Planning for Family Corporate Control

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I. INTRODUCTION

The vast majority of business corporations are closely held, with voting shares held by a single stockholder or a small group of stockholders.1 These closely held business corporations often involve relatively modest business enterprises and their stockhold-

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ers are typically active in management of the business. Although the corporate form is usually adopted for tax advantages or to obtain limited liability, it is not unusual for businesses to be incorporated merely because the principals feel that business should be conducted in corporate form. Many close corporations are also family corporations with all or a majority of the stock owned by individuals related through birth or marriage.

Individuals investing in closely held corporations should be concerned with the long range future of their investments and their continuing rights to receive benefits from their investments and to realize any appreciation in value. Family corporations are subject to unique pressures in this regard. Family members often have a strong desire to perpetuate family ownership and control for future generations, and the direct interpersonal relationships existing in family corporations intensify the pressures on management, thus increasing the risk of control deadlock.

This paper discusses a variety of planning techniques applicable to family control matters. Post mortem control efforts concern two principal objectives: preservation of the business by providing for payment of estate taxes without adversely affecting the business or its ownership and transfer of control to successive generations. The techniques discussed focus primarily on transfers of corporate control to younger family members and on discharge of

2. For example, in 1974 the Census Bureau reported 1,965,894 active corporations of which 58% reported total assets of less than one hundred thousand dollars and only 7% had total assets in excess of one million dollars. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 1977, at 560-61.

3. Possible tax advantages include lower corporate tax rates and corporate fringe benefits such as qualified pension and profit sharing plans. An excellent discussion of the tax advantages and disadvantages for a farm corporation is contained in Eastwood, The Farm Corporation From An Income Tax Viewpoint: Friend or Foe?, 54 Neb. L. Rev. 443 (1975). Limited liability may be a major consideration in adopting the corporate form although the stockholders probably will remain liable for the financial risks of loss through guarantees; moreover, good business judgement will require that risks of tort liability be insured against.


5. This paper is neither a catalog of control devices nor an exhaustive analysis of a particular device. Rather, the objective is to suggest a variety of techniques which might be considered when estate or income tax planning involves a family business corporation. The techniques also may be useful to other business planning situations but their application in other planning contexts is not discussed in this paper. When possible, the reader will be referred to more extensive analyses of a particular technique although some of the suggestions are relatively new or not well documented in the literature. This is particularly true for Employee Stock Ownership Plans, see § V of text infra; Roulette Buy-Sell Agreements, see § VI of text infra; and Independent Board of Directors, see § VII of text infra.
estate and income tax liabilities. As planning techniques they should be considered well in advance of the events which give rise to their need. Also discussed are two planning techniques (roulette buy-sell agreements and an independent board of directors) which address the problem of conflict and deadlock in family corporate control.

II. INSTALLMENT PAYMENT OF ESTATE TAXES

The Internal Revenue Code provides two separate procedures for the installment payment of federal estate taxes. A fifteen-year installment election may be made under section 6166 and a ten-year installment election may be made under section 6166A. Both provisions are intended to ameliorate the impact of estate taxes on the continuity of an active operating business. The specific harshness addressed by these provisions was the situation in which the family of a decedent who had nearly all of his financial resources committed to operating a business would be forced to dispose of the business in order to discharge the unanticipated estate tax obligation. Under the installment payment provisions, it is possible to use future income from the business to pay the estate taxes. The alternative of using future income rather than proceeds from a buy-sell agreement is made even more important by the carryover basis provisions. Carryover basis would impose a penalty in the

8. The Committee explanation stated:

[Past] provisions have proved inadequate to deal with the liquidity problems experienced by estates in which a substantial portion of the assets consist of a closely held business or other illiquid assets. In many cases, the executor was forced to sell a decedent's interest in a farm or other closely held business in order to pay the estate tax. This may have occurred even when the estate qualified for the 10-year extension provided for closely held businesses. In these cases, it may have taken several years before a business could regain sufficient financial strength to generate enough cash to pay estate taxes after the loss of one of its principal owners. Moreover, some businesses were not so profitable that they yielded enough to pay both the estate tax and interest especially if the interest rate was high.
Id. at 546, 1976-3 (vol. 2) C.B. 558.
9. I.R.C. § 1023. The carryover basis provisions were enacted by the Tax Reform Act of 1976, Pub. L. No. 94-455, tit. XX, § 2005(a), 90 Stat. 1872, and were originally to take effect on January 1, 1977. However, the Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2884, postponed the effective date of the carryover basis provisions until January 1, 1980, and it is possible that carryover
form of an income tax upon cash withdrawn from a corporation in exchange for stock pursuant to a buy-sell agreement which was originally intended to provide the liquidity required to pay estate taxes.

A. Fifteen-Year Installment Election

The fifteen-year installment election was added by the 1976 Tax Reform Act.\(^\text{10}\) It provides an election to pay estate taxes in up to ten annual installments, with the first installment due five years after the date the estate tax would otherwise have been due.\(^\text{11}\) The Code also provides an attractive annual interest rate of only four percent on estate taxes attributable to the first $1,000,000 of value of the closely held business portion of the estate.\(^\text{12}\)

In order for the estate to qualify for the fifteen-year installment election, in excess of sixty-five percent in value of the adjusted gross estate must consist of a closely held business.\(^\text{13}\) The amount of tax which may be postponed is limited to that portion of the total tax attributable to the closely held business portion of the adjusted gross estate.\(^\text{14}\) For example, if seventy-five percent of the adjusted gross estate is comprised of a closely held business, seventy-five percent of the estate tax may be paid in installments. For purposes of determining whether the estate qualifies for the fifteen-year installment payment election, the personal representative must value a farm or ranch estate under the alternative valuation methods of section 2032A if that method was used in valuing the property for the gross estate.\(^\text{15}\) In addition, the value of farm


\(^{11}\) I.R.C. § 6166(a).

\(^{12}\) I.R.C. § 6601(j)(2). See I.R.C. § 2001(c). The interest is paid annually during the five-year deferral period and thereafter is paid as part of each annual installment. I.R.C. § 6166(f)(1)-(2). In addition, interest on deferred estate tax obligations is deductible as an administration expense under I.R.C. § 2053(a)(2). Estate of Charles A. Bahr, 68 T.C. 74 (1977); Rev. Rul. 78-125, 1978-1 C.B. 292, revoking Rev. Rul. 75-239, 1975-1 C.B. 304. The language in revenue ruling 78-125 does not make it clear whether the entire projected interest may be deducted from the gross estate or whether the estate must file a refund claim with each annual interest payment.

\(^{13}\) I.R.C. § 6166(a)(1). Interests in two or more closely held businesses may be combined for purposes of meeting the 65% test if more than 20% of the value of each business is included in the decedent’s gross estate. I.R.C. § 6166(c).

\(^{14}\) I.R.C. § 6166(a)(2) provides: “The maximum amount of tax which may be paid in installments under this subsection shall be an amount which bears the same ratio to the tax . . . as—(A) the closely held business amount, bears to (B) the amount of the adjusted gross estate.”

\(^{15}\) Although it might be advantageous to value the farm or ranch at its fair mar-
residential buildings regularly occupied by the owner, lessee or an employee may be included in the value of the interest in a closely held business.\textsuperscript{16}

In order to be eligible for the fifteen-year installment election, the business must be an "active enterprise producing business income rather than income solely from the ownership of property."\textsuperscript{17} Thus, in order for the estate of a farm landlord to qualify for the election, the decedent must have materially participated in the production of income from the farm property.\textsuperscript{18} For example, in Revenue Ruling 75-36\textsuperscript{19} the Internal Revenue Service held that farm real estate qualified for an extension of time to pay estate taxes where the farm landlord received his rentals based upon farm production rather than a fixed rental and where he participated in important decisions such as crop and field selection, government program participation, and weed control.\textsuperscript{20} However, where the landlord’s activities consist solely of managing commer-

\textsuperscript{16} I.R.C. § 6166(a) (1). The closely held business must be in the business of farming and the buildings must be occupied by the owner or lessee or an employee for purposes of operating or maintaining the farm. \textit{Id.}

\textsuperscript{17} Rev. Rul. 75-365, 1975-2 C.B. 471. The revenue ruling interpreted the language "trade or business" contained in I.R.C. § 6166(A)(c) (1) (formerly codified at I.R.C. § 6166(c)(1)). The present I.R.C. § 6166(b)(1) contains the identical "trade or business" language contained in its predecessor, and the Committee Explanation states that "t]he Act generally retains the definition of existing law relating to an interest in a closely held business." \textit{J}oint \textit{C}omm. on \textit{T}axation, \textit{supra} note 7, at 548, 1976-3 (vol. 2) C.B. 560.

\textsuperscript{18} The revenue ruling stated:

It follows that the mere grouping together of income-producing assets from which a decedent obtained income only through ownership of the property rather than from the conduct of a business, in and of itself, does not amount to an interest in a closely held business within the intent of the statute.


\textsuperscript{19} \textit{Id.} at 472.

\textsuperscript{20} An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.

\textit{Id.}
cial and farm rental properties, the estate does not qualify for the election. Since material participation is a critical element for the farm landlord, the availability of the fifteen-year installment election and its advisability should be considered when determining which form the lease should take for Social Security purposes. If the farmer landlord materially participates, it is likely that the lease income will constitute earned income for purposes of Social Security. Thus, it may be difficult for an estate to qualify for the fifteen-year installment election if the farm owner has retired and does not have a material participation lease in order not to incur earned income that could offset Social Security payments.

After the fifteen-year installment payment election is made, events may occur which will cause an acceleration of unpaid installments. A disposition of one-third or more in value or a withdrawal of funds or assets representing one-third or more in value of the decedent's interest in a closely held business will cause the unpaid portion of the estate tax to become due upon notice and demand. Also, as an administrative measure, the failure to pay

21. Id. at 471:

[T]he decedent maintained a fully equipped business office to collect rental payments on the properties, receive payments on notes receivable, negotiate leases, make occasional loans, and by contract direct the maintenance of his properties. He maintained records and kept regular office hours for collection of the amounts involved and the maintenance of his properties.

. . . . In this case, the decedent's relationship to the various assets described was merely that of an owner managing investment assets to obtain the income ordinarily expected from them.

22. I.R.C. § 1402(a) defines earned income, or net earnings from self employment, as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business . . . ." If net earnings from self employment exceed the annual exempt amount provided under the Social Security laws, an individual is no longer deemed "retired" and, accordingly, Social Security benefits are reduced. 42 U.S.C.A. § 403(f) (West Supp. 1978). See 20 C.F.R. § 404.446 to .447 (1978). I.R.C. § 1402(a)(1) provides that earned income includes rental income earned through the "material participation by the owner . . . in the production or the management of the production of such agricultural or horticultural commodities."

23. I.R.C. § 6166(g)(1)(A). This provision does not apply to withdrawal of funds in an I.R.C. § 303 redemption if the redemption proceeds are applied against the deferred tax obligation either on the next installment date or within one year of the redemption, whichever is earlier. However, the value of the interest in the closely held business is reduced by the amount of the section 303 redemption, and this reduced value then becomes the basis for determining whether subsequent dispositions or withdrawals constitute one-third or more in value of the business. I.R.C. § 6166(g)(1)(B); Fleming, Funding Estate Tax Installment Payments With Section 303 Redemptions After the 1976 Tax Reform Act, 4 J. Corp. Tax. 22, 30-31 (1977).
any installment on time results in acceleration of the tax due.\(^{24}\)

**B. Ten-Year Installment Election**

The ten-year installment election has been in the Internal Revenue Code since 1958.\(^{25}\) It was retained when the 1976 Tax Reform Act adopted the fifteen-year installment election, since its eligibility terms are substantially easier for an estate to meet.\(^{26}\) In order to be eligible for the ten-year installment election the estate must include an interest in a closely held business which exceeds in value either thirty-five percent of the value of the gross estate or fifty percent of the value of the taxable estate.\(^{27}\) Again, the interest must be in an active trade or business and the decedent must have been the proprietor, partner or stockholder.\(^{28}\)

Although the ten-year installment election has lower threshold requirements than the fifteen-year installment election, it bears interest at the rate imposed on all deferred tax payments and deficiencies\(^{29}\) rather than the favorable four percent rate provided by the fifteen-year election for the closely held business portion of the estate.\(^{30}\) The maximum amount of estate tax which may be deferred by the ten-year installment election is a portion of the tax which equals the ratio of the value of the closely held business to the gross estate.\(^{31}\) This is in contrast to the fifteen-year installment election where the ratio is computed with regard to the adjusted gross estate,\(^{32}\) thereby resulting in a more generous deferral. In addition, under the ten-year installment election the first payment is to be paid on or before the regular due date prescribed for the payment of the estate tax, rather than the five year

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\(^{24}\) I.R.C. § 6166(g)(3).


\(^{27}\) I.R.C. § 6166A(a)(1)-(2). Interests in two or more closely held businesses may be aggregated in order to meet the tests of section 6166A(a)(1)-(2), but only if 50% or more of the total value of each business is included in the decedent's gross estate. I.R.C. § 6166A(d).


\(^{29}\) I.R.C. § 6166A(g) provides that the interest is payable under I.R.C. § 6601. That section provides that the rate of interest is the rate established under I.R.C. § 6621. Pursuant to section 6621(b), the Service has established the current annual rate of interest on tax obligations at six percent. Rev. Rul. 77-411, 1977-2 C.B. 480, 481.

\(^{30}\) I.R.C. § 6601(j).

\(^{31}\) I.R.C. § 6166A(b).

\(^{32}\) I.R.C. § 6166(a)(2).
deferral of any payment provided by the fifteen-year election.\textsuperscript{33}

Acceleration of unpaid installments is also required under the ten-year installment election.\textsuperscript{34} However, under the ten-year installment method there must be an aggregate withdrawal or disposition of fifty percent or more in value of the business before acceleration occurs, compared to the one-third or more in value that causes acceleration under the fifteen-year installment election.\textsuperscript{35}

C. Integration of Estate Tax Payment Installment Elections With Section 303 Stock Redemptions

Stock redemptions to pay death taxes which satisfy the requirements of section 303 have long been a favorite method of withdrawing corporate funds.\textsuperscript{36} Prior to the the Tax Reform Act of 1976, such corporate redemptions qualified as capital transactions in which the stepped-up basis resulting from death eliminated income taxes.\textsuperscript{37} Thus, an estate could extract corporate funds to pay death taxes and funeral and administration expenses without income tax consequences. In order to use section 303, the stock value must exceed fifty percent of the value of the gross estate reduced by the deductions allowed for estate expenses, indebted-

\textsuperscript{33} I.R.C. § 6166A(e) (the first installment being due on the regular due date prescribed by section 6151(a)); I.R.C. § 6166(a)(3) (first installment shall be paid on a date not more than five years after the date prescribed by section 6151(a)).

\textsuperscript{34} I.R.C. § 6166A(h).

\textsuperscript{35} Under I.R.C. § 6166(h)(1)(B), withdrawal of funds pursuant to a section 303 redemption does not accelerate payment if all the proceeds from the redemption are applied to the estate tax obligation on the date the next installment is paid. To the extent the section 303 redemption reduces the value of the interest in a closely held business, however, the basis for determining whether subsequent withdrawals or dispositions constitute 50% or more in value of the business is reduced. Fleming, \textit{supra} note 23, at 30-31.


\textsuperscript{37} Sections 303 and 1014 interacted to provide this result. Section 303 provided that redemptions to pay death taxes would be taxed as payments in exchange for the stock rather than as dividends under I.R.C. § 301. Since I.R.C. § 1014(a) provided that the basis of the stock would be stepped-up to its fair market value at the date of decedent's death, there was no gain requiring payment of income taxes unless the stock appreciated in value between the date of decedent's death and the date of the redemption.
ness, and taxes. The redemption must be from the stockholder who must actually pay or be obligated to pay the expenses.

The carryover basis provisions imposed by the Tax Reform Act of 1976, if implemented, would reduce the desirability of section 303 redemptions, in that redemptions may result in income tax liability, albeit at capital gain rates. Moreover, the section 303 redemption at capital gain rates cannot be increased to provide funds with which to pay the income tax liability.

If the estate elects to pay its estate taxes on an installment basis it must consider the effect that a section 303 redemption might have on the installment payment election. The first consideration in integrating the redemption with the installment election is the comparison of threshold requirements. Unfortunately, section 303 was not designed to integrate with either installment election provision so the eligibility requirements must be separately tested. The percentage of stock ownership tests for the ten-year installment election and section 303 redemption differ greatly and it is possible that an estate could qualify under one but not the other. However, the higher percentage requirement of the

38. I.R.C. § 303(b)(2)(A). Stock from two or more corporations may be combined for purposes of meeting the 50% test, but only if more than 75% in value of the outstanding stock of each corporation is included in the decedent's gross estate. I.R.C. § 303(b)(2)(B).

39. I.R.C. § 303(b)(3). Prior to the Tax Reform Act of 1976, stock qualified for a section 303 redemption if it was included in the decedent's estate. It was unnecessary that the proceeds be used to pay death taxes or administrative expenses, or even that the stock be redeemed from the estate of the decedent. Treas. Reg. § 1.303-2(f) (1960). See Kadish, supra note 36, at 898-99. The Tax Reform Act of 1976 amended section 303 "to require that capital gains treatment... will apply to the distribution by a corporation only to the extent that the interest of a shareholder is reduced either directly or through a binding obligation to contribute toward the payment of debts, expenses, or taxes." Joint Comm. on Taxation, supra note 7, at 551, 1976-3 (vol. 2) C.B. 563.

40. I.R.C. § 1023. The carryover basis provisions are currently scheduled to take effect on January 1, 1980. See note 9 supra.

41. When the carryover basis provisions take effect, stock will no longer receive a step up in basis to its fair market value at date of death, but will retain the basis it had in the hands of the decedent, with a step up in basis to its value on December 31, 1976. Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 2884.

42. I.R.C. § 303(a) provides that redemption proceeds shall be treated as received in exchange for stock only to the extent they do not exceed the amount of death taxes and of funeral and administration expenses allowable as deductions.

43. For an exhaustive analysis of the interrelationship between section 303 and sections 6166 and 6166A, see Fleming, supra note 23.

44. Fleming, supra note 23, at 24.

45. Stock qualifies for a section 303 redemption if it exceeds 50% of the adjusted gross estate (I.R.C. § 303(b)(2)), and for a section 6166A ten-year deferral if it
fifteen-year election would also qualify a section 303 stock redemption.\textsuperscript{46} In addition, there are separate stock ownership rules applicable to certain variations, such as when stock in two or more businesses is involved.\textsuperscript{47}

Obstacles to the joint use of a section 303 stock redemption and an installment payment election are also presented by the timing and acceleration provisions. Once four years from the date of the decedent’s death have elapsed, section 303 permits qualifying redemptions only to the extent they do not exceed the lesser of the amount of death taxes and funeral and administration expenses remaining unpaid on the date of the redemption or the amount of death taxes and funeral and administration expenses which are paid during the year beginning with the date of redemption.\textsuperscript{48} The net effect of this provision is to limit redemptions after the expiration of a four year period to the amount which will actually be applied to the unpaid balance of death taxes and expenses within

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\textsuperscript{46} Stock qualifies for the section 6166 fifteen-year deferral if it exceeds 65\% of the adjusted gross estate (I.R.C. § 6166(a)). Since the test for section 303 is 50\% of the adjusted gross estate, an estate qualifying under section 6166 should always qualify under section 303. See Fleming, \textit{supra} note 23, at 26-28.

\textsuperscript{47} Under section 303(b)(2)(B), stock in two or more corporations may be aggregated for purposes of meeting the 50\% of the adjusted gross estate test, but only if more than 75\% in value of each corporation is included in the decedent’s gross estate. In order to meet the 65\% of the adjusted gross estate test imposed by section 6166, stock of two or more corporations may be aggregated if more than 20\% of the total value of each is included in the decedent’s gross estate. To meet the 35\% of the gross estate or 50\% of the taxable estate tests under section 6166A, stock from two or more corporations may be aggregated, but only if more than 50\% of the total value of each is included in the gross estate. Thus section 303 imposes a much higher threshold requirement (75\%) on the value of the stock in each corporation which must be included in the gross estate before it may be aggregated than does either section 6166(20\%) or section 6166A (50\%).

\textsuperscript{48} I.R.C. § 303 provides that redemptions more than four years after the date of decedent’s death qualify only if the redemption proceeds do not exceed the lesser of (1) the decedent’s then-unpaid death taxes, funeral expenses, and/or administration expenses, or (2) the amount of the decedent’s death taxes, funeral expenses, and/or administration expenses paid within one year after the redemption transaction. Since (2) will never be greater than (1) in the preceding sentence, the effect of this rule is to require the proceeds of all redemptions occurring more than four years after death to be applied against the decedent’s death taxes, funeral expenses, and/or administration expenses within one year after the transaction.

Fleming, \textit{supra} note 23, at 29.
one year of the redemption.\textsuperscript{49} In addition, unless the estate applies all the proceeds of the redemption against the balance of the estate tax obligation within one year after the redemption, the withdrawal may reduce the value of the business to the extent that payment of the remaining installments is accelerated.\textsuperscript{50}

\section{III. BUY-SELL PRICING AND PAYMENT TERMS}

Buy-sell agreements are essential for a closely held corporation. They are commonly used to resolve control problems which might occur on the death of one of the principals and are a means of providing liquidity when a substantial portion of the gross estate is invested in a closely held business.\textsuperscript{51} Buy-sell agreements may have the additional advantage of establishing stock value for estate tax purposes.\textsuperscript{52} In a family corporation, the buy-sell may be the contractual mechanism whereby younger generations are encouraged to work in the business and are rewarded for their efforts with eventual ownership of the business on favorable terms.

Planning considerations for buy-sell agreements will be different if the carryover basis provisions of the Tax Reform Act of 1976 are made permanent as of January 1, 1980.\textsuperscript{53} Under existing law, stock held by a decedent in a closely held corporation receives a stepped-up basis to its date-of-death value solely at the cost of estate taxes imposed on the value.\textsuperscript{54} Thus, implementation of the buy-sell agreement after death results in no income taxes unless the value of the stock increases between the date of death and the date the buy-sell is implemented. If carryover basis is permitted to

\textsuperscript{49} Id. n.44.
\textsuperscript{50} I.R.C. §§ 6166(g) (1)(A), 6166A(h) (1). See notes 23 & 35 supra. The extreme complexities of combining a section 303 redemption with the deferral provisions of sections 6166 and 6166A are discussed at length in Fleming, supra note 23, at 28-40.
\textsuperscript{52} See § III-B-1 of text infra.
\textsuperscript{54} I.R.C. § 1014 continues to provide a step up in basis to date of death fair market value until January 1, 1980.
go into effect, there would be no step up in basis and a significant income tax liability may be incurred through implementation of a buy-sell agreement. Imposition of both estate and income taxes on stock received at death could result in a confiscatory levy which would make implementation of a buy-sell agreement undesirable.

Arrangements for the transfer of stock within a family involve considerations which may differ significantly from transfers among unrelated parties. Family transfers are likely to be based on love and affection together with a desire to have the family continue to control and operate the business. The presence of these factors encourages liberalization of price and payment terms. The planning technique discussed in this part explores the adoption of a minimum price for buy-sell agreements and extended payment terms which mesh with the estate’s requirements.

A. Taxation of Buy-Sell Agreements

1. Redemptions or Entity Purchases

A buy-sell agreement involves a purchase of stock by either the corporation, the remaining stockholders, or some combination of the two. A redemption by the corporation must fit within certain statutory exceptions to the general dividend rule for corporate distributions in order to qualify as a sale or exchange. If it qualifies as a sale or exchange, the amount realized is reduced by the stockholder's basis in his or her stock, and the gain is capital in contrast to the ordinary income treatment accorded dividends. The exceptions which would typically apply to a stock redemption

55. See note 9 supra.

56. Under I.R.C. § 1023(h)(1) stock acquired before December 31, 1976, receives a step up in basis to its fair market value on that date. Any appreciation in value after that date will be taxed as gain to the beneficiary or the estate when the stock is sold. The Revenue Act of 1978 did not alter the “fresh start” date although it postponed the effective date of the carryover basis provisions until January 1, 1980. Pub. L. No. 95-600, § 515, 82 Stat. 2884.

57. A purchase of stock by the corporation is referred to as an entity purchase. A purchase by the remaining stockholders is referred to as a cross purchase.


59. I.R.C. § 301(c) provides ordinary income treatment for distributions with respect to stock to the extent of the corporation's accumulated and current earnings and profits.

60. I.R.C. §§ 1202, 1221. The holding period requirements of § 1223 must, of course, be met in order for the redemption to qualify for capital gain treatment. Under section 1223(11), property which receives a step up in basis to fair market value at date of death is considered to meet the holding period requirements even if it is disposed of within one year after decedent's death. When the carryover basis provisions of section 1023 take effect, the decedent's holding period will be tacked onto that of the estate or the beneficiary. I.R.C. § 1223(2).
are contained in sections 302 and 303 of the Internal Revenue Code. A distribution will be treated as payment in exchange for stock if one of the exceptions provided in section 302 is met: (1) the redemption is "not essentially equivalent to a dividend,"61 (2) the redemption is "substantially disproportionate,"62 or (3) the redemption is of all of the stock of the corporation owned by the stockholder.63.

The Code and the regulations do not specify when a redemption is "not essentially equivalent to a dividend." Rather, the determination is based on all the facts and circumstances of the particular transaction.64 As a general rule, pro rata redemptions are subject to dividend treatment.65 Unfortunately, this means that redemp-

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61. I.R.C. § 302(b)(1).
63. I.R.C. § 302(b)(3).
64. Treas. Reg. § 1.302-2(b) (1960). The legislative history of section 302(b)(1) supports the factual nature of the inquiry. One of the proposals for the 1954 Code was to allow exchange treatment only for certain easily tested categories. H.R. REP. NO. 1337, 83d Cong., 2d Sess., § 302(a), reprinted in [1954] U.S. CODE CONG. & AD. NEWS, 4017, 4209-14. The Senate rejected this mechanical approach in favor of the more flexible factual inquiry. S. REP. NO. 1622, 83d Cong., 2d Sess. 42,233 (1954). However, in United States v. Davis, 397 U.S. 301 (1970), the Supreme Court eliminated a bona fide business purpose for the redemption as a relevant factor. Id. at 312. In addition, the Court ruled that the attribution rules of section 318 are applicable to section 302(b)(1) redemptions and the redemption "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation" in order to be taxed as an exchange instead of as a dividend. Id. at 313. Query whether a meaningful reduction occurs where the ownership percentage change is significant but the stockholder still has an absolute majority of the stock or actual working control. See Rev. Rul. 78-401, 1978-46 I.R.B. at 5, holding that a reduction from 90% to 60% is not a "meaningful reduction." The dissenting opinion in Davis maintained that the majority opinion mandated, in effect, that a redemption of stock in a closely held corporation is always equivalent to a dividend. 397 U.S. at 314. This would appear to be true in the case of a family corporation where as a result of the attribution rules of section 318 each family member is deemed to own all of the outstanding stock regardless of any redemption.

Davis stimulated additional comment on the nature of the test in a case which involved capital contributed to a closely held corporation for a specific purpose and a limited number of years. Nonvoting, nondividend paying preferred stock was issued which was redeemable within 10 years. The tax court held that the liquidating distributions were equivalent to dividends because the redemption did not change the relative economic interests of the parties. Miele v. Commissioner, 56 T.C. 556 (1971), acq., 1972-1 C.B. 2, aff'd per curiam, 474 F.2d 1338 (3d Cir.), cert. denied sub nom. Albers v. Commissioner, 414 U.S. 982 (1973). In a written dissent to the denial of certiorari, three Justices (Powell, Blackmun and Douglas) argued that a factual inquiry would have to lead to a different result, 414 U.S. at 986, and warned that the Davis rule falls most heavily on small family corporations lacking specialized tax counsel. 414 U.S. at 988 n.8.

tions involving family corporations probably will not qualify for the "not essentially equivalent to a dividend" exception because the constructive ownership rules of section 318 apply. The Supreme Court has held that where a stockholder constructively owning 100 percent of a family corporation causes part of the shares to be redeemed, the redemption is essentially equivalent to a dividend because the stockholder constructively continues to own 100 percent of the corporation. Under the family attribution rules of section 318 an individual is considered to own stock owned by or for his or her spouse, children, grandchildren and parents. There is no attribution from grandparents nor between brothers and sisters. Attribution is also effected from partnerships, estates, trusts and corporations.

If constructive ownership rules do not preclude use of the "not essentially equivalent to a dividend" exception, the redemption may qualify for capital gain treatment even though the resulting non-pro rata redemption does not meet the substantially disproportionate requirements of section 302(b)(2). The Service, for example, has ruled that a redemption which reduces a stockholder's interest to exactly fifty percent when the other fifty percent is held by an unrelated stockholder is not essentially equivalent to a dividend. The ruling focuses on the fact that the redeemed stock...

66. I.R.C. § 318. See also note 64 supra.
68. I.R.C. § 318(a)(1)(A). Application of the family attribution rules when hostility exists among parties between whom stock involved in ownership has been attributed has been frequently litigated. Perry S. Lewis, 47 T.C. 129 (1966); Estate of Arthur H. Squier, 35 T.C. 950 (1961), acq., 1961-2 C.B. 5. After the decision in Davis the courts continued to be troubled by the application of family attribution rules when the relationship of the parties was inconsistent with the attribution. In Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975), the court interpreted the "meaningful reduction" language of Davis to require a factual inquiry and rejected a mechanical application of the attribution rules. 510 F.2d at 48. See generally Note, Family Hostility as Mitigating The Constructive Ownership Rules of Section 318 When Applied to the Dividend Equivalency Provision of Section 302(b)(1), 55 B.U. L. Rev. 667 (1975).
70. I.R.C. § 318(a)(2). For example, corporate stock owned by a partnership is considered to be owned proportionately by the partners. I.R.C. § 318(a)(2)(A). Similar flow through rules are applicable for estates and trusts. I.R.C. § 318(a)(2)(A)-(B). A proportionate amount of stock held by a corporation, however, is only attributed to persons owning 50% or more in value of the corporation. I.R.C. § 318(a)(2)(C).
71. Rev. Rul. 75-502, 1975-2 C.B. 111. The redemption could not qualify under section 302(b)(2) (substantially disproportionate redemptions) because the stockholder did not own less than 50% of the outstanding stock after the redemption was completed.
holder gave up "dominant voting rights." The Service has also ruled that a substantial reduction in voting ownership may be treated as a sale of stock under the "not essentially equivalent to a dividend" exception even though the reduction was not enough to satisfy the substantially disproportionate test of section 302(b)(2). However, in another ruling the Service has indicated that in addition to the substantial decrease in ownership there must be additional control factors which suggest that there has been a meaningful reduction in the redeemed stockholder's proportionate interest in the corporation.

Similarly, substantially disproportionate reductions under section 302(b)(2) are difficult to achieve within a family corporation because the constructive ownership rules of section 318 attribute to the stockholder stock held by other family members. Thus, in a family corporation it is unlikely that after the redemption the stockholder will own less than fifty percent of the total combined voting power of all classes of stock entitled to vote unless control is held by a grandparent or brother or sister from whom there is no attribution.

The third exception to dividend treatment is a complete redemption of all of a stockholder's interest. This exception is un-

72. Id.
73. Rev. Rul. 75-512, 1975-2 C.B. 112. The ruling deals with a reduction from 30% to 24.3%, which is only a 19% reduction for purposes of the substantially disproportionate test of section 302(b)(2).
74. Rev. Rul. 76-364, 1976-2 C.B. 91 held that a meaningful reduction had occurred since the redeemed stockholder no longer could combine with only one other stockholder for absolute numerical control. The stockholder had barely missed satisfying the substantially disproportionate test of section 302(b)(2). The Service's reliance on actual control suggests that in order to constitute a meaningful reduction under section 302(b)(1) there must be an additional factor other than a large percentage reduction.
75. Treas. Reg. § 1.302-3(a) (1960). Although the family attribution rules may be avoided between hostile family members for purposes of the section 302(b)(1) "not equivalent to a dividend" redemption (see note 68 supra) and may be waived for purposes of a section 302(b)(3) "complete termination of interest" (see notes 79-83 & accompanying text infra), they may not be avoided for purposes of a substantially disproportionate redemption.
76. I.R.C. § 318(a)(1). If a corporation is owned by brothers and sisters, a substantially disproportionate redemption may be possible if one or more of them have stock redeemed. However, where stock ownership is concentrated in a nuclear family unit consisting of first, second and third generation (grandparents, parents and children) the attribution rules are likely to cause a proposed redemption to fail the substantially disproportionate test. Thus, if either the grandparents or parents have some stock redeemed, there will be full attribution under section 318(a)(1). However, if the children have some of their stock redeemed, their grandparent's stock will not be attributed to them.
77. I.R.C. § 302(b)(3).
doubtedly the most widely used by family corporations. Under this exception, the redemption qualifies as a sale or exchange as long as all of the stockholder's stock in the corporation is redeemed. When a complete termination of a stockholder's interest is involved, the family attribution rules do not apply if certain tests are met: (1) immediately after the distribution the taxpayer must not have any interest in the corporation except that of a creditor; (2) the taxpayer must not acquire any interest in the corporation, other than by bequest or inheritance, for ten years after the redemption; (3) the taxpayer must agree to notify the Service of any acquisition of an interest within ten years from the date of the

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78. This is due to the difficulty in satisfying the technical requirements of the other alternative redemption plans (see text accompanying notes 64-76 supra) and the possible waiver of family attribution rules which makes a complete termination feasible.

79. I.R.C. § 318(a) (1).

80. I.R.C. § 302(c) (2) (A) (i). This requirement constitutes a trap for the stockholder unwilling to sever all connections with the corporation other than as a creditor. The Service will challenge the waiver if the stockholder continues as an officer, director or employee. See Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967); Rev. Rul. 56-556, 1956-2 C.B. 177. The redeemed stockholder cannot even serve as an unpaid consultant. Rev. Rul. 70-104, 1970-1 C.B. 66; Rev. Rul. 56-556, 1956-2 C.B. 177. The Service has also ruled that a stockholder cannot have an attorney elected to the board of directors although the attorney may attend board meetings. Rev. Rul. 59-119, 1959-1 C.B. 68. The stockholder may, however, render future services to the corporation as an independent contractor. Estate of Lennard, 61 T.C. 554 (1974), acq. in result only, 1974-2 C.B. 3.

81. I.R.C. § 302(c) (2) (A) (ii). The limitation also applies to the acquisition of an interest in a successor corporation. Treas. Reg. § 1.302-4(c) (1960). A creditor may enforce a security interest in assets without violating the prohibition against subsequent acquisition of an interest in the corporation but may not acquire stock of the corporation albeit in a creditor status. Treas. Reg. § 1.302-4(e) (1960).
redemption;\textsuperscript{82} (4) the stock redeemed must not have been acquired within ten years before the redemption from a person whose stock ownership would be attributed to the taxpayer;\textsuperscript{83} and (5) the taxpayer must not have transferred stock within ten years before the redemption to another taxpayer whose stock would be attributable to the redeemed taxpayer unless it was also redeemed.\textsuperscript{84} However, the latter two tests do not apply if the taxpayer can show that the stock transfers were not for the principal purpose of avoiding federal income tax.\textsuperscript{85}

As noted earlier, the constructive ownership rules of section 318 attribute ownership from partnerships, estates, trusts and corporations as well as between family members.\textsuperscript{86} These constructive ownership provisions are not waived under section 302(b)(3) since the complete termination of interest waiver applies solely to the constructive ownership of stock through family relationships.\textsuperscript{87} This can create a difficult problem for post mortem implementation of family buy-sell agreements. If at the time of the redemption any of the stock is held by a trust or estate, there is a significant risk that the redemption will be taxed as a dividend distribution.\textsuperscript{88} For example, if the estate is the redeemed stockholder, it will be considered to own any stock which is owned by its beneficiaries and any stock which its beneficiaries may be deemed to own under the attribution rules. In a family corporation such attribution probably would mean that there has been neither a complete termination of interest nor a substantially disproportionate distribution. Rather, it is likely that the estate would be deemed to own 100 percent of the voting stock both before and after the redemption.

The Service's insistence upon a literal application of the statu-

\textsuperscript{82} I.R.C. § 302(c)(2)(A); Treas. Reg. § 1.302-4(a) (1960), amended, T.D. 7535, 1978-1 C.B. 84. The periods of limitations on assessments and collection are extended to include the period preceding such an acquisition and one year thereafter. I.R.C. § 302(c)(2)(A).

\textsuperscript{83} I.R.C. § 302(c)(2)(B)(i).

\textsuperscript{84} I.R.C. § 302(c)(2)(B)(ii).

\textsuperscript{85} I.R.C. § 302(c)(2)(B). Tax avoidance would occur, for example, where the stockholder transfers stock to a spouse with a contemplated redemption of either the transferor's remaining stock or the gifted stock held by the spouse. On the other hand, gifts of stock to children employed in the business in order to enable them to exercise control over the corporation will not be considered in avoidance of federal income taxes. Rev. Rul. 77-293, 1977-2 C.B. 91.

\textsuperscript{86} See note 70 supra.

\textsuperscript{87} Section 302(c)(1) requires the application in stock redemptions of all the attribution rules of section 318(a) whereas section 302(c)(2) provides that section 318(a)(1) (the family attribution rules) shall not apply in certain circumstances to a complete termination of interest under section 302(b)(3).

tory language can lead to nonsensical results. For example, a surviving spouse could receive capital gain treatment on stock owned in her own right and dividend treatment with respect to stock redeemed from the estate.\textsuperscript{89} In the two cases which have litigated the literal application of the statutory language, the courts have held that an estate may make the necessary agreement to waive the family attribution rule.\textsuperscript{90} The Service, however, has not acquiesced in these decisions and apparently will continue to litigate any attempted extensions of the waiver of family attribution rules. The problem may be avoided by having the estate distribute the stock to the beneficiary prior to the redemption. This would remove the estate from stock ownership and eliminate the estate attribution rules,\textsuperscript{91} but the distribution may carry out distributable net income to a high bracket taxpayer.\textsuperscript{92} There may, in addition, be practical limitations on early estate distributions and distributions to trusts would merely raise the trust attribution rules.\textsuperscript{93}

Finally, section 303 accords sale or exchange treatment to the redemption of some of a decedent's stock even though the redemption does not qualify under the exceptions of section 302.\textsuperscript{94} In order to qualify, the federal estate tax value of the decedent’s stock in the redeeming corporation must exceed fifty percent of the decedent’s adjusted gross estate.\textsuperscript{95} The purpose of section 303 is to permit favorable tax treatment on stock redemptions to the extent necessary to pay death taxes and funeral and administrative expenses.\textsuperscript{96} Thus, the party whose shares are redeemed must actually bear the burden of estate taxes and expenses, and any stock redemption in excess of the amount allowed by section 303 will be treated as an ordinary dividend unless the exceptions of section 302 apply.

2. Cross Purchase Agreements

The complexities of a stock redemption are avoided where the

\textsuperscript{90} Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976); Lillian M. Crawford, 59 T.C. 830 (1973), nonacq., 1974-2 C.B. 5. While these cases arrive at reasonable results the Service’s concern is understandable since the estate’s waiver does not prevent beneficiaries from subsequently acquiring an interest in the corporation.
\textsuperscript{91} Another example of post mortem estate planning exists where an estate is concerned about attribution from a beneficiary. It may be possible to complete estate distributions to the beneficiary in order to terminate the person’s beneficiary status.
\textsuperscript{92} I.R.C. § 662(a).
\textsuperscript{93} I.R.C. § 318(a)(2)(B).
\textsuperscript{94} I.R.C. § 303.
\textsuperscript{95} I.R.C. § 303(b)(2)(A). See note 38 supra.
\textsuperscript{96} See notes 36-50 supra.
purchase is made by surviving stockholders. Sale of stock may be made by the estate, a trust, or beneficiaries without resulting in ordinary gain. Cross purchase agreements, however, have not been widely used. If the buy-sell agreement is funded by insurance, a cross purchase agreement requires a complex arrangement of insurance policies which must be owned individually rather than by the corporation. This can result in unfairness when younger stockholders must pay higher premiums on the lives of older stockholders. If the purchase is not funded by life insurance, the surviving stockholders typically must look to the corporation for funds with which to make the purchase. This can create additional tax and cash flow burdens. Cross purchase agreements, however, will become significantly more popular if the carryover basis rules are adopted. In a cross purchase the surviving stockholder receives a basis in the acquired stock equal to its purchase price, thereby reducing income tax on the purchaser's eventual sale of the stock. Under existing laws this advantage has had minimal value in family corporations since the purchasing stockholder's stock has often been held until death, at which time a free step up in basis has occurred.

B. Minimum Pricing

For a family corporation, minimum pricing of buy-sell agreements should be considered along with other traditional techniques of transferring ownership to family members. Minimum pricing may reduce both estate and income taxes resulting from the death of a family member. It is highly desirable to establish a price or a method for determining a price prior to the events giving rise to the right or obligation to purchase. Failure to establish a price, either in a fixed amount or by formula, may cause the entire agreement to fail for lack of an essential term. A predetermined

97. I.R.C. § 1001. Sales to individuals as opposed to the corporation are not restricted by the stock redemption requirements of section 302. However, losses between related individuals may be disallowed. I.R.C. § 267.

98. Entity purchase agreements are much simpler in operation and stockholders typically prefer to use corporate funds for the purchase. The complexity of cross purchase agreements is due primarily to the multiple number of decisions to purchase which must be made.

99. For example, an entity agreement in a five person corporation would require that the corporation own five insurance policies, one on each stockholder. However, for a cross purchase agreement each stockholder typically would have four policies, one on each of the other stockholders, for a total of twenty insurance policies.

100. See note 9 supra.


102. See §§ III-B-1 to -2 of text infra.

103. See generally 1 A. Corbin, Contracts § 95 (1963); Restatement (Second) of
price also assures that personal or business considerations will not preclude an agreement on price when the sale is consummated.

There are four basic valuation methods for establishing a price for corporate stock: (1) book value, (2) agreed upon value, (3) appraised value, and (4) capitalization of earnings. Often several valuation methods are combined. For example, the parties may wish to agree annually on the value to be used for the buy-sell agreement but also provide that one of the other methods is to be used in the event of a failure to agree on a value.

Which of these pricing methods should be used in order to establish a minimum price? The appraisal method probably would be unsatisfactory when the parties are attempting to limit value increases. If the appraisal method is adopted, the buy-sell agreement might establish standards to guide the appraiser in determining an acceptable value. For example, inventories could be valued at cost as opposed to market value and goodwill could be ignored.

The capitalization of earnings method often results in higher valuations than the other methods. This is because the emphasis on earning power takes into account goodwill and other intangibles associated with the business. The product of the capitalization of earnings method, however, is dependent upon the period over which earnings are considered and the capitalization rate applied to those average earnings. If the capitalization of earnings method is used the agreement should specify the representative


106. A typical base period would be the five years preceding the year of sale although adjustments may be made to anticipate future increases or decreases in earnings or to eliminate years with unusual earnings. A. Dewing, Financial Policy of Corporations ch. 10 (5th ed. 1953), contains the traditional starting point for determining capitalization rates. Dewing establishes seven descriptive categories with different capitalization rates. However, the Dewing rates have been characterized as outdated. D. Herwitz, Business Planning 18 (1966). See also Krahmer & Henderer, Valuation of Shares of Closely Held Corporations, 221 Tax Mgmt (BNA).
earnings period and the capitalization rate. This alone, however, will not prevent future increases in value since the base period and its earnings will presumably change over time and could increase substantially, thereby increasing the resulting value determined under this method.

An agreed upon value obviously would establish a minimum price with certainty and simplicity. If the parties do so agree, they may wish to provide for periodic revaluations.\(^\text{107}\) If they are unable to agree upon subsequent valuations, the agreement should provide for a substitute formula method or a regression to a previously agreed value.

Valuation according to book value has been properly criticized in the literature.\(^\text{108}\) Book value does not take into account the appreciation in value of tangible assets or the value of intangible assets such as goodwill and secret processes.\(^\text{109}\) However, it is for this very reason that book value probably is the best valuation method when the parties wish to establish a minimum price for their stock. Book value is precise and simple and is probably the most frequently used method for establishing stock prices in buy-sell agreements.\(^\text{110}\) The value established is consistent with the books and records of the corporation, thereby providing a certain appealing symmetry to both the stockholders and the Internal Revenue Service. Although valuation according to book value generally results in a relatively modest value for the corporation, there is no requirement that the value be determined as 100 percent of book value, and the parties may wish to fix stock value in terms of a percentage of book value. Percent of book value formulas bear a similarity to minority interest discounts allowed by the Service in valuing stock of closely held corporations for estate tax purposes.\(^\text{111}\)

1. Fixing Estate Tax Values

There are two basic requirements in order for a minimum price in a buy-sell agreement to establish the estate tax value at an amount lower than the actual fair market value of the stock. First, the buy-sell agreement must absolutely restrict the stockholder's

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107. Annual valuations are standard. The buy-sell agreement should include an appendix for annual valuation which should be signed annually by all stockholders.

108. See, e.g., Krahmer & Henderer, supra note 106, at A-43.

109. Id.


market for his or her stock.112 This means that the agreement must constitute a completed contract, with the price either fixed or determinable and the estate required to sell at that price.113 In addition to the estate's obligation to sell at the contract price, the agreement must also restrict the stockholder's ability to dispose of the stock during his or her lifetime.114 Second, the agreement must represent a bona fide business arrangement as opposed to a device to pass the decedent's shares to family members for less than full consideration.115

The market limitation requirement is strictly enforced by the Service. Thus, the buy-sell agreement must be specific and complete and must not contain any method whereby the stockholder may avoid the limitations of the agreement. In order to control value the agreement must restrict lifetime transfers as well as post mortem transfers.116 Otherwise, the value of the stock would be its full fair market value since the decedent could have realized that amount by making a lifetime transfer. An example of the necessity for a complete restriction on transfer is contained in Matthews v. United States,117 which involved a family corporation. A stockholder agreement prohibited the transfer or assignment of stock to anyone except lineal descendants, i.e., children and grandchildren, without first giving other stockholders a right to buy the stock at book value. The court held that the restriction was not effective to establish estate tax values because the stockholder could have sold his stock to his descendants at other than book value without first offering it to other stockholders.118 Value may be controlled by setting an option price rather than a mandatory purchase price.119

Minimum pricing arrangements place special pressure upon

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114. Treas. Reg. § 20.2031-2(h) (1958). See Estate of Robert R. Gannon, 21 T.C. 1073, 1080 (1954). The form of the restriction should not matter. Thus, for example, the agreement may provide for a prohibition on transfer, a right of first refusal, or a mandatory purchase. See Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955). In addition, if the restriction on sale is not apparent from the buy-sell agreement, the court may look to other contractual relationships of the parties to determine whether a decedent was prohibited from disposing of the stock. See Estate of Lionel Weil, 22 T.C. 1267 (1954), acq., 1955-2 C.B. 10.
116. Id.
118. Id. at 1008. Although the agreement did not establish estate tax values, the court did consider the restriction on sale in determining the value of the stock. See also Estate of James H. Matthews, 3 T.C. 525 (1944), acq., 1944 C.B. 19.
the requirement in the regulations that "the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." 120 Minimum pricing buy-sell agreements among family members inevitably raise the question of whether the agreement served a valid business purpose or was tax avoidance motivated. 121 A principal argument is that the buy-sell agreement is necessary to insure the continuity of the family business. 122 It is often necessary to induce younger family members into the business and a certainty of future ownership control at a favorable price provides excellent motivation for younger family members while they are basically mere employees. These arguments are difficult to maintain, however, if the agreement is entered into when the principal stockholder is elderly or in failing health. 123 In addition to business management considerations, the courts have emphasized that complete reciprocity constitutes adequate and full consideration. 124 This occurs where the agreement is equally binding on all stockholders so that if the younger stockholder should die first, the agreement is applicable to his or her estate.

Some commentators have interpreted the regulations to require that the purchase price established in the buy-sell agreement must be reasonable. 125 Although the regulations do not specifically mandate a reasonableness standard, one may be inferred by the contrast in the regulations between a bona fide business arrangement and a device to pass stock to family members for less than full consideration. 126 Thus construed, any reasonableness standard presumably does not compare the buy-sell price with the fair market value of the stock. Rather, the price must be reasonable in terms of the business goals sought to be attained and the reciprocal nature of the agreement. 127 Nonetheless, a minimum price which could be considered nominal under the circumstances probably would be considered by the Service to be a bequest rather than a bona fide business arrangement. 128 Since

124. Brodrick v. Gore, 224 F.2d 892 (10th Cir. 1955); Wilson v. Bowers, 57 F.2d 682 (2d Cir. 1932).
125. See Kahn, supra note 51, at 6; Polasky, Planning For The Disposition of a Substantial Interest in a Closely Held Business (Part III), 46 Iowa L. Rev. 516, 567-69 (1961).
127. See notes 121-24 supra.
128. But see May v. McGowan, 194 F.2d 396 (2d Cir. 1952) (upholding a valuation
the determination of a bona fide business arrangement is dependent upon the facts and circumstances of the particular case, there will always be an element of uncertainty associated with buy-sell agreements and, in particular, the minimum pricing arrangements. In the final analysis the ability of a minimum pricing arrangement to control estate tax values depends upon the good judgment exercised by the stockholders and their financial consultants and professional advisors.129

2. Minimizing Income Taxes

The desirability of a minimum pricing arrangement in a buy-sell agreement will become substantially greater if the carryover basis provisions adopted in 1976 become permanent.130 The principal income tax effect of carryover basis is that transfers subsequent to death will no longer be entirely free of income tax liability for appreciation occurring prior to death. This may not be a significant factor for family corporations since family members receiving stock with a carryover basis will not normally sell the stock within the foreseeable future. Nonetheless, carryover basis would create substantial additional taxes upon eventual disposition of the stock, thereby as a practical matter making any transfer of the stock ill-advised due to the tax burden.

More importantly for the family corporation, carryover basis raises questions regarding the desirability of buy-sell agreements. Under existing law,131 buy-sell agreements among family members work very effectively because the stock transfer can take place at death without payment of income taxes. This is particularly desirable where a corporate redemption is involved since the agreement effectively provides a means for removing funds from the corporation without adverse income tax consequences.132 Carryover basis would add an income tax cost to such transactions which must be weighed against the desirability of extracting money from the corporation at capital gain rates.

If the income tax consequences of a buy-sell agreement are onerous, the stockholders might wish to have a buy-sell agreement formula for estate tax valuation when the value determined by the formula was zero).133 If the parties are concerned that the agreement will not be binding for purposes of estate tax valuation, they may wish to consider an agreement to release the estate of a deceased stockholder from the restrictive price. Otherwise, the estate may be taxed on a high value but be required to sell at a low value. Estate of Edward E. Dickinson, Jr., 63 T.C. 771 (1975), acq., 1977-2 C.B. 1.

129. See note 9 supra.
130. See note 9 supra.
131. IRC § 1014(a) (step-up in basis).
132. See note 37 supra.
primarily for the purpose of establishing reasonable estate tax values. Presumably, such an agreement would give an option to the corporation or the surviving stockholders to purchase the decedent’s stock. Such an option, however, might never be exercised because of the adverse income tax consequences. Obviously, when entering into an option agreement the individuals involved must have consistent objectives. An option arrangement with a minimum price would be undesirable where one family member might exercise rights under the buy-sell agreement thus burdening other family members with the income tax.

The adverse income tax consequences anticipated under carryover basis have already prompted a search for alternatives to the implementation of buy-sell agreements. One alternative would be to transfer stock by gift or bequest rather than by sale or exchange upon implementation of a buy-sell agreement. Major difficulties under this alternative are (1) funding the estate and the surviving spouse and (2) transferring control stock to younger family members.

Planning techniques relating to the financial needs of the estate and the surviving spouse are considered, in part, elsewhere in this paper. For example, the surviving spouse could be bequeathed preferred stock which would provide her with an annual income. Similarly, steps could be taken to insure that the estate will qualify for deferred payment of estate taxes. In this manner, future earnings of the corporation could be used by the surviving spouse to pay death taxes. If the estate does not qualify for deferred payment of estate taxes, it may wish to consider pledging company stock for a loan to pay estate taxes. This alternative, however, would be more expensive and the loan might not be available on a long-term basis.

If the buy-sell agreement is funded with life insurance, the proceeds typically are used by the corporation or surviving stockholders to purchase stock held by the decedent at death. The insurance proceeds are then used by the estate to pay estate taxes and by the surviving spouse to provide for personal needs. Under

133. The Service takes the position that buy-sell agreements do not establish value for gift tax purposes. Rev. Rul. 59-60, 1959-1 C.B. 237, 244. However, the courts have been willing to accord significant weight to restrictive agreements for the purpose of establishing gift tax values. Lloyd D. McDonald, 3 T.C.M. (CCH) 274 (1944); Clarence P. Chamberlin, 2 T.C.M. (CCH) 469 (1943). Contra, Driver v. United States, 38 A.F.T.R.2d 76-6315 (W.D. Wis. 1976).

134. See text accompanying notes 136-45 infra.

135. See text accompanying notes 146-49 infra.

136. See § IV of text infra.

137. See § II of text supra.

138. I.R.C. §§ 6166, 6166A.
carryover basis, the better alternative may be to have the surviving spouse named as the beneficiary of the insurance policy so that she receives both the stock and the insurance proceeds.\footnote{139} This would provide the surviving spouse the necessary liquidity to pay estate taxes and avoid income taxes which would otherwise be due on disposition of the stock.\footnote{140} Disadvantages of this alternative are that the insurance proceeds might be includible in the decedent's estate\footnote{141} and the estate of the surviving spouse is increased by any remaining amount of insurance proceeds paid directly to her and unspent at her death.\footnote{142} It also may be more difficult to transfer control of the corporation to children.

It seems reasonably clear that planning alternatives to implementation of buy-sell agreements will place a premium on management participation by the surviving spouse. Withdrawal of corporate funds by a surviving spouse as a bona fide employee is desirable because the corporation may deduct the payments as salary thereby avoiding the double taxation inherent in dividend payments.\footnote{143} Also, the payments would be subject to the fifty percent maximum tax limitation on personal services income.\footnote{144} If estate taxes are paid on the installment basis,\footnote{145} employment

\fnsymbol{139} If possible the surviving spouse also should own the insurance policy. If the decedent had no incidents of ownership in the policy, the insurance proceeds will not be included in the estate. I.R.C. § 2042 (2). Caution should be exercised, however, in transfers of existing policies. As a general rule death benefits are not includible in gross income. I.R.C. § 101(a)(1). However, where there has been a transfer of the policy for consideration the exemption from gross income rule becomes inapplicable and the proceeds are included in gross income except to the extent of such consideration and the amount of premiums paid after the transfer. I.R.C. § 101(a)(2). Transfers resulting in a carryover basis and transfers to the insured or the insured's partnership or corporation are not subject to the transfer for value limitation. I.R.C. § 101(a)(2)(A)-(B).

\fnsymbol{140} In order to keep the insurance proceeds out of the decedent's estate, the surviving spouse should not be obligated to pay taxes or other debts of the estate. Treas. Reg. § 20.2042-1(b) (1959).

\fnsymbol{141} Insurance proceeds are includible in the decedent's estate when the beneficiary is legally obligated to pay taxes and debts of the estate. Treas. Reg. § 20.2042-1(b)(1) (1958). Whether the proceeds are includable when the beneficiary is not legally obligated but does discharge obligations of the estate is much more questionable. See Rev. Rul. 77-157, 1977-1 C.B. 279, holding proceeds received by a trustee with unexercised discretionary authority to use trust funds to pay obligations were excludible under I.R.C. § 2039(c).

\fnsymbol{142} In addition, should the spouse be the first to die the value of the policy will be included and taxed in her estate just like any other asset. Estate of Ethel M. Donaldson, 31 T.C. 729 (1959).

\fnsymbol{143} I.R.C. §§ 162, 301.

\fnsymbol{144} I.R.C. § 1348. Obviously the employment arrangement must be bona fide and compensation must be reasonable and for services actually rendered. I.R.C. § 162(a)(1).

\fnsymbol{145} I.R.C. §§ 6166, 6166A.
compensation to the surviving spouse may provide a mechanism for matching the timing of income and expense in contrast to insurance, which requires an initial outlay for premiums which is nondeductible and often must be incurred many years prior to the actual need for funds.

The transfer of control stock to younger generations should not be significantly hindered by the alternative techniques to buy-sell agreements. The controlling stockholder may wish to provide for some transfers by direct bequest although such bequests would reduce the amount of the marital deduction.\textsuperscript{146} Other planning techniques which might be considered would be lifetime transfers of stock to children either as gifts or for consideration.\textsuperscript{147} Gifts transfer future appreciation to younger generations, and appraisers will discount the stock's value for gift tax purposes for minority interests,\textsuperscript{148} blockage,\textsuperscript{149} costs of public distribution,\textsuperscript{150} and other value-reducing factors.

\textbf{B. Payment Terms}

Payment terms for a buy-sell agreement depend largely upon the purchaser's ability to pay and the liquidity requirements of the estate. Many times, however, it may be necessary for the agreement to be structured to provide for installment payments of the purchase price. If installment payments are contemplated after carryover basis takes effect, the parties should insure that the contract terms satisfy the requirements for installment reporting of gain,\textsuperscript{151} particularly the requirement that no more than thirty percent of the selling price be received in the year of sale.\textsuperscript{152} Installment reporting will enable the seller to recognize gain proportionately as payments on the purchase price are received. This could result in a lower effective tax rate, especially if the stock is distributed to a number of beneficiaries—for example, children or trusts for their benefit—who are taxed at a lower tax rate on the gain from its sale. It should be noted, however, that the transfer of installment obligations obtained by an estate in the sale of stock

\begin{footnotesize}
\textsuperscript{146} L.R.C. § 2056(a).
\textsuperscript{147} Lifetime transfers may affect the availability of the installment payment death tax redemption provisions. See text accompanying notes 13, 27 & 38 supra (outlining the ownership requirements applicable to L.R.C. §§ 6166, 6166A & 303).
\textsuperscript{149} \textit{E.g.}, Helvering v. Maytag, 125 F.2d 55 (8th Cir.), cert. denied, 316 U.S. 689 (1942).
\textsuperscript{150} See generally Maher, \textit{Discounts for Lack of Marketability for Closely Held Business Interests}, 54 TAXES 562 (1976).
\textsuperscript{151} L.R.C. § 453.
\textsuperscript{152} L.R.C. § 453(b) (2).
\end{footnotesize}
constitutes a disposition requiring the immediate recognition of the full amount of gain inherent in the obligations.\textsuperscript{153} Thus, if installment payments will be received over an extended period, consideration should be given to distributing the stock prior to sale so payments can be reported by beneficiaries on an installment basis.

Another advantage of installment payment terms is that they may be integrated with the installment elections for the payment of estate taxes. The principal difficulty with integrating installment elections and payments is the provision that disposition of a substantial portion of the value of the closely held business will cause the unpaid portion of the estate taxes to become due immediately.\textsuperscript{154} It is unclear whether an installment contract for the sale of the decedent's entire interest in a closely held business constitutes a present disposition for purposes of the estate tax payment installment election provisions. Since there is no authority directly on point, it would seem best to provide for a series of purchases of stock rather than for an immediate purchase of all of the stock with a delivery of a promissory note. A series of sales would probably be possible only with a cross purchase agreement, since they would not satisfy the complete termination of interest requirement under section 302.\textsuperscript{155}

IV. PREFERRED STOCK ALTERNATIVES

The preferred stock recapitalization has become a favorite estate planning technique.\textsuperscript{156} In the recapitalization, common stock typically is converted into both common and preferred stock. This can be accomplished without adverse income tax consequences.\textsuperscript{157}

\textsuperscript{153} I.R.C. § 453(d).


\textsuperscript{155} In most closely held corporations, redemptions are unable to qualify for the other two exceptions provided in I.R.C. § 302. \textit{See} § III-A-1 of text supra. The disposition problem would not arise in a section 303 redemption since such a redemption does not reduce value if proceeds are used to pay estate taxes within one year. \textit{See} notes 23, 35 supra.


\textsuperscript{157} In order to be taxfree the reorganization must qualify as a corporate reorganization under I.R.C. § 368(a)(1)(E) so that the nonrecognition provisions of I.R.C. § 354 will apply. A business purpose must exist for the recapitalization. Transfers of control in order to provide continuity in management constitute
Thereafter the common stock is gifted to younger generations while the parents continue to hold the preferred stock which provides a fixed income. The value of the preferred stock is determined by its voting rights, dividend rate and terms, and the rights on liquidation. Gifting the common stock effectively transfers future appreciation in the value of the corporation to the younger generation and keeps it out of the estates of the donors. For these reasons preferred stock recapitalizations often occur at the midpoint of an individual's business career. Preferred stock may, however, be issued earlier or later and this portion of the paper examines two such alternatives. First, preferred stock might be issued on incorporation, thereby doing away with the need to recap-

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158. A gift tax is levied upon transfers made for less than full consideration. I.R.C. § 2501. However, there is an annual exclusion for gifts of present interests of $3,000 per donee. I.R.C. § 2503(b). Thus, a husband and wife could make joint gifts of common stock worth $6,000 to each child without incurring a gift tax liability. In addition, a single unified credit is allowed against gift tax liability. I.R.C. § 2505. The credit is $38,000 for gifts made in 1979, $42,500 for gifts made in 1980 and $47,000 for gifts made after 1980. These credits may be claimed by both husband and wife. However, the method of computing estate taxes provided in I.R.C. § 2001 has the effect of reducing the amount of the unified credit against estate taxes provided in I.R.C. § 2010 by the amount of the unified credit against gift taxes which was used for life time transfers.

159. If the value of newly issued preferred stock is not equivalent to the value of the common stock secured in exchange, the Service will argue that the difference constitutes a gift, compensation or some similar taxable transaction. Rev. Rul. 74-269, 1974-1 C.B. 87. For example, assume a father and daughter own all of the outstanding common stock in a corporation which is recapitalized with the father exchanging all of his common stock for preferred stock. If the preferred stock which he receives has less value than the common stock surrendered, the father has made a gift to his daughter since she retains the common stock which represents the value of the corporation after the preferred stock has been taken into account.

160. Certain lifetime transfers will be included in the estate of the donor. Primarily such transfers are incomplete where the donor has retained rights with respect to the property such as voting rights, a life estate, or the right to revoke or alter the gift. See I.R.C. §§ 2036, 2037, 2038 & 2041. Also included in the donor's gross estate are all gifts, other than those for which the decedent was not required to file a gift tax return, made within three years of the date of death. I.R.C. § 2035. The gross estate is increased by the amount of any gift taxes paid with respect to gifts within the three year period (I.R.C. § 2035) although a credit is allowed for gift taxes paid (I.R.C. § 2012).
Secondly, the corporation and its stockholders might agree to recapitalize at some time in the future, thereby assuring a future shift in control and flow of income without presently affecting existing stockholders.162

A. Issuance of Preferred Stock on Incorporation

Whether preferred stock should be issued on incorporation is a question seldom fully analyzed at the time of incorporation. If the business is modest, few advantages can be gained by issuing preferred stock in addition to common; but if the business has substantial value, there are advantages to issuing preferred stock immediately. First, the preferred stock does not run the risk of being treated as a stock dividend163 and it is not considered section 306 stock.164 The business purpose test applicable to corporate recapitalizations is not relevant to preferred stock received on incorporation.165 If the stockholders incorporate pursuant to an estate plan, they can immediately gift common stock to their children while retaining the relatively fixed value preferred stock, thereby shifting a greater amount of appreciation to their children than if only common stock were issued. However, if the parents are not immediately prepared to gift common stock to their children, the issuance of preferred stock can result in serious disadvantages. If the parents are relatively young and expect to retain the preferred stock for a substantial period of time, the corporation may be faced with the need to pay nondeductible dividends on the stock over a prolonged period. Moreover, the common stock will appreciate in value as the business appreciates in value, so that when the parents decide to begin a gifting program they will be confronted with

161. See § IV A infra.
162. See § IV B infra.
163. I.R.C. § 305 provides that gross income does not include stock dividends. There are, however, significant exceptions to the general rule which may give rise to a deemed dividend distribution. An exception potentially applicable to preferred stock recapitalizations occurs when some stockholders receive preferred stock and others increase their interests in earnings and profits. I.R.C. § 305(b)(3)-(c). However, the exception should not apply where the recapitalization is an isolated transaction. Treas. Reg. § 1.305-3(e), exp. (12) (1973). See Rev. Rul. 75-93, 1975-1 C.B. 101.
164. Section 306 stock is any stock, other than common stock, received as a nontaxable stock dividend under section 305 when the corporation has earnings and profits. Preferred stock issued in a preferred stock recapitalization is a typical example of section 306 stock. The section 306 taint means that the sale or disposition of the stock will be treated as a dividend rather than a sale or exchange. The amount realized will be characterized as ordinary income to the extent of the stock's pro rata share of earnings and profits at the time it was issued.
165. See note 157 supra.
the necessity of making larger gifts. If the appreciation is substantial, a recapitalization of the company might be necessary in order to allocate more of the value to the preferred stock.

An advantage to issuing preferred stock on incorporation is that the terms of the preferred stock may be determined only by state law without regard to the effect of such provisions on value that must be considered with preferred stock recapitalizations. For example, the stockholders presumably have complete flexibility with respect to dividend rates and whether dividends are mandatory or cumulative. This presents some intriguing planning alternatives including the possibility that the terms of the preferred stock might change automatically over a period of time. For example, the preferred stock could initially be voting and non-cumulative with no intent to pay dividends. These terms could shift eventually to non-voting with mandatory or cumulative dividends. Presumably liquidation rights could also be altered. Although the Service has apparently never addressed the tax effect of such shifting terms for stock interests, it would seem that the lapse of certain rights or the maturation of other rights would not, in and of themselves, constitute taxable transactions either for income tax or gift tax purposes. Thus, future appreciation could be separated from control so that common stock could initially be gifted without adversely affecting control; the control would shift automatically at the time the preferred stock automatically lost its voting rights. Similarly, appreciation in value could be shifted to younger generations through gifts of common stock but the parents could receive current benefits through compensation for services rendered until the time they are willing to retire and shift actual control to the younger generation. At that time the preferred stock would presumably begin paying dividends.

A principal disadvantage of issuing preferred stock on incorporation is that the preferred stock will undoubtedly constitute a second class of stock, thereby precluding an election to be taxed under subchapter S. This may be a significant disadvantage if the corporation anticipates substantial business losses after incor-

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166. See note 158 supra (discussion of the tax effect of making larger gifts).
168. Id.
169. See, e.g., id. § 21-2015.
170. Gains and losses are not taken into account for tax purposes until realized as a result of a definable transaction such as a sale or exchange or other disposition. Thus, mere increases and decreases in the value of preferred stock, whether due to changing economic conditions or the terms of the stock, should have no tax affect. See generally Eisner v. Macomber, 252 U.S. 189 (1920).
The subchapter S election also has been recommended as a timing device for midstream incorporations to insure that the stockholders do not suffer an adverse allocation of income and expense.\textsuperscript{173}

B. Agreement to Recapitalize in the Future

Implementation of a preferred stock recapitalization and gifting program is a major step for most business people. Often the need to recapitalize occurs long before the stockholders are willing to commit themselves to either a transfer of control or a limitation on their interest in the future appreciation in the value of the business. One possible alternative in such circumstances is an agreement to recapitalize at some time in the future.

The advantages of an agreement to recapitalize in the future are that existing stockholders retain absolute control and full equity participation in the business while arrangements are made for an orderly transfer of control and direction of future income. For example, the agreement could provide for a preferred stock recapitalization upon the death of the majority stockholder. The purpose of the recapitalization would be to provide both voting common stock and nonvoting preferred stock with a reasonable dividend rate which could be transferred to surviving family members. Individuals succeeding to the controlling stockholder's position in the company would receive a majority interest in the voting common stock. The preferred stock could be distributed according to the decedent's wishes among the surviving spouse and children not participating in the business. Thus, the participating child would have control of the business while other members of the family would be treated fairly through receipt of the preferred stock. The advantage, of course, is that the child who will succeed to the controlling stockholder's position in the corporation is assured of succession by the agreement. Even though it might not take place until the successor is middle-aged, the guarantee of succession enables the individual to commit his or her future to the corporation.

While such an agreement may provide for the orderly disposition of a controlling stockholder's interests in a family business, the agreement does nothing to reduce or limit the value of the

\textsuperscript{172} Corporations may carry over net operating losses for seven years. \textit{I.R.C. § 172(b)(1)(B)}. A subchapter S election permits stockholders to deduct their pro rata share of the corporation's losses. \textit{I.R.C. § 1374}. Thus, stockholders may benefit from the immediate use of business losses if they have sufficient ordinary income to offset the losses. \textit{See} \textit{I. Grant,Subchapter S Taxation § 1.4 (1974)}.

\textsuperscript{173} Eastwood, \textit{supra} note 3, at 466.
gross estate. Furthermore, the agreement is subject to a degree of uncertainty. The Service will not issue a private letter ruling with respect to prospective transactions.\textsuperscript{174} The recapitalization must be tested under the law and facts existing at the time of its implementation rather than at the time the agreement was adopted. In addition, it may be possible to abrogate the agreement in the future, in which case it is merely a statement of intent.

V. EMPLOYEE STOCK OWNERSHIP PLANS

Employee stock ownership plans (ESOPs)\textsuperscript{175} have been recently touted as a cure-all for the estate planning problems of farmers and ranchers.\textsuperscript{176} The premise of this suggestion is that the ESOP can be used to transfer control to other family members upon the death of the principal stockholder while the value of the stock held by the ESOP is excluded from the decedent's estate.\textsuperscript{177}

ESOPs can result in favorable income, estate and gift tax benefits to the employees of a corporation and to the corporation itself,\textsuperscript{178} as well as providing a vehicle for estate planning for the principal stockholder.\textsuperscript{179} If the plan qualifies under section 401(a) of the Code, the contributions a corporation makes to the ESOP are deductible within the limits prescribed by section 404(a)(3).\textsuperscript{180} The ESOP trust receives either cash or company stock. If it receives cash it normally uses the cash to purchase company stock.\textsuperscript{181} In either case, the corporation continues to have use of the money and additional cash flow is created as a result of the

\begin{itemize}
  \item[\textsuperscript{174}] Rev. Proc. 72-9, 1972-1 C.B. 718.
  \item[\textsuperscript{176}] Kruse, No Reason to Pay Estate Taxes on Farmland, SUCCESSFUL FARMING, Sept. 1978, at 23.
  \item[\textsuperscript{177}] Id.
  \item[\textsuperscript{178}] See generally Callahan, Problems and/or Advantages in Using an Employee Stock Ownership Plan (ESOP) as a Buy-Out Arrangement, 35 N.Y.U. INST. FED. TAX 713 (1977).
  \item[\textsuperscript{179}] See generally Rock & Brooks, ESOP May Facilitate Tax-Free Transfer of Interest in Closely Held Corporations, 56 TAXES 43 (1978).
  \item[\textsuperscript{180}] In stock bonus plans the corporation can take a deduction for contributions of up to 15\% of the compensation of covered employees. I.R.C. § 404(a)(3)(A). However, if the corporation also has a money purchase pension plan the deduction limit is raised to 25\%. I.R.C. § 404(a)(7).
  \item[\textsuperscript{181}] ERISA §§ 407, 408(e), P.L. 93-406, 88 Stat. 829, 1974-3 C.B. 49, 55, provide that the acquisition of employer securities is not a prohibited transaction.
\end{itemize}
allowable tax deduction. An ESOP, like other qualified plans, results in favorable income tax benefits to participating employees of the corporation. They are not taxed on the value of the employer's annual contributions to the plan. A further advantage is that the income which the ESOP trust derives from the contributed assets is not currently taxed. Rather, employees are taxed on property distributed to them or their designated beneficiaries from the ESOP trust, whether the distribution is at death, disability or retirement, or at termination of employment. Cash distributions are taxed in full but taxation of distributed employer securities is limited to the value of the securities when they were contributed to the plan. Any unrealized appreciation is taxed upon disposition of the stock.

The ESOP may also result in estate planning benefits to the principal stockholder and other employees of the corporation in either of two ways. First, if after the participant's death the designated beneficiary takes a distribution from the plan in annuity form, the value of the plan assets will not be included in the participant's gross estate. Second, for estates of participants dying after 1978, if the beneficiary of the plan is not the participant's estate, and the beneficiary makes an irrevocable election to forego income tax benefits available for lump sum distributions, the value of the lump sum distribution will not be included in the participant's gross estate. Thus, the recipient must elect between income tax advantages and exclusion of the value of the participant's plan assets from the gross estate. If the income tax advantages are foregone, control of the corporation can be shifted to the children of the deceased principal stockholder without the value of the stock held in the ESOP trust and allocated to the decedent's account being included in the gross estate. The principal stockholder may indirectly have control over voting the stock and administration of the ESOP during lifetime through the administrative committee so that the dilution effect of contributing stock to a plan may not have any practical disadvantage to the

183. I.R.C. § 402.
185. I.R.C. § 402(a).
188. I.R.C. § 2039(c).
190. I.R.C. § 2039(c).
principal stockholder or the corporation. 191

Designating children of the participant as beneficiaries of the plan does not result in the imposition of a gift tax. 192 Thus, stock can be shifted at death to the principal stockholder's family members without gift or estate tax consequences if the beneficiary makes the proper election. 193 By designating a particular child as the beneficiary, the control can be transferred to a child active in the corporate business.

Another advantage of an ESOP results from the fact that under certain circumstances the ESOP trust may purchase stock owned by the major stockholder, thereby creating a market for the stock. Gain from this purchase is taxed at capital gains rates without being subject to the restrictions imposed on stock redemptions under section 302(b). The Service scrutinizes these transactions and has issued Revenue Procedure 77-30 194 which informs tax planners when the Service will issue advance rulings on the tax effect of such sales. 195

A possible disadvantage of an ESOP in the family farm context is the potential cost of having to grant plan benefits to unrelated employees. The terms of the ESOP must be nondiscriminatory, and the plan cannot be designed to favor officers, stockholders, or highly paid employees of the corporation. 196 Further, if the corporation employs seasonal employees, the plan may have to be made available to them. 197 However, if the employees of the corporation

191. See generally Knight, An Analysis of the Special Problems That Arise When Employers Adopt ESOPs, 43 J. Tax. 328 (1975). The control over voting stock is subject to fiduciary obligations that the stock must be voted exclusively for the benefit of the plan participants.
193. Alternative computations should be made to determine whether the estate tax or income tax advantages are more favorable.
195. Rev. Proc. 77-30, 1977-2 C.B. 539, requires that the selling stockholder and related persons must not possess more than 20% of the beneficial interests in the plan. Revenue procedure 77-30 is merely a statement of the Service's position for advance ruling purposes. Whether the courts will treat a majority stockholder's sale to an ESOP trust as a dividend is questionable, as is the percentage ownership in excess of 20% at which the Service will challenge a sale as a dividend distribution.
196. I.R.C. § 410(b). Treas. Reg. § 1.401-1(b)(3) (1960) and Rev. Rul. 71-263, 1971-1 C.B. 125, provide that all of the facts and circumstances will determine whether there is a bona fide plan exclusively for the benefit of general employees. This requirement goes both to the terms of the plan and its operation. Thus, a plan which is valid according to its terms might fail to qualify if in operation it discriminates in favor of highly compensated employees. See also Furseth, Retroactive Cure of Employee Plan Defects: When, What and How, 48 J. Tax. 220 (1978) (enumerating various operational defects and suggesting possible cure techniques).
197. Rev. Rul. 73-283, 1973-2 C.B. 133. A plan may be able to exclude all employees
FAMILY CORPORATE CONTROL

consist solely of the husband and wife and their children, the family may derive substantial estate, gift, and income tax benefits from an ESOP without concern that the plan may be discriminatory.

An ESOP may result in considerable annual administration expense to the corporation adopting it. Because a qualified plan may be disqualified through administration which does not comply with applicable statutes, regulations or the plan documents, it is critical that closely held corporations administer the ESOP in conjunction with legal advice designed to avoid an inadvertent disqualification. In addition, accurate records must be kept of the basis and fair market value of stock being contributed and distributed from the ESOP trust to allow an accurate determination of the tax consequences of a distribution to participating employees. An ESOP presents the same administrative burdens as do other qualified plans, with the additional requirement that the corporation be appraised annually to determine the fair market value of the stock. The stock must be valued annually to accurately determine the value of stock being contributed to or purchased by the ESOP trust, the value at which it is distributed to participants and the value for repurchases by the ESOP trust or corporation from the beneficiary. If a farm or ranch corporation is involved, the annual independent appraisal might be made by a local appraiser familiar with local land costs, who computes the fair market value of the corporation as a going concern. Other costs involved with an ESOP are the expense of a trustee and legal and accounting expenses. Since a modest family held corporation will not have many employees, the reporting requirements can be streamlined, and even if a professional administrative organization is retained to administer the plan, the cost should not be unreasonably high.

It may be difficult, however, with a modest family corporation to

who are credited with less than 1000 hours of service during a plan year. However, if a plan adopts this participation requirement, and the corporation employs a significant number of seasonal employees, the plan may be attacked by the Service as being discriminatory. Further, the Department of Labor may make a similar claim, and may issue regulations at a later date giving further guidance in such circumstances.

198. See Furseth, supra note 196.
201. Id.
202. Use of a local real estate appraiser is not without problems and uncertainties. Normally appraisers consider many factors in addition to asset value such as values determined under a capitalization of earnings method. The proper treatment of the various factors for a farm or ranch corporation is a matter of judgment. However, the single most important factor probably is the value of the underlying real estate.
transfer substantial amounts of stock into the trust in order to derive income and estate tax benefits sufficient to justify the administrative expense of the plan. Under section 404(a)(3)(A), contributions are deductible only to the extent of fifteen percent of the compensation of participants in the plan.\textsuperscript{203} If, for example, the corporation has a small number of employees whose total compensation equals $200,000, the deductible contributions to the ESOP would be limited to $30,000 in cash, stock or other property. If the corporation is in the forty-six percent federal income tax bracket, the tax savings resulting from contributing stock worth $30,000 to the ESOP trust would be $13,800. This level of contribution and tax savings implies that the corporation is paying relatively high salaries to its employees, while its taxable income exceeds $100,000 per year. If the corporation does not have compensation and taxable income of this magnitude, its income tax benefits will be reduced accordingly.

It is unlikely that ESOPs can be used to replace traditional estate planning techniques or even play a dominant role in the estate plans of most farmers, ranchers or small businessmen. Since deductible contributions are restricted to a percentage of employees annual salaries,\textsuperscript{204} a goal of diluting the percentage of ownership of the majority stockholder may take many years.\textsuperscript{205} The problem is compounded by inflation and the fact that the corporation may be worth a substantial amount at the time that the ESOP is adopted. If the corporation issues new stock to the ESOP, the total number of shares outstanding increases, which diminishes the relative significance of the amount of the stock held by the ESOP. However, if the ESOP purchases stock from a majority stockholder, the total number of shares will not increase but the purchase will result in taxable income to the stockholder (although it may be at capital gains rates).\textsuperscript{206}

In short, an ESOP may be financially advantageous to a small closely held business if expenses can be controlled satisfactorily. If the corporation has no employees other than family members

\begin{footnotes}
\item[204] I.R.C. § 404(a)(3)(A).
\item[205] Section 404(a)(3)(A) provides that excess contributions may be deducted in future years subject to the 15% of compensation limit in any one year. The statutory language suggests that a company may thus contribute a large block of stock in one year and realize the deductions in subsequent years. This could be a tremendous advantage since the applicable value for subsequent deduction presumably would be as of the time of contribution. Note, however, that excess allocations to a participant’s account may result in disqualification of the plan. A suspense account may be effective to prevent disqualification.
\end{footnotes}
who are required to be allowed to participate in the plan, common stock can effectively be transferred to the ESOP and then to the succeeding generation while generating both income tax and estate tax benefits.

VI. ROULETTE BUY-SELL AGREEMENTS

A roulette buy-sell agreement can be a fair and reasonable method for stockholders of a closely held corporation to resolve problems of abuse of minority stockholders and corporate deadlock.207 The basic concept of the roulette buy-sell agreement is that any stockholder who is a party to the agreement may activate the agreement and thereby force a purchase or sale of corporate stock with one stockholder setting the price and the other stockholder electing to buy or sell. Typically the agreement provides that a stockholder who is a party to the agreement may give notice to the other stockholder that the agreement is activated. For example, in a corporation with two equal stockholders, one stockholder would give notice to the other stockholder that the agreement was activated.208 The notified stockholder would have a reasonable period within which to determine the value of the corporation's stock. At the conclusion of the notice period the stockholder receiving notice would advise the initiating stockholder of the price at which stock subject to the agreement would be bought and sold. Then, the stockholder activating the agreement must either elect to purchase from or sell to the stockholder establishing the price.

The attractiveness of a roulette buy-sell agreement is two-fold: (1) it enables an individual with a non-controlling interest in a corporation to either withdraw from the corporation or obtain control

207. Roulette buy-sell agreements survive under a variety of colloquial aliases including "shotgun," "Russian," and "Mexican standoff." Unfortunately, the colorful, albeit insensitive, nomenclature has not generated much legal analysis of the agreements and there is a lack of judicial authority on their functioning.

208. Roulette buy-sell agreements function best when there are only two stockholders or two defined groups of stockholders. See § VI-F of text infra. For this reason and for purposes of clarity the discussion in this section assumes that two stockholders own all of the outstanding voting stock. A roulette buy-sell agreement probably is undesirable for a professional service corporation other than a two person firm. In addition to the complexities of multi-person agreements, most professionals prefer to have buy-sell agreements which favor the continuing entity. Thus, their agreements typically specify the terms upon which a person may leave the organization and it is unusual for the agreements to provide a financial incentive for leaving. A roulette buy-sell would not favor the institutional continuation in the same manner.
if there is an irreconcilable dispute with other stockholders;\textsuperscript{209} and (2) it may prevent the damage which might occur to a corporation if a deadlock between stockholders continued for a substantial period.\textsuperscript{210}

The terms of a roulette buy-sell agreement can significantly alter the model described above. Factors which should be considered include determining (1) which party is likely to give notice of activation of the agreement and who, therefore, has the right to elect to become a purchaser or seller; (2) whether the agreement should encompass an entity purchase or a cross purchase; (3) length of notice and waiting period; (4) pricing and payment terms; (5) provisions for default; and (6) multi-stockholder problems.

A. Activation of the Agreement and the Buy-Sell Election

Notice of activation of the agreement always determines which party has the election to purchase or sell.\textsuperscript{211} The election, however, may either remain with the party giving notice of activation or shift to the party receiving notice. The only mandatory requirement for the agreement to work fairly and properly is that the party having the election to buy or sell should not establish the price.\textsuperscript{212} Thus, the stockholders should consider such things as whether they might wish to activate the agreement and whether it would be advantageous to be able to set the price or to be able to make the election to be a purchaser or seller. If a stockholder anticipates activating the agreement, he or she may wish to retain the right, after giving notice, to elect to be a purchaser in order to become sole owner of the business. On the other hand, if the stockholder anticipates that the other party will eventually succeed to control, the right to specify the price of the stock may be more important. In this case, assuming that the stockholder anticipates giving notice, the agreement could provide that the stockholder giving notice and activating the agreement would also specify, at the time of giving notice, the price per share. The other party would then have the right to determine whether to be a purchaser or seller pursuant to the terms specified by the party giving notice.

\textsuperscript{209} See generally 2 F. O'Neal, \textit{supra} note 51, § 905. Typically the agreements require that all stock of a selling stockholder be purchased.

\textsuperscript{210} \textit{Id}.

\textsuperscript{211} This is due to the fact that the sequence of events must be determined by the agreement. Thus, once the agreement is activated, the parties can easily determine their respective roles and responsibilities.

\textsuperscript{212} Fairness mandates that one party establish the price and the other choose to buy or sell. This basic legal maxim of fairness probably is sourced in mother's kitchen where one child would divide a piece of cake and the other would choose either piece. Obviously an attempt to be unfair in dividing the cake resulted in a benefit to the other child if he or she chose wisely.
The difficulty with the foregoing analysis is its highly speculative nature. The stockholder must anticipate at the time the agreement is drawn both who will be the party to activate the agreement and the relative interests of the parties in being purchasers. These are not only difficult subjective matters but the underlying facts which shape the analysis may change. For example, the stockholder who apparently has an unquenchable thirst to control the entire business might later tire of the business or otherwise become less capable of purchasing the business.

A similar difficulty with roulette buy-sell agreements concerns the relative abilities of the parties to exercise their rights under the agreement. The parties may differ in their desire to have full control of the business and such differences may be the major factor in determining the eventual outcome of the agreement. Differences in individual motivation, however, do not adversely affect the fairness of roulette agreements although they may affect the price established for the stock. Financial differences between the parties, however, may affect their ability to take advantage of rights under the agreement and may alter the fairness intended in roulette buy-sell agreements. For example, if one stockholder is obviously unable to accomplish the purchase the other stockholder may be able to establish a bargain price for the stock. If the financial abilities of the parties can be reasonably determined in advance, it may be possible to partially control this type of disadvantage by providing that the stockholder giving notice activating the agreement will not establish the price. Thus, the stockholder with the greater financial resources could not both activate the agreement and establish the purchase price. This method is not entirely satisfactory, however, since the financially disadvantaged stockholder must take finances into account when establishing a price. If he establishes a price which is too high he may face the prospect of having the other stockholder require a purchase of the stock. In that event the financially disadvantaged stockholder may find himself in breach of contract on his obligation to purchase. Although it is difficult to anticipate possible damages, it seems clear that a defaulting purchaser would be at a severe disadvantage in litigation if he or she was financially unable to complete the purchase and had designated the purchase price.

213. Roulette buy-sell agreements obviously place pressure on the traditional notion of fair market value as the price at which a willing buyer and a willing seller will trade. Montrose Cemetery Co. v. Commissioner, 105 F.2d 238 (7th Cir. 1939), aff'd per curiam, 309 U.S. 622 (1940). Individual differences obviously affect the purchase price.

214. See § VI-E of text infra.
B. Entity or Cross Purchase

The concept of roulette buy-sell agreements contemplates purchases by individual stockholders rather than corporate redemptions as the agreements involve personal stockholder decisions and actions to activate the agreement and determine the parties’ rights. A purchase by the corporation, however, has the advantage of using corporate funds without the income tax problems inherent in transferring funds to purchasing stockholders.215 The risk of an entity purchase agreement is that the remaining stockholders may be deemed to have received dividend income if the corporation discharges their personal obligations.216 It should be possible to structure an entity purchase roulette buy-sell agreement which minimizes dividend risks if the parties are willing to substitute different business risks. If the agreement specifically provides that the individual stockholders have no obligation to make the purchase, no dividend income should result to the remaining stockholder from the corporation’s redemption of the selling stockholder’s interest.217 The agreement, however, would have to completely eliminate any individual obligation to purchase. The agreement would require both parties to cause the corporation to make the redemption on the agreed terms. Financial support of the redemption by the remaining stockholder probably is possible although capital contributions and debt guarantees further obscure whether the obligation to purchase is personal or corporate—especially if a stockholder is required in the buy-sell agreement to fund or guarantee the redemption. However, without mandatory funding obligations, the obligation of the corporation to make the redemption may be unenforceable.218 Thus, a stockholder not wishing to allow the other party to sell pursuant to the agreement might be able to set a price beyond the capabilities of the corporation.

C. Length of Notice and Waiting Period

Buy-sell agreements are entirely voluntary and not subject to

218. The right of a corporation to redeem stock generally is dependent upon its retained earnings. Nebraska law provides that no redemption may be made which would make the corporation insolvent or affect stockholders having prior rights on dissolution. Neb. Rev. Stat. § 21-2066 (Reissue 1977). Insolvency is either the inability to pay debts as they come due or an excess of liabilities over assets at fair market value. Neb. Rev. Stat. § 21-2002(15) (Reissue 1977).
state law requirements. Thus, there are no mandatory lengths of time for notice or waiting period, and timing of its operation should be detailed in the agreement. Adequate time should be allowed for both determining price and financing purchase obligations. The length of time required depends upon the nature of the business, the necessity of obtaining professional assistance in determining value, and the anticipated difficulty of financing a purchase.

A well drafted roulette buy-sell agreement normally provides for a significant cooling-off period during which the parties can resolve those differences which resulted in activation of the agreement. If possible, the cooling-off period should be prior to the time at which the price is to be fixed. To encourage reconciliation, the agreement should provide that the stockholder activating the agreement may unilaterally withdraw notice of activation within a specified period of time without the consent of the other stockholder. If the stockholder receiving notice of activation disagrees with the withdrawal of notice, he or she can independently tender notice. The agreement should also encourage resolution outside its provisions by specifically authorizing agreements by the stockholders which may be substituted for the functioning of the buy-sell agreement.

D. Pricing and Payment Terms

Pricing normally is not specifically covered by roulette buy-sell agreements. Instead, the agreement specifies a procedure which results in one stockholder having the right to set the price. Fairness of price is controlled by uncertainty as to whether the stockholder setting the price will be a purchaser or seller. The parties may wish, however, to establish a framework or formula within which the price must be determined. The risk in such a provision is that an unfair price may frustrate the intent of the parties and effectively neutralize the agreement. If price is predetermined by the agreement, fairness requires that the right to elect to buy or sell is assigned to the stockholder receiving the notice. But, if the price is unfair, no stockholder would give notice activating the


220. See text accompanying notes 211-14 supra. Typically the price is in dollars per share. This avoids complicated formulas for the purchase price which result if one stockholder sets a price for a block of stock. However, if the stock is held equally by the two parties one price applicable to each other's stock is feasible.
agreement, since the unfairness probably would work to that stockholder's disadvantage.

Payment terms should be set by the agreement. If no terms are specified, any purchase under the agreement presumably must be made in cash payable in full at closing. Even if the stockholders could currently effect a purchase for cash, they should consider circumstances, such as growth of the business, under which a deferred payment agreement might be necessary or desirable.

If the parties wish to allow deferred payments as an alternative, the agreement should specify circumstances under which deferred payments may be elected by the purchaser. In no event should the selling stockholder have the right to elect deferred payments. Such rights would constitute constructive receipt of income with the result that the seller would have to take the entire purchase price into income in the year of sale even though most of the proceeds are received in future years.221

Deferred payment terms should be structured to satisfy the installment reporting requirements of the Code which require that the seller receive no more than thirty percent of the selling price in the year of sale.222 For entity purchase agreements it might be possible to structure the purchase as a series of stock redemptions which satisfy the substantially disproportionate requirements of the Code.223 An advantage to a series of substantially disproportionate redemptions is that payment in the initial year is not restricted to thirty percent of the selling price.

E. Default

Roulette buy-sell agreements usually do not contain default provisions. Presumably if stockholders follow the terms of the agreement, the price of the stock and the identity of the purchaser will be determined and the purchase will take place. Unfortunately, this will not always be the case and a default raises complex problems of the appropriate remedy.

The problem of a defaulting purchaser usually will arise when the purchasing stockholder fixes a price which is beyond his or her financial capabilities and is required by the other stockholder to make the purchase. The stockholders probably did not contemplate this possibility when entering into the agreement but if they had considered whether the stockholder fixing the price had to

223. I.R.C. § 302(b)(2).
have financial ability to buy at that price they probably would have
rejected the notion since personal financial considerations do not
normally play a part in stock valuation. Thus, no breach of con-
tract should occur merely because a stockholder fixes a price
greater than that which he or she can afford despite the fact that
his or her actions may appear to lack good faith.

A breach of contract does occur when a stockholder is desig-
nated as the purchaser and is unable to complete the purchase
since the stockholder had agreed to be a purchaser at the estab-
lished price. Failure to complete the purchase should constitute a
breach for which some form of equitable relief should be available.
The appropriate judicial remedy, however, is unclear. Specific per-
formance is not possible since the purchaser cannot discharge the
payment obligation. A monetary award probably is inadequate, es-
pecially if the selling stockholder has a minority interest which re-
alistically is not saleable to a third party.

Since the selling stockholder does not wish to purchase at the
established price and the purchasing stockholder cannot perform,
a reasonable solution may be a renegotiation of the purchase price.
Will a court set a different price for the stock if it finds the estab-
lished price unfair or unworkable? Even sitting in equity, the
court is unlikely to provide basic contract terms such as
price—even where the reduced price would work to the ad-
vantage of the defaulting purchaser. If the court does set a new
price, it presumably could require that the putative seller have the
right to elect to buy or sell at the new price.

If the court is unwilling to fashion an equitable remedy, the
agreement may become worthless as a device for eliminating dead-
lock or securing the rights of a minority stockholder. For example,
a minority stockholder who activates the agreement and elects to
sell cannot recognize the value of his or her stock if the purchaser
defaults and the courts will not redefine the contract. The minority
stockholder is, in effect, stymied in the efforts to sell the stock for
which there may be no other market.

Since the appropriate judicial remedy is uncertain and the will-
ingness of the courts to act is in doubt, the agreement should at-
tempt to set forth the rights of the selling stockholder if the
purchaser defaults. One alternative would be to permit a different
party, the selling stockholder, to set a new price and allow the de-
faulting purchaser the right to elect to purchase or sell. In fixing
the price the selling stockholder would have the advantage of
knowing the defaulting purchaser's financial limitations, a reason-
able advantage considering the circumstances which gave rise to

224. See § III-B of text supra.
the problem. If the same stockholder elects to purchase and again defaults, the other stockholder would have the right to purchase at the new price.\footnote{225. This would, of course, allow the financially stronger stockholder to force the other stockholder to sell at his or her price and with specific information of the other stockholder's financial weakness.}

The default problem is less severe if the stockholder activating the agreement also must set the purchase price. Such an agreement could also require that the activating stockholder provide a letter of credit in the amount of the purchase price for the other party's stock. Thus, the stockholder receiving notice is assured that the activating stockholder can perform and default should not occur. An alternative remedy would be to provide in the agreement for liquidated damages. If the stockholder activating the agreement also sets the price, a forfeitable deposit could be required to insure the stockholder's good faith.

Another alternative the agreement might provide is that default by the purchasing stockholder permits the selling stockholder the option of purchasing from the defaulting stockholder a controlling interest at a price established by the agreement. This would at least resolve any deadlock and guarantee to a minority stockholder that the buy-sell agreement cannot be negated without giving the minority stockholder control of the corporation. A variation of this alternative would be to subject the defaulting stockholder's stock to a voting agreement giving control to the selling stockholder until the purchaser can complete the purchase.

F. Multi-Stockholder Problems

Roulette buy-sell agreements work well when only two stockholders are involved.\footnote{226. Roulette buy-sell agreements are particularly desirable where there is equal ownership. In such situations neither has voting control. Thus, the roulette buy-sell agreement provides an alternative to inherent stalemate.} The rights and obligations of the parties are determined with relative ease. The addition of even one additional stockholder to the agreement, however, creates considerable complexity. If stockholders can be segregated into two groups, the two stockholder agreements discussed above can be implemented. Each group must, however, have a voting agreement or understanding which enables each group to function as one for purposes of the roulette buy-sell agreement.

If segregation into two stockholder groups is not feasible, the buy-sell agreement must address the functional complications caused by additional stockholders. For example, if there are five stockholders, should the four receiving notice from one stockholder that the agreement is activated be allowed to fix different
prices for the stock or should the stockholder giving notice be required to set the price so that all purchases and sales will be at the same price? Under the latter, what happens if two stockholders elect to sell and two elect to buy? Do the rights and obligations extend to stock acquired as a result of the agreement? If so, how can a stockholder know the extent of a purchase obligation before the purchase election is made? Must the stockholder activating the agreement be prepared to purchase all stock other than his own in order to activate the agreement when the principal goal is to disengage from the business? The very existence of such questions may make a roulette buy-sell agreement impractical for more than two stockholders.

VII. INDEPENDENT BOARD OF DIRECTORS

A form of corporate deadlock occurs when several members of a younger generation compete for control of the business and the older generation is unwilling to choose a successor. This can be particularly true when the candidates vying for control are members of different family units such as the children of brothers and sisters in control. The inability to select a successor chief executive officer can perpetuate control by the older generation and prevent effective estate planning due to the inability to dispose of control common stock.

The principal difficulty with resolving such a deadlock is that close family loyalties block the decision making process. One planning technique which neutralizes personal family considerations is the election of an independent board of directors and the employment of a chief executive officer who is not a family member. Depending on numbers and individual preferences, both the older generation and members of the younger generation interested in seeking control could be members of the board of direc-

227. A recent example of the difficulty in shifting corporate control to children of brothers and sisters concerns the prestigious Ford Motor Co. Benson Ford, Henry Ford III and William Clay Ford, were active as officers in Ford Motor Co. and owned or controlled approximately 40% of the Class B voting stock. Benson Ford, Sr., owned the second largest block of Class B voting stock and was a director. Following his father's death in July, 1978, Benson Ford, Jr., at age 29, sought his father's position on the board. Interestingly, Henry Ford apparently is grooming his son, Edsel Ford II, age 30, for an executive role. Although purely business considerations may govern Henry Ford's failure to respond affirmatively to Benson Ford's request, it also is possible that he does not want to aid someone who might compete with his son Edsel in future years. Benson Ford's participation on the board of directors at such an early age could give him a significant advantage over Edsel Ford II in any future struggle for control among family members. See Newsweek, April 9, 1979, at 82, col. 1-2; Wall St. J., May 10, 1979, at 1, col. 1.
tors together with outside directors. If and when older members become unwilling or unable to serve on the board, their positions could either be eliminated or transferred to additional outside directors. In other words, the company would continue to be family owned but it would be run by outsiders including an independent board of directors and an independent chief executive officer. Those vying for control could be assigned principal responsibilities within the company, each reporting directly to the chief executive officer. At the end of a predetermined period, such as five years, the outside directors could select a chief executive officer from within the family based solely on merit. The plan could, for example, be combined with a preferred stock recapitalization so that only individuals active in the operation of the business would receive common stock. Common stock could be equally divided among active members of the younger generation and a buy-sell agreement could effectively prevent any one individual from acquiring a greater interest than that held by the others. This assurance that no one individual could obtain majority control helps to insure the continued existence of an independent board of directors which would make corporate decisions based upon the general corporate good and the best interests of the family group.

Employment of an unrelated chief executive officer and an independent board of directors is not without its own difficulties. Although the method could be effectively used to neutralize the personal anguish associated with the necessity of choosing among members of the younger generation, it does not resolve long-term control problems. With common stock evenly split among various family members, family control as opposed to control by outside directors could only be achieved through agreement of the parties. If voting stock is equally split between three or more individuals, a voting agreement may be imposed by the older generation to insure that an independent board of directors protects all family interests. In other words, unless the corporation can afford substantial stock redemptions, and individual stockholders will agree to be redeemed, an independent board of directors may become a permanent fixture. But, the protection for the minority provided by an independent board of directors is even more important when a family member is the chief executive officer.

VIII. CONCLUSION

Control problems of family corporations are as unique as the individuals who own and control them. Often traditional corporate control devices are ineffective to achieve the control objectives in

family corporations. Family buy-sell agreements may wish to emphasize minimum pricing. Roulette buy-sell agreements may be desired to protect minority rights or resolve problems of deadlock. The planning alternatives suggested in this article are merely a few of the possibilities which might be considered for a particular control situation. Each family control issue is different and requires the sort of creative analysis which comes from a familiarity with the various control alternatives and mechanisms.