Estate Tax - Buy-Sell Agreements

Merwin M. Brandon Jr.
is attacked by a candidate seeking to have himself adjudged winner of an election, it is likely that courts will require exacting proof of injury to the plaintiff before granting the remedy sought. If the contest seeks to protect the public's right to an election which represents the free will of the majority and the remedy sought is that of annulling the election, the court will probably continue to require less exacting proof of secrecy violations in order to sustain a judgment annulling the election. Thus the public has a right to a secret election, but plaintiff does not have a right to be declared winner of an election because his opponent received more non-secret votes than plaintiff received.

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A family partnership agreement provided that upon the withdrawal of any partner the remaining partners had the option to purchase his interest at two-thirds of "net value." Failure to exercise this option within twelve months automatically dissolved the partnership. The agreement also provided that upon the death of a partner, the remaining partners had the option to purchase the interest of the decedent for its full "net value." Following the death of two partners, estate tax returns were filed. The partnership interest of each was included in the respective estates at two-thirds of its "net value." The Commissioner assessed a deficiency, basing his valuation upon the full value of each partner's interest in the total net assets of the firm. The deficiency was paid. On suit for a refund, held, allowed. The value of the interest for estate tax purposes cannot exceed the value of those interests during the lifetime of the deceased partners. Land v. United States, 187 F. Supp. 521 (S.D. Ala. 1960).2

1. Land v. United States, 187 F. Supp. 521 (S.D. Ala. 1960) (the net value of a partnership interest was to be determined by valuing the assets of the partnership either by agreement among the partners, in accordance with accepted accounting procedures, or, if necessary, through arbitration).
Owners of a closely held business may attempt to prepare for the problems which arise upon the withdrawal or death of a participant in the venture by entering into agreements with one another concerning the disposition of the business interest. The many different types of agreements employed to achieve these ends are loosely referred to as “buy and sell agreements.” The agreement may require a sale in the event of the death of a participant by binding his estate to sell his interest and by obligating the survivors to purchase it. It may provide only that the survivors have an option to purchase the interest owned by a participant who withdraws or dies. Or the agreement may merely give the remaining participants a “first refusal” by denying to any withdrawing participant the right to sell his interest to an outsider without first offering it to the other participants. When the valuation of the interest in these agreements is lower than the “fair market value,” taxpayers urge that the agreement fixes the value of the business interest for estate tax purposes. If the agreement restricts transfer of the business interest during life and upon death, the position of the Internal Revenue Service is that the valuation is fixed for estate tax purposes by the agreement. However, if the agreement restricts transfer of the business interest only upon death of a participant, the Internal Revenue Service is that the valuation is fixed for estate tax purposes by the agreement.

3. See, e.g., Brown, How To Plan and Draft a Stock Purchase Agreement, in EIGHTH TAX INSTITUTE 519 (University of Southern California 1956); Fried- man, Buy and Sell Agreements, in FIFTEENTH INSTITUTE ON FEDERAL TAXATION 1053 (New York University 1957); Richm, Buy-Sell Agreements, in FOURTH ANNUAL PROCEEDINGS, TEXAS INSTITUTES 49 (1956); LOWDINES & KRAMER, FEDERAL ESTATE AND GIFT TAXES c.20, § 46 (1956); WILLIS, HANDBOOK OF PARTNERSHIP TAXATION (1957); O’Neil, Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting, 65 HARV. L. REV. 773 (1952). For an enlightening article on the buy-sell agreement in Louisiana, dealing with some areas of possible difficulty, see Cahn, Buy and Sell Agreements in Louisiana, 8 LA. B.J. 26 (May 1960).

4. IRC Regulation 20.2031-1(h): “The value of every item of property includible in a decedent’s gross estate under sections 2031 through 2044 is its fair market value . . . the price at which the property would change hands between a willing buyer and a willing seller.”

5. Int. Rev. Code of 1954, 1961 Regulations 20.2031-2(h) provides in part: “Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime.” See also Rev. Rul. 59-60 § 8 (IRB 1959-8, p. 15); IRB 1953-2 Ruling 197, p. 255. The courts apparently feel that the restriction during lifetime on the alienation of a business interest is necessary if that figure is to be used for fixing value. Broderick v. Gore, 224 F.2d 892 (10th Cir. 1955); May v. McGowan, 194 F.2d 396 (2d Cir. 1952); Bensel v. CIR, 100 F.2d 639 (3d Cir. 1938). Cf. Worcester County Trust Co. v. CIR, 134 F.2d 578 (1st Cir. 1943); Estate of Fiorito, 31 T.C. 440 (1959); Estate of Littick, 31 T.C. 181 (1959); Estate of Weil, 22 T.C. 1267 (1954); Estate of Salt, 17 T.C. 92 (1951); Estate of Matthews, 3 T.C. 525 (1944). But see City Bank Farmers Trust Co., Executor, 23 B.T.A. 663 (1931); Estate of Trammell, 18 T.C. 662 (1952).
ternal Revenue Service position is that it does not fix the value of the business interest.\(^6\)

The partnership agreement involved in the instant case bound the partners while living and their estates after death, thus meeting the conditions required by the Internal Revenue Service in order to have the valuation of the business interest involved fixed by the agreement.\(^7\) It was unusual, however, in that it permitted the purchase of the interest of a living partner at one-third less than the amount required to be paid his estate if the interest were purchased after his death.\(^8\) The court was called upon to fix the time at which the interest was valued. In so doing, although the estates involved actually received the full net value of the interest, the court set the valuation of the interest at two-thirds of the net value attributable to that interest — the amount which could have been received during the lifetime of a partner. This was done on the theory that the value of the interest of the deceased for estate tax purposes should not exceed the value of that interest which the decedent could have received during life.

A situation somewhat analogous to the instant case was presented in *Goodman v. Granger*,\(^9\) where the decedent's widow received monthly payments from her husband's employer under a deferred compensation contract. The court there stated that the right to the payments was to be valued at the time when that right vested in the widow and became absolute, even though the decedent's right to deferred compensation was contingent upon several conditions so long as the decedent was living. In the instant case, however, the court would seem to be according the amount actually paid to a decedent's estate for a business interest less importance in fixing value than the amount for which he could have sold his interest during his lifetime.\(^10\) Regardless

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6. See note 5 *supra*.

7. The regulations require that the agreement must be valid and executed at arm's length and must be supported by a full and adequate consideration. The court has recognized that mutual promises constitute full and adequate consideration. Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932); Davis v. United States, 60-1 U.S.T.C. para. 11943, p. 8560 (U.S. D.C. Utah 1960); Estate of Fiorito, 33 T.C. 440(A) (1959).


9. 243 F.2d 264 (3d Cir. 1957).

10. 187 F. Supp. 521, 526 (S.D. Ala. 1960). The opinion did not consider the possible argument that the decedent provided his estate with a right to receive a greater amount than he could have received and that this right was transferred in contemplation of death. See Broderick v. Gore, 224 F.2d 892 (10th Cir. 1955), where the Commissioner attempted to claim that the difference in the open market value and the book price stipulated in the agreement was a gift, a transfer in
of the correctness of the holding in the instant case, the use of the device approved by the court appears to offer a wide avenue for avoiding estate taxes.

Merwin M. Brandon, Jr.

INCOME TAX — GAIN FROM A STOCK FOR STOCK PLUS BOOT TRANSACTION

Taxpayer, sole stockholder of International Dairy Supply Company, transferred his stock in that company to Foremost Dairies, Inc., for 82,375 shares of the common stock of Foremost and $3,000,000.00 cash. He reported a capital gain on the transaction limited to the cash less certain expenses. The Commissioner determined that the entire gain, $4,163,691.94, was recognizable at the time of the transaction and assessed taxpayer for the deficiency. The Tax Court held that the recognizable gain on the transaction was to be limited to the cash received.1 On appeal to the United States Court of Appeals, Ninth Circuit, held, reversed. An exchange in which cash plus voting stock is received is not a reorganization.2 The entire amount of the gain is recognizable at the time of the transaction. Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960).

Generally, gains on sales or exchanges are recognizable to the full amount of the gain at the time of the transaction.3 However, it was early recognized that it would be desirable to delay recognition of gain so that business readjustments could be made without tax consequences in cases where the stockholders in the enterprise are retaining their interests without the receipt of cash and the essential continuity of business is being preserved.4

contemplation of death. While the court did not accede to this point, it should be noted that the agreement involved in the Gore case provided for the estate to receive the same amount which the decedent would have received had he sold out during his lifetime. That fact might well make the reasoning of the Gore case inapplicable in situations similar to the Land case, where the agreement provides for a change in the value of the business interest when the partner’s estate, rather than the partner, is the vendor.

2. The only reorganization definition that could be applicable would be Int. Rev. Code of 1939, § 112(g) (1) (B), now Int. Rev. Code of 1954, § 368(a) (1) (B). See note 11 infra.