Buy-Sell Agreements in Close Corporations: A Summary for the New York Lawyer

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BUY-SELL AGREEMENTS IN CLOSE CORPORATIONS: A SUMMARY FOR THE NEW YORK LAWYER

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I. INTRODUCTION

"Buy-Sell Agreements" concerning the stock of closely held corporations have become increasingly popular in recent years and consequently of increasing interest to both lawyers and the Internal Revenue Service. The purpose of this article is to draw together into one place for the New York lawyer the principal considerations as to taxes, New York law, and drafting which enter into the problem.

Basically a buy-sell agreement provides for two things:

1. A stockholder may not sell his stock during his lifetime without first offering it at an agreed price to the corporation and/or the other stockholders. We shall see later that this "lifetime restriction" is an essential requirement in order that the contract price be accepted as the value of the stock for estate tax purposes. It also has the practical advantage of enabling the stockholders to keep control in their own hands.

2. On the death of a stockholder, his shares will be purchased from his estate at an agreed price by the corporation and/or the surviving stockholders.

Thus, the estate of a deceased stockholder receives cash for his stock. This is a substantial benefit, since the stock of a closely held corporation is in most cases of little or no value to the estate. The estate also receives tax benefits: (a) The stock can be valued for estate tax purposes at the contract price, thus avoiding the frequently difficult, and at best uncertain, problem of valuing the stock of a closely held corporation; (b) although there is a sale of the stock by the estate, there is normally neither gain nor loss for income tax purposes, since the amount realized by the estate and the estate's basis in the stock are identical, viz., the price fixed in the agreement. The foregoing tax considerations, together with the hazards and qualifications to which they are subject, are discussed below.

The surviving stockholders also benefit from the agreement, since they acquire complete control of the corporation, free from interference by, or accountability to, the estate of the deceased stockholder.

II. TYPES OF AGREEMENT

There are numerous variations of buy-sell agreements, but they fall into two general classes, depending upon whether the corporation or the other stockholders are to purchase the stock:

(a) The "Redemption Contract" provides in substance that on the death of a stockholder the corporation will purchase his stock from his estate.

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Similarly, if a stockholder desires to sell during his lifetime, he must first offer the stock to the corporation.

(b) The "Cross-Purchase Contract" provides in substance that on the death of a stockholder the other stockholders will purchase his stock from his estate. Similarly, if a stockholder desires to sell during his lifetime, he must first offer the stock to the other stockholders.

The redemption contract is usually preferred, because corporate funds on which only the corporate income tax has been paid are used to make the purchase. Where individual stockholders purchase under a cross-purchase contract, they usually are obliged to use funds which were obtained from the corporation in taxable form such as salary or dividends, and on which both the corporation and the individual stockholders have paid income tax. For this reason the purchase under the cross-purchase contract is usually more costly to the remaining stockholders, particularly in the case of lifetime purchase where life insurance proceeds are not available to make payment. Nevertheless, there are situations in which the cross-purchase contract is preferable; e.g., as discussed more fully below, in the case of certain family-owned corporations, a redemption contract can have serious income tax consequences which can be avoided by use of a cross-purchase contract.

III. USE OF LIFE INSURANCE

A buy-out under either type of contract usually requires a substantial sum of money, and insurance on the lives of the stockholders is frequently used as a source of the funds with which to make the purchase. In the case of a redemption contract, the corporation procures a policy on the life of each stockholder; the corporation is the beneficiary, owns the policies, and pays the premiums. On the death of a stockholder, the corporation collects the proceeds and uses them to purchase the decedent's stock from his estate.

In the case of a cross-purchase contract, each stockholder owns, pays the premiums on, and is the beneficiary under a policy on the life of each other stockholder. On the death of a stockholder, each surviving stockholder collects the proceeds of his policy on the life of the decedent and the survivors together purchase the decedent's stock from his estate.

It is obvious that the redemption contract lends itself more readily than the cross-purchase contract to funding by life insurance. For the redemption

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1. If the corporation has elected to be taxed as a partnership under Subchapter S of the Internal Revenue Code (Sec. 1371 ff.) the income tax distinction between the two contracts becomes unimportant because the corporation is not subject to federal income tax (Internal Revenue Code Sec. 1372(b)(1)).

2. It might seem simpler for each stockholder to own and pay the premiums on a policy on his own life, the policy being payable to the other stockholders; but then the insurance proceeds (as well as the value of the stock) would be included in the decedent's estate for estate tax purposes (Internal Revenue Code Sec. 2042).

3. A trustee is sometimes used to insure the proper application of the insurance proceeds.
contract the corporation need purchase only as many policies as there are stockholders. On the other hand, to fund a cross-purchase contract, each stockholder must own a policy on the life of each other stockholder, so that where there are more than two stockholders it will be necessary to procure and keep track of a large number of policies; when a stockholder dies, his policies on the lives of the survivors must be obtained from his estate; when a new stockholder comes into the corporation, a large number of new policies must be obtained.

For income tax purposes, under either type of contract, the insurance proceeds are not taxable to the beneficiary,\(^4\) and the premiums paid are not deductible even when paid by the corporation.\(^5\) There formerly was danger that insurance premiums paid by a corporation to fund a redemption contract would be considered taxable dividends to the stockholders; however, the decisions\(^6\) so holding have been reversed,\(^7\) and it is now clear that a redemption contract may be funded with life insurance without fear that the premiums paid by the corporation will be considered dividends to the stockholders.\(^8\)

The use of life insurance raises the question of insurable interest. Does a corporation have an insurable interest in the lives of its stockholders for purposes of funding a redemption contract? Do stockholders have an insurable interest in each other's lives for purposes of funding a cross-purchase contract? The New York statute,\(^9\) which has not been construed as to these questions, defines an insurable interest (between unrelated persons) as "a lawful and substantial economic interest in having the life . . . of the person insured continue, as distinguished from an interest which would arise only by, or would be enhanced in value by, the death . . . of the person insured." It seems clear that a corporation has an insurable interest in the life of an officer or an active principal stockholder, and that a stockholder has an insurable interest in the life of another active stockholder.\(^10\) The test of insurable interest is to be applied at the time the insurance is obtained, so that the insurance remains effective even after the retirement of an officer or active stockholder.\(^11\) Therefore, there should be no problem in the case of the ordinary close corporation where all stockholders are active in the business; however, there is doubt as to whether either the corporation or the other stockholders have an insurable interest in the life of a stockholder who is inactive at the time when the insurance is procured.

5. Id. Sec. 264(a).
7. Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).
9. N.Y. Insurance Law Sec. 146.
10. 2 Couch on Insurance 2d, Sec. 24:147, 24:149.
11. Id. Sec. 24:148.
Before leaving the subject of life insurance, it should be pointed out that its use primarily benefits the surviving stockholders rather than the decedent. The stockholders themselves provide the premiums for the policies—directly in the case of a cross-purchase contract, through the corporation in the case of a redemption contract. Therefore, when a stockholder dies he has directly or indirectly paid an amount equal to the premiums for the insurance on his life, and thus has, in effect, provided the funds with which his interest is bought out; his estate would be better off if the stockholder had put the same money into a policy on his life payable to his estate—then on his death the estate would have both the insurance proceeds and the stock. It follows that on the death of a stockholder the surviving stockholders get something of a bargain by reason of the insurance. This is not to say, of course, that the use of insurance is inadvisable; at the time the agreement is entered into no one knows who will die first, and who will reap the windfall described above. Moreover, each stockholder desires to buy out the interest of a deceased associate and to have the necessary funds available; in many cases life insurance is the only practicable source of funds, particularly in the case of a cross-purchase contract where after-tax dollars would otherwise have to be used in most cases, as we have seen. In the case of a redemption contract, the corporation might be able to build up a fund out of its profits, but it would then run the risk of the heavy tax on unreasonably accumulated earnings.

IV. FEDERAL ESTATE TAX CONSEQUENCES OF PURCHASE ON DEATH

One of the purposes of a buy-sell agreement is to have the stock of a deceased stockholder valued for estate tax purposes at the purchase price fixed by the agreement. Valuation of the stock of a closely held corporation for estate tax purposes is a knotty problem. If the purchase price set forth in the agreement is accepted as the value of the stock, this problem is avoided; if the Commissioner of Internal Revenue decides that the estate tax value of the stock is greater than the contract price, the estate obviously suffers because it then must pay estate tax on the excess value which it never receives. The Commissioner and the courts do not seem to be in entire accord as to when the contract price is acceptable.

The Commissioner's position is as follows: whether or not the contract price will be accepted as the value of the stock for estate tax purposes "depends upon the circumstances of the particular case"; the following specific tests are then given in negative terms: (1) "Little weight will be accorded a price contained in a . . . contract under which the decedent is free to dispose of

12. Internal Revenue Code Sec. 531 ff.; see Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958); Mountain State Steel Foundries, Inc. v. Commissioner, 24 TCM 1959, 59.
13. The standards of valuation to be applied are discussed in Regs. Sec. 20.2031-2(I) and Rev. Rul. 59-60, IRB 1959-9, 8.
14. Or perhaps the purchasing stockholder or corporation; see In re Galewitz Estate, infra note 65.
the underlying securities at any price he chooses during his lifetime"; and (2) "Even if the decedent is not free to dispose of the underlying securities at other than the . . . contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case 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." Moreover, "special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners."

Translated into more positive terms, this seems to mean that the contract price will be accepted as the estate tax value of the stock if: (1) the stockholder is restricted during his lifetime from selling his stock at other than the contract price; (2) the contract does represent a bona fide business arrangement; and (3) the agreement is not a device to pass the stockholder's shares to the natural objects of his bounty for less than adequate consideration. There should be no difficulty in meeting these requirements where the stockholders are not related. The real difficulty arises in the case of a family corporation: suppose that the stockholders are a father and his two sons; if the father dies and the contract price is less than the actual value of the stock determined by the Commissioner, the latter would be expected to challenge the contract price as a device to pass the stock from the father to his sons without paying the full estate tax on it. However, the Commissioner has met with little success in such situations.

Let us first mention two cases which, while they involve partnerships and not corporations, establish principles which were relied upon in the corporate case which we shall consider in a moment. Broderick v. Gore dealt with a partnership composed of a father and his two sons; their agreement contained a lifetime restriction on sale, and provided that on the death of a partner his interest would be bought out at its book value. The father died, naming his sons as his executors and residuary legatees; the sons proceeded, as executors to sell to themselves as partners, the interest of their father at its book value, $345,000; the Commissioner contended that for estate tax purposes the father's interest should be valued at its fair market value, about $516,000. The court upheld the contract price as the estate tax value, even though the fair market value of the father's interest "may have been more than

15. Reg. Sec. 20.2031-2(h); see also Rev. Rul. 59-60, IRB 1959-9, 8 Sec. 8.
17. The proposed regulations (Prop. Reg. Sec. 20.2031-2(h)) provided in substance that the contract price was presumed to be acceptable if there was a lifetime restriction and the agreement was the "result of arm's length bargaining between strangers." This presumption is not contained in the final regulations.
18. 224 Fed. 2d 892 (10th Cir. 1955).
its book value. But such interest was burdened and encumbered with a certain restriction contained in the partnership agreement. If the decedent had concluded during his lifetime to withdraw from the partnership, he would not have been free to sell his interest in the open market or to a willing buyer at its fair market value... And inasmuch as the estate was thus bound and obligated, such interest had no value to the estate in excess of its book value. In other words, the interest of the estate in the property was by the contract limited in respect to value, the limitation being the book value thereof at the time of the death of the decedent. And where the interest of an estate in property is burdened or encumbered in that respect by such an effective contractual provision, the estate tax should be based upon the book value rather than a fair market value in excess of the book value...

"... The agreement was by its clear terms enforceable in favor of and against the estate of the first copartner to die and the two surviving copartners, whether the first to die was the decedent or one of the sons. It was specifically enforceable regardless of which copartner should die first. It was not known whether the decedent would outlive one or both of the sons. And it was supported by an adequate and full consideration...

Thus in Broderick v. Gore a decedent was permitted to pass his interest in the business to the "natural objects of his bounty" at an estate tax value considerably less than its alleged actual value. A similar result had been reached a year earlier in Estate of Lionel Weil.19 The corporate situation was presented in Estate of Orville B. Littick.20 There the decedent and his two brothers were the sole stockholders. Less than a year before the decedent died, and while he was suffering from an incurable cancer, he and his brothers entered into a redemption contract which contained a lifetime restriction and provided for purchase of a deceased stockholder's interest for $200,000. The actual value of the decedent's stock was stipulated to be almost $258,000. The Tax Court held for the taxpayer, following Broderick and Weil, supra. The Court pointed out that the lifetime restriction was present. While it was stipulated that the fair market value of the stock exceeded the contract price of $200,000, "there is nothing in the record to indicate that the $200,000 figure was not fairly arrived at by arm's-length negotiation or that any tax avoidance scheme was involved." Although the decedent was mortally ill when he entered into the agreement, "it certainly was possible that one or the other of his brothers could still have predeceased him." The court then stated the rule as follows: "Where for the purpose of keeping control of a business in its present management, the owners set up in an arm's-length agreement, which we consider this to be, the price at which the interest of a past owner is to be disposed of by his estate to the other owners,

19. 22 T.C. 1270 (1954) (Acq.).
that price controls for estate tax purposes, regardless of the market value of
the interest to be disposed of." (Emphasis added.)

Two 1960 decisions involving partnerships follow the same line. In
Angela Fiorito\textsuperscript{21} the partnership consisted of the decedent, his wife and their
two sons; on the death of decedent the sons purchased the decedent's interest for
a book value of $182,782.25 as against a stipulated fair market value more
than $113,000.00 higher; nevertheless the Tax Court upheld the contract
price as the estate tax value of the decedent's interest, despite the fact that the
partnership agreement was vague as to whether the decedent could have sold
during his lifetime. In \textit{Davis v. United States}\textsuperscript{22} a father and son were equal
partners under a partnership agreement allowing the survivor to purchase the
interest of the decedent for one-half of its book value; this value was upheld,
apparently on the ground that the agreement was entered into "for legitimate
business reasons," viz., that under the circumstances it would be impossible for
one partner to raise the funds to buy out the interest of the other at full value.

The Commissioner has acquiesced in both the \textit{Littick}\textsuperscript{23} and \textit{Fiorito}\textsuperscript{24}
decisions; it may be doubted whether \textit{Littick} can be squared with the Com-
missioner's regulations and ruling,\textsuperscript{25} at any rate, they must be read in the light
of these cases.

It seems safe to conclude from the foregoing that the estate tax value
of the decedent's stock will be measured by the contract price even in the case
of a family-owned corporation, when the following conditions are fulfilled:
(1) the stockholder is restricted during his lifetime from selling his stock with-
out offering it to the corporation or the other stockholders at the contract
price; (2) all of the stockholders are bound by the agreement, in order to
provide the mutuality of obligation which seemed important in \textit{Broderick} and
\textit{Littick}; and (3) there is no evidence of a purpose to avoid estate tax in fixing
the price.

Mention should be made of the estate tax consequences of the use of life
insurance to fund the contract. In the case of a cross-purchase contract, the
proceeds of the policy on the decedent's life, which is held by the other stock-
holders, are not included in the decedent's taxable estate,\textsuperscript{26} because the decedent
possessed no incidents of ownership in that policy;\textsuperscript{27} however, under the
agreement, the decedent will have owned the policies on the lives of the other
stockholders, and the value of these unmatured policies is includible in his
taxable estate.\textsuperscript{28} In the case of a redemption contract, the corporation owns a
policy on each of the stockholders—if the purchase price is based on book

\textsuperscript{21} 33 T.C. 440 (1960).
\textsuperscript{22} — Fed. Supp. —, 60-1 USTC (CCH) Sec. 11, 943 (D.C. Utah 1960).
\textsuperscript{24} I.R.B. 1960-20, 7 (May 9, 1960).
\textsuperscript{25} Supra note 15.
\textsuperscript{26} Rev. Rul. 56-397, I.R.B. 56-34; 14, C.B. 1956-2, 599.
\textsuperscript{27} Internal Revenue Code Sec. 2042(2).
\textsuperscript{28} Rev. Rul. 56-397, supra note 26.
value, the unmatured value of all of the policies must, of course, be taken into account in the computation of the book value, since the policies are assets of the corporation.  

V. Federal Income Tax Consequences of Purchase on Death

At first sight, it would seem that there should be no income tax consequences of a purchase on death, whether under a redemption contract or under a cross-purchase contract: assuming that the contract price is accepted as the estate tax value of the stock, the stock is valued in the decedent's return at that price; thus the contract price becomes the estate's basis for gain or loss; when the estate sells the stock for the contract price, the basis and amount realized are equal, so that there is neither gain nor loss.

In the case of a cross-purchase contract, this result is achieved without difficulty, but in the case of a redemption contract there can be complications.

The purchase by a corporation of its own stock in accordance with a redemption contract is a "redemption" within the meaning of the Internal Revenue Code; therefore, the payment by the corporation is treated as a dividend unless one of the four tests set forth in Sec. 302(b) is met. The problem, then, is to bring the redemption within one of those tests. Usually the "complete redemption" test of Sec. 302(b)(3) is met by a redemption contract, since the corporation redeems all of the stock owned by the stockholder. This test is always met by a redemption contract if the stockholders have no relationship to one other, but problems arise if they are related.

Under Sec. 318 of the Code a stockholder is deemed, under certain circumstances, to own the stock owned by certain members of his family, and by certain partnerships, corporations, estates and trusts in which he has an interest. These provisions are made applicable to redemptions under Sec. 302 by Sec. 302(c); accordingly, to the extent that the attribution rules of Sec. 318 apply to the redemption under Sec. 302, the stockholder is deemed to own, not only the stock which he actually owns, but also the stock owned by these related parties. Therefore, even if the stockholder sells all of his stock to the corporation, he may still be deemed to "own" other stock held by a related party, so that the corporation will not have redeemed all of his stock.

29. In his proposed regulations (Prop. Reg. Sec. 20.2041-1(c)(6)) the Commissioner took the position that the insurance proceeds paid to the corporation on the death of a stockholder should be taken into account (1) in determining whether the contract price is acceptable as estate tax value, and (2) if it was determined that the price is not acceptable, the proceeds would be taken into account in valuing the stock. This provision does not appear in the final regulations; in any case, it is doubtful whether it would be accepted by the courts which decided Littick and the partnership cases discussed above.

30. Internal Revenue Code Sec. 1014, Regs. Sec. 1.1014-1(a).
31. Sec. 317(b).
32. Id. Sec. 302(d).
33. The tests are: (1) Redemption not essentially equivalent to a dividend; (2) substantially disproportionate redemption; (3) complete redemption terminating the stockholder's interest; and (4) redemption in certain railroad reorganizations.
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within the meaning of the "complete redemption" test of Sec. 302(b)(3), and the redemption will be treated as a taxable dividend to the stockholder.

In a complete redemption the attribution rules are waived to a limited extent: the provisions of Sec. 318(a)(1), by which an individual is deemed to own the stock held by his spouse, children, grandchildren and parents, are waived in the case of a complete redemption if certain conditions are met.\textsuperscript{34} However, only the "family rule" is waived—the attribution rules concerning partnerships, corporations, estates and trusts contained in Sec. 318(a)(2)\textsuperscript{35} remain in effect. From these general principles the following conclusions can be drawn:

1. If all of the stock of the corporation is owned by individuals (even if they are all related within the family rule), and if the selling stockholder\textsuperscript{36} has no interest in any partnership, corporation, estate or trust in which another stockholder\textsuperscript{36} is interested, then the family rule alone can be applicable and the selling stockholder may sell all of his stock to the corporation during his lifetime without difficulty, since the family rule is waived.

2. However, if a partnership, corporation, estate or trust in which the selling stockholder\textsuperscript{36} has an interest, holds stock in the corporation, or if the selling stockholder\textsuperscript{36} is interested in a partnership, corporation, estate or trust in which another stockholder\textsuperscript{36} is also interested,\textsuperscript{37} the other attribution rules can\textsuperscript{38} come into play and prevent the redemption from being complete within the meaning of Sec. 302, whether the sale is made during lifetime or on death.

3. On the death of a stockholder the selling stockholder is his estate, so that all of the attribution rules concerning estates must be taken into account.

For our purposes the last of the foregoing conclusions is the most important, because it deals with the situation arising when a corporation purchases the interest of a deceased stockholder on his death. This is the most frequent culmination of a redemption contract and it is essential to bear in mind that the waiver of the family rule does not apply here. If John Jones and his two sons own all of the stock of the corporation, John may sell all of his stock to the corporation during his lifetime and the redemption will be complete because the waiver of the family rule prevents the stock of the sons from being attributed to him; but, if John dies, and the stock is redeemed from his estate, the estate may be charged with ownership of the stock of the sons and the redemption will not be "complete". Therefore, it is important to understand the extent of the attribution rule for estates, and we will proceed to discuss it in some detail.

\textsuperscript{34} Internal Revenue Code Sec. 302(c)(2).
\textsuperscript{35} And the option rule of Sec. 318(a)(3).
\textsuperscript{36} Or a "member of his family" within the meaning of Sec. 318(a)(1); Cf. the discussion of Rev. Rul. 59-233 infra.
\textsuperscript{37} See Regs. Sec. 1.318-1(a) Example 3.
\textsuperscript{38} Depending upon the specific provisions of Sec. 318(a)(2) for partnerships, corporations, estates and trusts.
In general, an estate is deemed to own, not only the stock which it actually owns, but also the stock "owned, directly or indirectly, by or for a . . . beneficiary." Therefore, in our example, above, if John Jones’ two sons are beneficiaries of his estate, the estate is deemed to own all of the stock of the corporation.

What stock does an estate own actually? It actually owns all stock "subject to administration by the executor or administrator for the purpose of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent’s heirs, legatees or devisees immediately upon death." Therefore, an estate does not actually own stock not subject to the payment of claims, even though it may be includible in the estate tax return as a gift made in contemplation of death or as property held in joint tenancy. On the other hand, the estate does actually own stock of the decedent, even though under local law title vests in the beneficiaries of the estate, as long as the stock is subject to administration for the purpose of paying claims and expenses.

What stock does an estate own by attribution? An estate is deemed to own the stock of its "beneficiaries". The regulations under Sec. 318 have interpreted this term as follows:

1. A beneficiary is "any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution." Therefore, one who takes only assets passing outside the estate, such as the direct beneficiary of life insurance proceeds, or a joint tenant with the decedent, is not a "beneficiary".

2. A person is not a "beneficiary" unless he has a "direct present interest" in the estate—therefore, a remainderman is not a "beneficiary".

3. A person ceases to be a "beneficiary" when he has been paid his share in full and there is only a remote possibility that he will have to refund any of his share as a contribution to estate liabilities. However, the Commissioner has ruled that a residuary beneficiary does not cease to be a "beneficiary" until the estate has been closed, even though he has received his full share.

Therefore, purchase by the corporation under a redemption contract is endangered if any other stockholder is a "beneficiary" of the deceased stockholder's estate. The Commissioner has attempted to broaden the danger area still further: the three conclusions concerning attribution arrived at above were punctuated with the qualification "or member of his family"; these were

40. Regs. 1.318-3(a).
41. Internal Revenue Code, Sec. 2035.
42. Id. Sec. 2040.
43. Regs. Sec. 1.318-3(a).
44. Ibid., Examples 1 and 2.
45. Regs. Sec. 1.318-3(a).
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necessitated by Rev. Rul. 59-233.\textsuperscript{47} This ruling concerned a situation in which all of the stock of a corporation was owned by a widower and by a trust created by the will of his late wife for the benefit of their children. The trust wished to sell its shares to the corporation in a complete redemption; the Commissioner held that the sale would not be a complete redemption under Sec. 302(b)(3) because the shares of the widower were attributable to the trust. The reason for this was not that the widower was a beneficiary of the trust and that his shares would be attributed to the trust under Sec. 318(a)(2)(B)—this rule could not apply because the widower was not in fact a beneficiary of the trust. Rather, the Commissioner's reasoning proceeded as follows: the trust is deemed to own the shares of the children;\textsuperscript{48} now the children own no shares actually, but they are deemed to own the shares of their father (the widower) by reason of the family rule;\textsuperscript{49} since the children are deemed to win the shares of their father, and the trust is deemed to own the shares of the children, the trust is deemed to own the shares of the father, and thus is considered as owning all of the stock of the corporation; Therefore, a redemption of the shares owned directly by the trust would not be a "complete redemption" under Sec. 302(b)(3). This reasoning seems to fly in the face of Sec. 302(c)(2) which states that the family rule "shall not apply" in the case of a complete redemption—therefore, it should not be used to attribute the father's shares to the trust through his children. The Commissioner's answer is that the legislative history of Sec. 302(c)(2) "makes it clear" that the family rule is to be waived in a complete redemption only where it would attribute shares to the selling stockholder; it is not waived where, as in this case, it would attribute shares to others (viz. the children) than the selling stockholder, and through those others, to the selling stockholder.

It may be doubted whether Rev. Rul. 59-233 is correct and whether it will survive challenge;\textsuperscript{50} nevertheless, it must be taken into account in preparing buy-sell agreements as long as it stands. Its most serious danger is that it would apply if an estate were substituted for the trust in the fact situation; suppose that a father and son own all the stock; the father dies and leaves his entire estate to his wife. Under the statute and regulations we would conclude that the stock may safely be redeemed from the estate, because the son's shares are not attributable to it; he is not a beneficiary of the estate, so that Sec. 318(a)(2)(A) does not apply; his shares should not be attributed to the estate through his mother because the family rule is waived. However, under the theory of Rev. Rul. 59-233 the son's shares

\textsuperscript{47} I.R.B. 1959-28, 9.
\textsuperscript{48} Internal Revenue Code, Sec. 318(a)(2)(B).
\textsuperscript{49} Id. Sec. 318(a)(1)(A)(ii).
\textsuperscript{50} See the sharp criticism by Gleason and Jones in 12 Journal of Taxation 268 (May, 1960), where the ruling is attacked as being contrary to the Internal Revenue Code, its legislative history, and the regulations.
would be attributed to his mother and, through her, to the estate so that the redemption would not be complete.

We can see from the foregoing that a redemption contract can be dangerous where the stock is held by members of a single family, or where the stockholders (or members of their families) are interested in the same partnership, corporation, estate or trust. It may be possible to rely on other sections of the Code to prevent the redemption on death from being a taxable dividend; perhaps it can be shown that as a matter of fact "the redemption is not essentially equivalent to a dividend";51 or it may be that the redemption from the estate will be "substantially disproportionate with respect to "the estate within the meaning of Sec. 302(b)(2)—although here all of the attribution rules would apply,52 including the broad "chain reaction" attribution permitted by Sec. 318(a)(4)(A);53 or it may be that a dividend can be avoided, to the extent of the amount of estate taxes and funeral and administration expenses, under Sec. 303. Nevertheless, in many cases of family corporations, it will be found impracticable to use a redemption contract. The only solution in such cases is to use a cross-purchase contract, despite its disadvantages.

A few miscellaneous income tax consequences of purchase on death remain to be mentioned. In the case of a redemption contract, there is no change in the basis of the stock of the surviving stockholders, because they pay nothing for the decedent’s stock—the corporation makes the payment; on the other hand, in a cross-purchase contract the surviving stockholders buy the decedent’s stock, and their basis in that stock is the amount they paid pursuant to the cross-purchase contract.54 Formerly there was danger that a buy-out of one stockholder by the corporation would be considered a dividend to the surviving stockholders;55 that danger is now past,56 and it is clear that "a redemption by the corporation of the decedent shareholder's shares of the corporation's stock from his estate does not constitute a constructive dividend to the remaining shareholder."57

VI. VALIDITY AND EFFECT OF THE CONTRACT UNDER NEW YORK LAW

In general, it may be said that buy-sell agreements can be validly drawn under New York law. Redemption contracts have been held to be valid and specifically enforceable,58 against attack chiefly on the ground

51. Internal Revenue Code, Sec. 302(b)(1).
52. Id. Sec. 302(c).
53. Slightly moderated by Regs. Sec. 1.318-1(b).
54. Id. Sec. 1012.
BUY-SELL AGREEMENTS IN CLOSE CORPORATIONS

that they were lacking in consideration furnished by the corporation under the theory of *Topken, Loring & Schwartz, Inc. v. Schwartz.*

There a corporation and one of its employees (who was also a stockholder) agreed that on termination of his employment the employee would sell his stock back to the corporation; after termination of the employment the corporation unsuccessfully attempted to enforce the agreement. The Court of Appeals said that under this agreement the corporation's only promise was to buy the stock—it gave no other consideration for the employee's promise to sell; now, a corporation may purchase its own stock only out of surplus, and since there was no way of knowing at the time when the contract was executed whether the corporation would have sufficient surplus when the time came for it to purchase the stock, it would be impossible for the corporation to perform under certain conditions. The Court concluded: "It is as if the (corporation) had a choice to buy or not to buy as it pleased. . . . Under these circumstances, we have a contract not mutually binding, and therefore lacking in consideration." The court pointed out that its decision was based on the fact that the corporation's promise to purchase its stock was its only promise; if the corporation had furnished other consideration, then the contract "would be good unless it appeared that the stock would be purchased out of capital. This would be a matter of defense."

Therefore, a redemption contract is not lacking in consideration as long as the corporation is to do something in addition to purchasing its own stock; in the redemption contract cases the courts have in fact distinguished *Topken* by finding additional consideration, such as cancellation of a prior contract, or the corporation's agreement to pay life insurance premiums on the policies used to fund the contract, even if this agreement is only implied.

The cross-purchase type of contract has been upheld against attack on the grounds that it was an attempted testamentary disposition, that the contract price was less than the actual value of the stock, and that the contract was an attempt to destroy the right of election of the stockholder's widow; it has also been held specifically enforceable. The contract in the *Galewitz* case did not contain a restriction on lifetime transfer by a stockholder: we have seen that such a restriction is desirable (and, indeed,

59. 249 N.Y. 206, 163 N.E. 735 (1928).
60. N.Y. Penal Law Sec. 664(5).
61. Murphy v. George Murphy, Inc., supra note 58.
63. Ionic Shop, Inc. v. Rathfeld, supra note 58.
66. Supra notes 63 and 64.
67. Supra, Part IV.
essential) in order that the contract price be acceptable as estate tax value on death; the court held the contract valid and enforceable under New York law despite the absence of this restriction, stating, however: "it does not appear to be seriously questioned that had the contract contained restrictions against the disposition of his stock by either party during his lifetime, it would be enforceable." This language points out another advantage of the lifetime restriction: It strengthens the validity of the contract under New York law.

The absence of a lifetime restriction caused further difficulty when Galewitz came to the Appellate Division for a second time, after a trial of the issues. For federal estate tax purposes, the decedent's shares had been valued at more than double the contract price—in large measure, no doubt, because of the absence of the lifetime restriction. There being no provision in the will for the apportionment of estate taxes, the Appellate Division held that the estate tax deficiency, representing the difference in value between the contract price and the estate tax value, had been properly apportioned to and was payable by the purchasing stockholder in accordance with Sec. 124 of the New York Decedent Estate Law.

Problems can arise when the buy-sell agreement is too closely related to the will of the deceased stockholder. In Mofsky v. Goldman the agreement did not contain the usual provision that the estate of the deceased stockholder would sell; rather, it provided that the deceased stockholder would make a will bequeathing his shares to the plaintiff. On motion to strike certain defenses to the plaintiff's action to enforce the agreement, the Appellate Division upheld as sufficient defenses alleging in substance (1) that the plaintiff had an adequate remedy at law, and (2) that performance of the agreement would thwart the widow's right of election.

In In re Bracalello's Will, the stockholder made a will bequeathing any stock in three corporations "which I have a right to convey" to appellants; less than a week later he entered into a redemption contract with the three corporations. On his death the question arose whether the stock was to be delivered to the legatees under the will, or sold to the corporations under the contract; the Appellate Division reversed the Surrogate's determination that the contract governed and remitted the matter to the Surrogate to take proof as to the intention of the testator in bequeathing the stock. Therefore, while it is harmless, and perhaps helpful, to include in a stockholder's will a provision directing his executor to carry out the buy-sell agreement, it is just as well not to refer to the stock in any other way.

68. Supra note 63.
69. Supra note 64.
70. Some $400,000 in this case.
73. The Surrogate took proof and once again reached the conclusion that the redemption contract governed — Misc. —, 196 N.Y.S.2d 286 (Surr. Ct. 1959).
VII. Basic Provisions of the Contract

A brief summary of the basic provisions of the buy-sell agreement may serve to sum up the conclusions reached above and show how they can be applied in practice. The discussion is not intended to be complete, nor the provisions outlined unalterable: numerous variations can be used to carry out the basic purposes of the agreement, and additional provisions can be added to cover special situations. The purpose here is simply to mention the general classes of provisions which should appear in every buy-sell agreement.

a. Parties: All stockholders should be parties to the agreement. If less than all are parties, the lack of complete mutuality of obligation to sell may imperil the use of the contract price as estate tax value.

b. Recitals: The recitals should include a statement that it is considered to be in the best interest of the stockholders and of the corporation that the latter's stock continue to be held by those active in its management. This is usually the case, and shows that the agreement has a business purpose, which is valuable for estate tax valuation purposes.74

c. Lifetime Restriction: The agreement should provide that no stockholder may sell his stock during his lifetime without first offering it at an agreed price to the corporation or the other stockholders (depending upon which type of agreement is used). We have seen the importance of this provision for the purpose of both estate tax valuation and validity under New York law.

d. Purchase on Death: Ordinarily the most important part of the agreement to the parties is the provision that on the death of a stockholder his shares will be purchased, either by the corporation or by the surviving stockholders (depending upon the type of agreement). Occasionally a stockholder will wish to reserve the right to give away his shares during his life, or to bequeath them on death, to a specified person or persons; this is usually because the stockholder has a son or other close relative who may some day wish to be active in the business. This motive is obviously important to the stockholder, but the parties should understand that such a provision, even though narrowly restricted, does mean that the stockholder in question can dispose of his shares free of the agreement, and thus runs the risk of having them valued in his estate at a value in excess of the contract price.

e. Price: Usually the same price is fixed for both lifetime sale and sale on death. Sometimes the parties will wish to fix a lower price for sale during lifetime, either as an incentive to stockholders to retain their stock or because the unavailability of life insurance proceeds makes the price payable on death impracticable. At any rate the lifetime price should not exceed the price on death.

The methods of fixing price are numerous: book value may be used, with

74. See Estate of Orville B. Littick, supra note 20.
or without adjustments to reflect actual value of assets; or the parties may fix a dollar value and agree to revise it annually by mutual consent (usually with a provision for adjustment of the agreed value by percentage of later increase or decrease of book value if the last agreed value is over a year old); or average earnings for a period may be capitalized at an agreed percentage; or the price may be fixed by appraisers. Sometimes combinations of the above are used. The method used will depend to a large extent on the size and nature of the business. At all events, the parties should bear in mind that the price cuts both ways and should attempt to fix it as fairly as possible.

f. Terms of Payment: It is frequently impossible to pay the entire purchase price in a lump sum, particularly in the case of lifetime purchase; therefore, the agreement may contain provisions for payment in installments, the obligation usually being evidenced by promissory notes and sometimes secured by a pledge of the stock purchased.

g. Insurance: There no longer seems to be any danger in mentioning insurance in the agreement,75 so that the agreement can describe the policies and provide for payment of the premiums. We have seen that a provision in a redemption contract for payment of premiums by the corporation strengthens the validity of the contract under New York law.

h. Corporate Surplus: We have seen that a redemption contract can run into difficulties under New York law if the corporation's only promise is to purchase its own stock. This obstacle can be overcome by providing that if the corporation shall not have sufficient surplus to enable it to make any payment under the contract, the entire available surplus shall be used to make part payment, and the corporation and its stockholders shall take measures to create surplus, e.g., by reduction of capital or re-appraisal of assets; moreover, the provision can be made that in any event payment is merely postponed and that during the postponement there shall be no dividends or increase in executive salaries.

A provision like the above usually will provide the machinery to handle a surplus problem if it arises, and furnishes the additional consideration on the part of the corporation (agreement to create surplus, not to pay dividends or increase salaries, plus agreement to pay premiums when insurance is used) which the New York courts require.

i. Miscellaneous Provisions: It is usually well to provide that the agreement covers any additional shares in the corporation which the stockholders may acquire; that their stock certificates shall bear notice that transfer is subject to the agreement; and that the agreement is specifically enforceable. A redemption contract should, of course, be approved by a resolution of the directors, since the corporation is a party to it.

VIII. Conclusion

A number of factors must be taken into account in the preparation of buy-sell agreements. Most of the law on the subject is of very recent date, and not all of it is well settled; therefore, it is advisable to check new developments before preparing an agreement, and also to review existing agreements periodically.