocated on a pro rata, per share, per day basis for the artificially elected short taxable year.

For example, assume that S Corporation, a calendar year S corporation, has a \$100,000 loss during the first six months of operation (January 1

193. Treas. Reg. § 1.1361-1(b)(3) (1992).

194. Priv. Ltr. Rul. 89-20-016 (Feb. 13, 1989); Treas. Reg. § 1.1361-1(l)(1) (1992) ("[A] corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock . . . are disregarded in determining whether a corporation has more than one class of stock.").

195. See Richard D. Blau, et. al, *Shareholder Agreements and the Single Class of Stock Requirement*, 68 J. TAX'N 238, 239 (1988). See also Priv. Ltr. Rul. 85-06-114 (Nov. 19, 1984), 85-28-049 (Apr. 17, 1985), 89-08-069 (Feb. 24, 1989); Rev. Rul. 85-161, 1985-2 C.B. 191 (nonuniform buy-sell terms did not affect a shareholder's rights to corporate profits and assets and, therefore, did not create a second class of stock).

196. See Rev. Rul. 67-269, 1967-2 C.B. 298; Priv. Ltr. Rul. 88-34-085 (June 2, 1988).

197. Treas. Reg. § 1.1361-1(l)(2)(iii)(B) (1992).

198. Jerry A. Kasner, *How the Final Regulations on the One-Class-of-Stock Rule for S Corporations Will Affect Buy-Sell Agreements*, TAX NOTES 621 (August 3, 1992).

199. Treas. Reg. § 1.1336-1(l)(2)(iii)(B) (1992).

200. Kasner, *supra* note 198, at 621.

201. I.R.C. § 1377(a)(2) (1988).

202. I.R.C. § 1377(a)(1) (1988).

through June 30) and breaks even for the next six months, thereby incurring a \$100,000 loss for the year. For the entire year up until July 1, A and B are equal shareholders of *S* Corporation. A dies on July 1 and B acquired all of A's stock.

If no election is made, the pro rata rule would result in the loss being spread equally throughout the year and, thereafter, allocated to A for the six month period during which A owned stock. Thus, A would report a \$25,000 loss on his final individual income tax return for 1989. B would be allocated \$75,000 of the loss.

If an election to close the books were made, the \$100,000 loss would be allocated entirely to the artificially created first short taxable year ending on June 30. As a result, A would be allocated \$50,000 of the loss and B would be allocated \$50,000 of the loss.

In determining whether or not to elect to "close the books," the impact of receipt of insurance proceeds on the basis of surviving shareholders should be considered. If an election to close the books is made for an accrual method taxpayer, then upon the death of a shareholder and simultaneous closing of the books, the insurance proceeds will be immediately accrued and constitute income in the first short year.²⁰³ In the preceding examples, one-half of the insurance proceeds would be allocated to each shareholder. If the purpose was to maximize the surviving shareholder's basis, no election would be made. If the *S* Corporation is on the cash basis, the considerations would be reversed. Thus, whereas cross-purchase agreement guarantees a basis equal to the purchase price, a redemption agreement with an *S* corporation may give the same increase in basis but such an increase depends upon whether or not the election was made to close the books and whether or not the corporation was on the accrual basis or the cash basis of accounting.

Shareholders and their advisors should consider whether or not the stock transfer agreement should provide for all shareholders to consent to the election to close the books. Some rule regarding distribution of income should likewise be established, whether or not the election is made.

203. See I.R.C. § 1362(e) (Supp. 1992).

