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# A Family Buy Sell Gone Awry

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This is based on a true story of a family buy sell situation. The names are fictitious to protect the innocent and not so innocent. Some facts were altered to avoid undue complexity.

*MDRT I/R Code 1450.00, 2100.06, 2500.07*

## A LONG, LONG TIME AGO, IN A GALAXY FAR, FAR AWAY…..

Well, not really. This story begins in New York City some 13 years ago when this writer was in private practice and became involved in a case that would serve as an excellent case study for those professionals who work in the closely held family business market. Although this writer's firm was retained in 1989, it is important to set the stage for problems encountered at that time by reviewing the history of the family and the family business.

### THE EARLY YEARS

The family consisted of Harry and his wife, Elizabeth. They had three sons (no, not Robby, Chip and Ernie), who were named Stan, Arnold and Patrick. In the mid 1940's Harry began a parts business in his neighborhood in a small storefront. With the construction business picking up after World War II, Harry was nicely positioned to grow a successful business.

As with any family held business, each of the boys worked there part time after school and during the summers. Stan, the oldest, continued to work at the store while pursuing an engineering degree. Arnold and Patrick after graduating from school successfully pursued other careers, with Patrick becoming a doctor and Arnold becoming an artist.

In the early 1960's, Stan married his wife, Irene, who bore him two children, Stuart and Ellen. Arnold and Patrick also started their families in the late 1960's. It was during this decade that Harry realized that his son, Stan, would make the family business his career. Harry eventually gave 35% of the business, which was now a C corporation, to Stan in recognition of his hard work over the years. Stan was thrilled to be a formal owner of the family business. Patrick and Arnold continued to pursue their respective careers, and became recognized in their fields.

During the 1970's, Harry and Stan worked closely together to turn the business into a well-known vendor in the construction community. The business eventually outgrew the small storefront building and purchased significant parcels of real estate to store inventory. The business was booming, making extremely nice profits. Harry treated Stan as an equal partner, listening to his advice and new ideas regarding the business. In the late 1970's, Stan's son Stuart began to work at the business after school and during vacations. This made Harry very happy since the business he founded was the career choice of his eldest son and now his grandson was showing some interest in it as his career. Harry relished the thought that three generations of his family were involved with the business he founded years ago.

### THE EARLY 1980'S

As Harry entered his mid 70's, he realized that he wanted to slow down and he also wanted to reward Stan for his long time contribution

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in building the business. He had treated Stan as an equal partner for years now, even though Harry retained a 65% majority interest in the business while Stan owned only 35%. Harry then decided that he wanted it to be made official; he wanted Stan to be a full 50% owner. Harry discussed the idea of transferring an additional 15% of the stock with Stan, who was flattered. However, Stan had a different idea. He thought it would be a better idea if the 15% Harry wanted to transfer to Stan were to be transferred to Stuart and Ellen. This would formally put three generations of the family in the family business. Harry could not have been more pleased. It didn't matter to him whether Stan or his children owned the stock, he considered himself 50-50 owners with Stan. After all, he had treated Stan as an equal owner in running the business all these years, so nothing was really changing in his mind.

Now that the stock of the company was owned by Harry, Stan, Stuart and Ellen, the family recognized the need to enter into some sort of arrangement to provide for the orderly transfer of the business should something happen to Harry or Stan. They contacted their attorney, who proposed a buy sell contract addressing the transfer of the business shares should Harry or Stan pass away. The pertinent provisions were the following:

- Upon Harry's death, the corporation would purchase Harry's shares.
- Upon Stan's death, Stan's wife, Irene, would receive his shares.
- The business's value was set at $1.6 million. Provisions were made for an annual revaluation and if no revaluation had occurred for two years prior to a death, the price was to be set at arbitration.
- The buyout price was to be paid with a 15% down payment with the balance paid over seven years at 10% interest.

It is important to point out that Ellen and Stuart were not parties to the agreement, the reasons for which remain unknown. The family had never considered a formal valuation of the business and was pleased to learn that the small storefront business Harry began years ago had blossomed into a multi-million dollar business, a business that was going to continue in the family. No consideration was given to funding the purchase of Harry's shares, whether by creating a savings plan or the purchase of life insurance; it was presumed that the purchase price would be paid from the business's profits.

In 1984 Elizabeth passed away. Although she was never a formal owner of the business, she was present from the beginning and this had a profound effect on Harry. Elizabeth's passing away prompted Harry to review his estate planning situation. Harry thought that it would be a good idea to actually own only 40% of the business, which would enable his estate to save estate taxes due to certain lack of marketability and minority discounts.

Of course, Harry wanted to transfer this additional 10% to his son, Stan, but again, Stan had a better suggestion. Rather than transfer the 10% to Stan, why not transfer it to Stuart, who was becoming much more interested in the family business? Better yet, Stan reasoned, let's give Stuart a sense of accomplishment by making him purchase the 10%, thus making him a "buyer" of the business.

Stuart then purchased the 10% interest in the business by giving Harry a promissory note of $300,000. Although at this time no one looked at this transaction as an indication of the value of the business, it appeared that the value of the business had increased to at least

$3 million based on the purchase price of the 10% interest. (Note: Not a fact overlooked by the IRS later in this tome.)

You will recall that the real estate and construction market during the mid-1980's was booming. Harry also at this time created a new Last Will and Testament. In addition to several bequests and devises, he left his estate in equal shares to his three sons, Stan, Arnold and Patrick, if they survived him. The will also forgave the note due Harry from Stuart, if there was any outstanding amount due when Harry passed away. Of course, Stan was named Harry's Executor, and if he could not serve, then Patrick and Arnold would serve as Co-Executors.

At this time Harry did recognize that he no longer controlled the business by majority ownership, which was not a problem because he was still working side by side with his son, Stan. After all, Harry had treated Stan as an equal partner during the building of the business despite the fact that Harry owned the majority of the stock. Stan now returned the favor, working side by side with his father, working as equals in the flourishing business.

In 1986, Congress passed the Tax Reform Act of 1986, which substantially revamped almost the entire tax code. One of the major items in this Act was the lowering of individual income tax rates. When compared to corporate tax rates, the individual income tax rates were much lower, which prompted many small corporations to convert from C corporations to Subchapter S corporations. The thinking here was that converting to an S corporation would allow the income of the business to pass through pro rata to the shareholders' individual tax returns, producing lower taxes than if the corporation remained a C corporation. Of course, the business's CPA advised Harry and Stan to convert to an S corporation to save substantial taxes and that's what they did. Now the business's income was taxable to its shareholders, pro rata. This was not a problem since Harry and Stan made sure that their salaries and the distributions of profits were sufficient to meet the shareholders' individual income tax burdens.

## AN UNEXPECTED TRAGEDY

The business continued to flourish into the late 1980's despite the real estate and construction industries reaching their peaks. Business slowed down slightly but the business remained profitable. Then an event occurred that changed the family and business forever. Stan, while working in the store, was held up at gunpoint and killed in the robbery. Stan's widow, Irene, and his two children, Stuart and Ellen, were devastated by Stan's death. Harry, too, was overcome with grief. He not only lost his eldest son, but they had an extremely strong and close relationship since he had worked with Stan in the business every day for decades. Patrick and Arnold also mourned the loss of their brother. Although they were not in the family business, all the brothers had remained close, participating in the normal family functions throughout the years as well as sometimes vacationing together with their families.

## THE BEGINNING OF THE BUSINESS AFTERMATH

After grieving, Harry returned to the running of the business. However, some things had changed. After decades of working side by side with Stan, Harry was running the business himself with Stuart's help. Then something strange happened. Stuart and Irene began communicating with the business's vendors as well as the business's attorney and accountants. Harry was being left out of major decisions that affected the company. Harry then realized that although he owned 40% of the company, Stan's 35% passed to Stan's wife, Irene. It was Irene, Stuart and Ellen who controlled 60% of the business stock. Harry then approached Stuart and

offered to purchase the 10% interest Harry had sold him years before. Stuart declined. Soon, Harry was not even consulted on the day-to-day running of the business. Harry did receive a salary from the business, although his participation in the business became insubstantial. Harry felt that overnight he became an outsider in his own business.

Less than a year after Stan's untimely death, Harry passed away. One could speculate the loss of his eldest son coupled with being shut out of his own business contributed to his death.

Harry's Last Will and Testament provided that:

- the debt owed to Harry from Stuart was forgiven.
- Elizabeth's jewelry was left in equal shares to his three daughters-in-law.
- The summer home was left to Harry's grandchildren.
- Harry's residuary estate was to pass to Patrick and Arnold, as his surviving sons.
- Patrick and Arnold were appointed as Co-Executors (since Stan predeceased Harry).

The major asset of Harry's estate was the 40% share of the family business. Other items in the estate included a residence, the summer home in the Catskills, some brokerage and bank accounts and a small insurance policy.

## THE BUY SELL AGREEMENT AND THE VALUATION

The original buy sell agreement set the value of the business at $1.6 million and it was more than two years since it was executed. Further, no new certificate of revaluation was ever made. Therefore, the value of the family business could not be clearly established. You will recall that under the terms of the buy sell agreement, the corporation was obligated to purchase Harry's shares from his estate following his death. The question now was: What was the value of the business?

Well, there were two sides to this issue. The obligation to purchase was that of the corporation. The corporation was controlled by Stan's family unit (Irene, Stuart and Ellen, hereinafter "Stan's family"), which owned 60% of the corporate shares. The Co-Executors, Patrick and Arnold, had a duty to all the beneficiaries of the estate, including themselves as the residuary beneficiaries. It became quite evident that the corporation wanted to pay the least amount possible while the estate wanted the largest amount possible.

At first, both sides began a family negotiation, initially looking at the initial valuation of $1.6 million, which was clearly outdated. Although this writer does not know for sure, it is quite possible each side looked at the sale of the 10% interest to Stuart, which would peg the value at approximately $3 million. Eventually, the negotiations became intense, with the corporation submitting a value of $4 million. The Executors maintained it was worth much more than that. Eventually, these informal family negotiations broke down and the parties looked to the procedures in the buy sell agreement to establish the value of the family business.

These negotiations took significant time and the Executors changed attorneys several times during this period. Due to these delays and the uncertainty of the valuation and attorney changes, the Form 706, U.S. Estate Tax Return was filed 6 months late.

## LITIGATION AND ARBITRATION

Once the negotiations stopped, the Executors' attorney reviewed the buy sell agreement to ascertain what procedures were agreed to regarding the valuation of the

business. Rather than allowing for a lawsuit, the agreement provided that the value be established via arbitration. Each of the two sides was to select an arbitrator and these two arbitrators would pick a third. The decision of the majority of these three arbitrators would establish the value of the business after hearing evidence from both sides. The attorney for the Executors filed the necessary paperwork to begin the arbitration proceeding.

In the summer of 1989, this writer and his firm were retained to represent the Executors. Although it was a small firm, its partners and associates had the necessary expertise to represent the Executors, particularly in the corporate and tax areas.

The first order of business to prepare for the arbitration was to examine the books and records of the corporation. Until this time, Stan's family, which controlled the business, had not allowed access to the books and records of the business since they were in negotiations with the Executors. Once the situation truly became adversarial, Stan's family was not quick to produce the requested books and records. Repeated requests were made and denied. Finally, the Executors were forced to file a lawsuit to demand a review of the books and records, as well as physical inspection of the business. It should be noted that the right to examine the books and records was not based on the buy sell agreement, which was silent on this point, but rather on the right of the shareholders under New York state law.[1] The arbitration provision of the buy sell agreement, which was designed to avoid litigation in the courts, failed to do so since a lawsuit was necessary to access the books and records to prepare for the arbitration.

Once the court ordered the business to open its books and records for the Executors, the next order of business was to retain forensic accountants. Forensic accountants are specialist CPAs who are intimately familiar with the valuation of closely held businesses, including the particular nuances attributable to specific industries. In other words, these accountants know where to look for income that may have been "inadvertently omitted" and expense items that were "slightly exaggerated." The forensic accountants in this case concentrated on expenses paid by the business for its shareholders that were beyond the scope of the business's purpose. One such expense was Stuart's flying lessons. Other normal expenses such as travel and entertainment were more difficult to review. The forensic accountants concentrated on the business's inventory, its turnover and its comparison to actual items on hand.

Following completion of the review of the books, records and physical inventory, the forensic accountants determined that between $10,000 and $15,000 worth of weekly cash sales were not properly recorded. That equates to, at a minimum, $500,000 of sales on an annual basis. Needless to say, this had a significant impact on the valuation of the business. When all was said and done, the forensic accountants prepared a detailed report outlining their process of determining the business's value. This report stated that the value of the business could be as high as $16 million to $18 million. This was based on a projection of what they expected to find if they could perform a very detailed and comprehensive examination, based on what they actually found in the somewhat limited examination conducted for the arbitration hearing. Based on their actual examination, a value of $12 million to $14 million would be proper and that was the value advocated at the arbitration hearing.

Stan's family, which originally maintained that the value of the business was $4 million, retained a Big Six accounting firm (yes, at that time, there was still a Big Six after the two Big

[1] New York BCL § 624.

Eight mergers of 1989). Their valuation for the business was $5.6 million. Obviously, the parties were very far apart with little hope of settlement. Accordingly, the parties proceeded with the arbitration hearing.

The arbitration hearing took place over three days. Expert witnesses were called by the Executors supporting their side and cross examined by the attorneys for Stan's family and vice versa. Documents and reports were reviewed by the arbitration panel. No settlement offers were made by either party, each believing it had proven its case. Shortly thereafter, the arbitrators issued their decision. The value of the business was determined to be $12.5 million. The Executors were happy with this result while Stan's family was not. This meant that the shares in Harry's estate were valued at $5 million.

Stan's family then commenced a legal proceeding to vacate the arbitration panel's decision. This proceeding was later withdrawn after additional legal fees were incurred.

In fact, because of the arbitration and litigation, both sides incurred substantial legal and accounting fees to present their case to the arbitrators. While the Executors clearly felt this was necessary and productive since they established a valuation of $12.5 million for the business, Stan's family could not have been pleased to pay these fees while obtaining a valuation of the business more than two times the value they advocated. There was also another cost that was not monetary. The relationships between Arnold and Patrick and their sister-in-law, Irene, and niece and nephew, Ellen and Stuart were rapidly deteriorating. There were no happy family holidays as there had been in the past. The only time the family communicated was through their attorneys; the only time they saw each other was in court. Although the business continued, the family unit fell apart.

From the time Harry passed away until the arbitrators rendered their decision, almost three years had passed. During this time a tax issue emerged relating to the business.

## THE ESTATE IS TAXED ON PHANTOM INCOME

You will recall that the family business converted to a Subchapter S corporation in the mid 1980's. The estate was the owner of the 40% interest previously owned by Harry and according to Federal income tax law, the income of the Subchapter S corporation is passed through to its shareholders pro rata. During the three year wait to determine the value of the business, the business continued to produce income. The estate as owner of 40% of the stock of the business was responsible for taxes on 40% of the company's income. During this three year period, over $800,000 of income had to be reported on the estate's fiduciary income tax return, based on the K-1[2] generated by the business to the estate. This required the Executors to pay hundreds of thousands of dollars in income tax. To make matters worse, when the business mailed the K-1 to the Executors, no distribution checks were enclosed to assist in payment of the taxes due. The Executors had to use other estate assets and personal funds to pay the income taxes on the corporate income, income that they did not actually receive.

Another lawsuit was brought by the Executors against the business, demanding that the business distribute the earnings that they were being taxed on. This proceeded with a trial in New York Supreme Court where the court found for the corporation. The judge, in this writer's opinion, did not distinguish between C Corporation dividends and S corporation earnings and held that a shareholder cannot force a dividend to be

[2] Form K-1, Shareholders Share of Income, Deductions, Credits, etc.

paid from the corporation. The Executors appealed to the New York State Appellate Division, which affirmed the Supreme Court's holding. A subsequent appeal to the New York State Court of Appeals was denied.[3]

Once these decisions were entered, the Executors attempted to disqualify the corporation as a Subchapter S corporation. Communications to the Internal Revenue Service alleging various violations of tax law were unpersuasive and the corporation retained its Subchapter S status. The Executors, prior to the commencement of the arbitration proceeding, also initiated a corporate dissolution proceeding[4] in order to halt the phantom income on the K-1.

The bottom line here was that the Executors were forced to pay income taxes on monies they never received. To make matter worse, from the Executors' viewpoint, the earnings on which they were taxed were retained by the corporation. It was these retained monies that would ultimately be used (at least partially) to redeem the shares pursuant to the buy sell agreement. It was the equivalent of the Executors buying themselves out. In addition to this ignominy, substantial legal fees were incurred to bring the lawsuit and the subsequent appeals.

## COMPLETING THE BUY OUT

After the establishment of the value of the business at $12.5 million, the buy sell required the corporation to purchase the shares from Harry's estate. The buy sell stated that there would be a 15% down payment with the balance of the purchase price paid over 7 years at 10% interest. (Note: The 10% interest rate was a reasonable rate at the time the buy sell agreement was entered into. In fact, it was probably at the lower end of a permissible range.) Since the 40% owned by Harry was valued at $5 million, this meant that the down payment would be $750,000 with the balance of $4,250,000 payable over 7 years at 10% interest. Where would the corporation find the down payment and funds to make the future payments?

The business, although continuing, lost both Harry and Stan within one year of each other. The outlook for the business was questionable at best. Further, the construction industry was beginning a downturn. In order to meet its obligation under the buy sell agreement, the corporation would have to earn approximately $8.2 million before taxes to meet this obligation. Paying this out of earnings would most certainly put a strain on the business and its shareholders. This obligation together with the loss of the two major forces behind the business, Harry and Stan, would also inhibit the business's ability to acquire loans or lines of credit, a vital factor for most businesses. Lastly, the corporation had no life insurance on Harry to assist in funding the buy sell agreement.

The business also had to make an immediate initial down payment of $750,000. Although the business did have significant retained earnings on its books, it was not in cash or otherwise liquid assets. It was tied to both inventory and real estate. Fortunately for the corporation, the business's earnings, undiminished by income taxes which were paid by the shareholders (including the estate), were available for the down payment. Pursuant to the buy sell agreement, the closing took place and the Executors received the $750,000 down payment in cash together with notes for the balance of the purchase price of $4.25 million payable over seven years at 10% interest.

## THE REDEMPTION CAUSES AN INCOME TAX PROBLEM

The buy sell agreement dictated that the corporation purchase the shares owned by

[3] Citations omitted for anonymity.

[4] New York BCL § 1104-a.

Harry's estate. This type of transaction is called a redemption and is governed by certain provisions of the Internal Revenue Code pertaining to transactions between corporations and their shareholders.

Generally, distributions from a corporation to a shareholder will result in dividend taxation.[5] There are several exceptions to this treatment if the shareholder is redeeming his stock and meets certain criteria.[6] To make matters more complicated, there is a complex set of attribution rules[7] that are applicable to these transactions.

Determining whether a redemption is an exchange or a dividend is extremely important because of the tax treatments applicable to these two types of transactions. A dividend from a corporation to a shareholder is subject to ordinary income tax and the payment of the dividend by the corporation is not deductible by the corporation. An exchange is treated as a capital transaction where the seller may reduce its gain by its basis in the shares exchanged. In an exchange there is no deduction available to the corporation. So depending on the correct tax treatment for the redemption in our case, the sale of the shares owned by the estate for $5 million could either be treated as a dividend, which would cause the estate to pay ordinary income tax on the entire $5 million, or treated as an exchange, which would allow the estate to deduct its basis in the stock from the $5 million purchase price to arrive at a capital gain. In this case, if the transaction qualified as an exchange, there would be no capital gain since the estate would have received a "step-up" in basis in the stock included in Harry's estate.[8]

Generally, in order for a redemption to be treated as an exchange, and therefore as a capital transaction, the redemption must meet certain criteria. For instance, the full or complete redemption of the shareholder's shares would qualify as a capital transaction.[9] The purpose of these rules is to prevent a 100% shareholder (assume there are 100 shares outstanding) from redeeming 30 shares or some other amount of his stock and treating the transaction as a capital transaction. If this 100% shareholder redeems 30 of his shares (or any other percentage less than all), he would still remain as a 100% shareholder. All that would happen would be that instead of owning 100 shares or 100%, he would own 70 of the 70 outstanding shares after the redemption, or again, 100%. At first blush, a "complete redemption" seems to fit our case since Harry's estate will redeem all of its 40% interest with the other 60% of stock owned by other parties, Stan's family. However, this is where the complex set of attribution rules comes into play. These attribution rules state that due to the relationships between certain family members and between entities and certain individuals with an interest in those entities, certain shareholders are treated as indirect or deemed owners of stock. The family attribution rules attribute ownership of shares to a spouse, parent, grandparent or child. That is not entirely applicable here. The other set of attribution rules regarding entity attribution must be applied. These rules state that beneficiaries of an estate will be treated as the owners by attribution of the shares owned by the estate and vice versa. Due to the fact that Irene, Stuart and Ellen are beneficiaries of the estate and also own shares, this causes the transaction to fail as a complete redemption since the estate is deemed to indirectly own the shares actually owned by Irene, Stuart and Ellen.[10] This means the estate is a deemed

5 IRC § 301.

6 IRC §§ 302 and 303.

7 IRC § 318.

8 IRC § 1014.

9 IRC § 302(b)(3).

10 This would also be the result due to the family attribution rules under IRC § 318 even if Irene was not a beneficiary of the estate. The stock owned by

100% shareholder before the redemption (40% actually owned and 60% indirectly owned through the estate beneficiaries) and a deemed 100% shareholder after the redemption (the remaining 60% indirectly owned through the estate beneficiaries now represents 100% of the outstanding stock). This is spelled out in analyzing the substantially disproportionate exception below.

Another possibility allowing a redemption to be treated as an exchange would involve what is called a substantially disproportionate redemption.[11] This would involve the application of an 80% test to determine whether the redemption was in fact "substantially disproportionate." Simply put, the shareholder seeking exchange treatment must redeem enough shares so that after the redemption, the shares it owns (directly and indirectly through attribution) is less than 80% of the interest it owned before the redemption. In applying this test to Harry's estate, the substantially disproportionate test is failed. Before the redemption, the Executors owned 40% directly. The estate is also deemed to own the shares of its beneficiaries. Irene, Stuart and Ellen were all beneficiaries of the estate so their respective 35%, 17.5% and 7.5% interests were also deemed to be owned by the estate prior to the redemption. This results in the estate owning (directly or indirectly) 100% of the business. After the redemption, the estate owns -0- shares directly, but is deemed to own the shares of its beneficiaries. If Harry's corporation had 100 shares outstanding before the redemption, and 40 share were redeemed, the 60 shares owned by the estate beneficiaries would be attributed to the estate and would result in the estate owning 100% of the business after the redemption. Therefore, the redemption fails both the complete redemption exception and substantially disproportionate redemption exception under IRC § 302.

Another item worth mentioning is the potential waiver of the application of the attribution rules, which is allowed in certain situations.[12] This would allow the waiver of family attribution rules if certain conditions are met.[13] Unfortunately, this waiver of the attribution rules is not applicable to entity attribution[14] and does not apply based on the facts in this case.

Accordingly, the Executors had no choice but to treat the proceeds as a dividend, subject to ordinary income tax. To soften the blow, the estate's accountant determined that part of the proceeds were in fact the distribution of the previously taxed but undistributed earnings which somewhat reduced the estate's income tax bill. The estate was also successful in applying a specific exception to the dividend treatment of the redemption, which applied to the amount of estate taxes and administration expenses payable by the estate.[15] Nevertheless, a substantial amount of the redemption proceeds were taxed to the estate as a dividend.

## THE ESTATE TAX AUDIT AND APPEAL

To make matters worse, while in the process of pursuing the litigation and arbitration

Irene is attributable to her children, Ellen and Stuart. Ellen and Stuart directly own their 25% and would be deemed to own Irene's 35%. Hence, Ellen and Stuart would be deemed to own 60% of the stock. Before the redemption, the estate would own 40% of the stock directly and be the deemed owner of the other 60%. The estate's redemption of the 40% it directly owns would also result in the estate being an owner of 100% of the stock after the redemption. Therefore, the complete redemption and substantially disproportionate redemption exceptions are not met.

11 IRC § 302(b)(2).

12 IRC § 302(c)(2).

13 IRC § 302(c)(2).

14 IRC § 302(c)(2)(C).

15 IRC § 303.

aspects of the case, the estate's Form 706, U.S. Estate Tax Return was selected for audit. The IRS Estate Tax Attorney (IRS ETA) did not vigorously pursue the audit until the forensic accountant prepared his report and the arbitration proceeding was concluded. Once this occurred, the IRS ETA reviewed the documents and initially determined the following:

- The value of the 40% share of the business returned on the Form 706, $1.6 million, was extremely low.

- The value of the business as per the forensic accountant's report was $16 to $18 million.

- This was a family business.

- The Form 706 was filed 6 months late which triggered a failure to file penalty.[16] This equated to 25% of the unpaid tax bill.

- The estate did not pay the necessary tax based on the forensic accountant's valuation which triggered a failure to pay penalty from the due date of the return until such payment was in fact made.[17]

- The estate was liable for an under-valuation penalty which was 30% of the under-valuation.[18]

- The Subchapter S earnings attributed to the estate of some $800,000 was also an asset of the estate and was subject to estate tax despite the fact that the estate never received it, even after bringing a lawsuit and subsequent appeals.

The IRS ETA refused to accept the arbitrated value of $12.5 million for the value of the business. He maintained that this was a family business and the family was in collusion to defraud the IRS of tax revenue. It was only after several meetings and the production of boxes and boxes of litigation documents (there were up to 7 different lawsuits on various matters throughout this time period) that he agreed to accept the $12.5 million valuation.

This writer argued unsuccessfully to obtain a minority and lack of marketability discount on the 40% interest with the IRS ETA. After all, it was almost four years after Harry's death, and the estate had not received one dollar under the buy sell agreement. Eventually, the case went "Unagreed" which allowed for a review by the IRS Appellate Office of all the outstanding issues. However, before the case was sent to the Appellate Office, the IRS ETA, after reviewing the forensic accountant's report which raised questions as to weekly un-recorded cash sales of $10,000 to $15,000, made a formal referral to the corporate income tax audit area of the IRS to search for unreported income by the business. Unfortunately, this writer was not privy to the scope or consequences of the audit, but it is a safe bet that it was not a pleasant experience.

After several meetings with the IRS Appellate Officer, a compromise was worked out. First, he recognized that the estate would never receive the Subchapter S earnings in addition to the redemption proceeds and removed that as a potential asset of the estate. Next, the Executors' counsel successfully argued that an under-valuation penalty was inapplicable to the case because the estate was caught between a rock and a hard place. There was no way to ascertain the true value of the overall business and hence the estate's 40% interest at the time the Form 706 was filed. Unless the Executors hit the value right on the nose, they could be subject to either an

[16] IRC § 6651(a)(1).

[17] IRC § 6601(a)(2).

[18] IRC § 6660. Note this section was repealed for returns due after December 31, 1989.

under-valuation penalty[19] or an over-valuation penalty.[20] This created a "whip-saw" effect where the estate was penalized either way. The fact that it took close to four years to ascertain the value added to the uncertainty of the valuation. This same argument was also used successfully reduce the 25% late filing penalty to 15%. It was also successfully argued that the estate paid all the tax it could have at the time the return was filed and no funds were available to make any additional payments until such time as the value of the business and the estate's 40% interest was determined and payment was made to the estate under the buy sell agreement. Accordingly, the failure to pay penalty was also waived.

The big issue remaining was the value of the estate's 40% interest in the business. Clearly, the buy sell agreement mandated the 40% interest be purchased by the business which equates to a gross value of $5 million. Yet it took over four years and several lawsuits to get to that point. At the time this writer was negotiating a discount on the 40% interest owned by the estate, no payments were yet made to the estate, which made a very potent argument for a discount. This, together with affidavits from Stuart and Irene outlining the family disharmony and the multiple boxes of litigation documents were enough to convince the IRS Appellate Officer to apply a 40% minority and lack of marketability discount to the value of the 40% interest. We agreed in principle on one Friday morning on this 40% discount, again stressing that the estate had to date not received any payment from the business. It was only after this agreement in principle with the IRS Appellate Officer that the estate actually received the $750,000 down payment together with the payments due from Harry's date of death to the date of payment.

[19] IRC § 6660. Note this section was repealed for returns due after December 31, 1989.

[20] IRC § 6659. Note this section was repealed for returns due after December 31, 1989.

In fact, it was approximately *2 hours* after the conference with the IRS Appellate Officer where we "settled for a 40% discount" that the estate did in fact receive a multi-million dollar check for the down payment and the payments and interest past due.

On the following Monday, the IRS Appellate Officer asked once again whether the estate had received any payment. Of course this writer was duly bound to answer truthfully and stated that the estate had in fact received the down payment together with past due payments that totaled in excess of several million dollars. Immediately, the discount became an issue once again. Would the estate be allowed a discount? If so, at what percentage? It was argued that the actual payment at that point in time did very little to affect the discount that was otherwise applicable because of the significant delay in enforcing the buy sell which involved the estate in numerous lawsuits. Clearly, the value of the 40% interest held by the estate could not be valued as of the date of death at the gross value of $5 million. Following additional negotiations, a reduced discount of 35% was agreed upon. Not bad when you consider this reduced the estate value by approximately $1.5 million which would have triggered approximately $900,000 of estate taxes.[21] And don't forget the interest[22] due on the tax for the four years it wasn't paid plus the agreed (but reduced) failure to pay penalty at 15%.

[21] Based on a 55% Federal estate tax plus New York State estate tax net of the state death tax credit.

[22] The estate did elect § 6166 treatment which allowed the deferral of tax attributable to the business's value for four years after the due date of the return (although interest was payable during this four year period) with ten annual installments beginning after this four year period. The attractive reduced rate of 4% available under § 6166 was only applicable to the first $1 million of the business's value reduced by the available unified credit. This resulted in the 4% interest rate being applied only to approximately $150,000 of the estate tax deficiency; the balance of the interest was at the normal IRS rate of approximately 8%.

This was quite an accomplishment considering the estate not only received each dollar owed to it, but also received 10% interest on the past due payments.[23] The Executor's attorneys were quite pleased with this result while the Executors seemed to accept the savings as if it was due them.[24]

## THE AGREEMENT: GOOD OR BAD?

In looking back at the buy sell agreement with 20/20 hindsight, was the agreement a good thing or a bad thing? Would the Executors have been better off if there was no agreement? Would the corporation (and Stan's family) have been better off if there was no agreement?

From the Executors' point of view, the agreement was very important since it firmly established a market for the sale of the estate's 40% interest in the business. If there was no agreement, there would have been no obligation for the purchase of the estate's 40% interest. Who else (any third party) would want to purchase a minority interest in a closely held business where they would have no control? And even if such a buyer were to be found, it would not pay the gross price of $5 million for that interest. It should also not be forgotten that this was a Subchapter S corporation that required its shareholders to pay income tax on its earnings. Any prospective purchaser could have been frozen out of a corresponding distribution of earnings by the majority shareholders, as the Executors were during the litigation period. At least they were able to see light at the end of the tunnel since an arbitration proceeding was underway and a bona fide obligation to purchase the shares by the corporation was enforceable under the buy sell agreement. It could be argued that the Executors would have been worse off if there had been no agreement. Notwithstanding this "benefit" of the buy sell agreement, there is no doubt that from the Executors' viewpoint, the buy sell agreement could have been better drawn.

## WERE BETTER RESULTS POSSIBLE?

Let's review what went wrong with this case.

1. Harry gave up control of his business. This was no one's fault except Harry's Although many founding patriarchs and matriarchs of family businesses eventually give up control to a child or children, there are no guarantees the parent will be able to exercise control after the transfer. Other estate planning techniques could have rewarded Stan with ownership and a share of the business's profits. In the early years when the business was a C Corporation, a family limited partnership could have assured Harry of control while still passing the benefits of ownership to Stan. The decision to give up control of the family business is one that must be reviewed carefully, with an analysis of potential events that could affect control of the business.

2. The buy sell agreement, although ultimately helpful to the Executors, violated one of the basic tenets of buy sell or business succession planning. Generally, co-shareholders of a business want to remain in control and do not want to work with the other co-shareholder's spouse or children. Continuity of management by existing shareholders is the preferred result where the deceased shareholders' family receives the value of the business. The agreement in this case

[23] The 10% interest paid to the estate was post mortem and did not trigger an estate tax although it was reportable on the estate's Form 1041, U.S Fiduciary Income Tax Return.

[24] Note: Attorneys for Stan's family were also impressed with the Executors' attorneys in accomplishing this feat. Several years later, Stan's family's attorneys retained this writer to assist in another valuation case regarding a closely held business during the audit appeal at the IRS Appellate level. Favorable results to the taxpayer were accomplished through negotiations.

provided that Irene inherit Stan's shares. This writer would agree that having Harry purchase Stan's shares might not have been an economical thing to do since Harry would have had a larger, majority interest in the business which would have increased his potential estate taxes.[25] The solution here could have been the creation of a trust for the benefit of Irene (and/or Ellen and Stuart) under Stan's Will where Harry could have served as trustee. This would have assured Harry of control of the business while providing income to Stan's family and prevented Stan's family from interfering with the business.

3. The buy sell agreement could have been structured as a cross purchase agreement. This would have avoided the partial dividend treatment on the redemption. It could also have provided the purchasers with a step up in basis.[26]

4. The failure to update the valuation was costly. Harry and Stan and the other shareholders never updated the value of the business after the buy sell agreement was entered into. If the business had been revalued annually, there would have been no need for the arbitration and the litigation to access the business books and records. The parties were at cross purposes from the beginning on this issue. The Executors wanted the highest possible value; the corporation (and Stan's family) wanted the lowest possible value. Hundreds of thousands of dollars in legal and accounting fees could have been avoided if this simple step had been taken each year.

5. The choice of funding for the buy sell agreement was an installment sale, which is very similar to borrowing. In borrowing from a third party such as a bank, the estate could have received its payments and gone on its merry way. With an installment sale, the estate was tied to the business and if the business had failed, the estate would not have been paid. Generally, an installment sale is the funding mechanism of last resort. A better alternative would be to establish a sinking or savings fund to prepare for this future liability. However, in this case, the corporation had to earn enough to pay taxes <u>and</u> pay off Harry's estate. The most desirable method of funding is the purchase of life insurance on the shareholders' lives. This would provide the funds necessary to purchase a deceased shareholder's shares in the business at any time, now or in the future, via payment of death benefit.[27]

6. The Subchapter S election can potentially paralyze a minority shareholder. The Executors had to pay income tax on the corporation's earnings, earnings that they did not receive. To make matter worse, it was these earnings that were partially used to redeem the shares of the estate's stock. Extreme care should be given to these types of tax elections. When a Subchapter S election is made, the parties should consider amending the buy sell agreement to mandate distributions of cash to allow the shareholders to pay income taxes on the income attributed to them via the corporation's K-1.

[25] Generally, you do not want to have appreciating assets "going upstream" to a generation above yours, since that would involve two separate estate taxes. Gift or estate taxes would be due upon your death and estate taxes would also be due upon the death of the older generation member.

[26] A step up in basis may be available to shareholders of a Subchapter S corporation should the corporation make a § 1377(a)(2) election. See Kugler Cases available from Advanced Planning.

[27] N.B. Harry's estate tax return showed life insurance death benefit of less than $25,000.

## CONCLUSION

The events described here could not have been the results Harry wanted when he transferred shares to Stan and Stuart and entered into the buy sell agreement. Only a fraction of the purchase price paid to the estate ultimately passed to the estate beneficiaries after the payment of estate taxes, income taxes, interest, penalties, legal fees, accounting fees, court fees and arbitration fees. Nevertheless, it was probably fortunate that the buy sell did at least provide a buyer for the estate's shares, when considering what may have happened if there was no agreement.

When this writer discusses this case at a seminar, the following question is posed:

"How many of you think this was a good buy sell plan?"

Almost no one says it was a good plan. And they are wrong. It was a good plan if you look at the case a little differently. The normal viewpoint is to look at the overall buy sell agreement from Harry's perspective. After all, Harry was the founder of the business. But what if you look at it from Stan's perspective? Stan owned 35% of the business and his children owned 25%. The buy sell stated that if Harry died (which everyone expected to occur before Stan's death), the corporation would purchase Harry's shares. Stan and his children would then be 100% shareholders of the business, *without having to pay for it.* Further, who was Harry's first choice in appointing his Executor? It was Stan. And although Stan would be bound by his fiduciary responsibility in administering Harry's estate, the stock redemption could have been viewed as "self-dealing" and would not have sat well with the estate beneficiaries.

The buy sell agreement provided that when Stan died (again, presumably after Harry's death), his shares would pass to Irene. This seems to show an intent to benefit Stan and his family rather than protect the interests of both Harry and Stan. Therefore, from Stan's family's point of view, the plan did all it was supposed to by making sure the family business ended up with Stan's family. The only problem was that the unexpected death of Stan pitted Arnold and Patrick as Executors against the corporation (and Stan's family) regarding the valuation, and the corporation had to pay much, much more than it expected to complete the redemption. What if Stan and Harry had updated the value of the corporation annually and kept it low but within reason? That would have made Arnold and Patrick travel a much longer and more expensive road to try to get what they perceived as fair market value for their interests in Harry's estate. The IRS, however, would not have accepted such a valuation, citing the family relationship, which could have resulted in additional estate taxes.

## EPILOGUE

The real end of the story concluded in 2001 when the New York State estate tax proceeding was completed and all outstanding litigations were settled. The business did more than just survive under Stuart's leadership and the corporation paid off the balance of the outstanding notes plus the 10% interest early, since by that time interest rates had dropped significantly. This writer from time to time sees the business's trucks throughout New York City, and although not privy to the actual goings on at the business, guesses the business continues to thrive. Arnold and Patrick no longer socialize with Stan's family. The bottom line is that Arnold and Patrick feel they received fair value for the business, but were not happy about the expenses incurred to get what they felt they deserved. To be fair to Stan's family, they felt that Stan took Harry's small business and was primarily responsible for its growth. They viewed Arnold and Patrick as taking away the business that Stan, not Harry, built and felt

they had to pay Arnold and Patrick an increased value of the business attributable to Stan's hard work. No matter how you look at this case, it could have destroyed the family business and it clearly destroyed the family. All the more reason to have a properly drawn buy sell agreement that accurately reflects the intentions of all the parties, requires revaluation of the business no less frequently than every two years, and provides the necessary funding to effect the buy sell, providing continuity of management and also providing fair market value to the deceased shareholder's estate.