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The Life Cycle of a Business Entity:
What You Need to Know to Advise Your Clients in Business Matters

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Session 2

Governance, Operation and Management of an Entity

Life Cycle of a Business Entity

Selected Issues relating to the Governance, Operation and Management of an Entity

ACTEC

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Best Practices for Partnerships, Corporations, and Limited Liability Companies

Importance of Best Practices

- **Improves Quality of Business Decisions and Operations**
  - More perspectives tend to lead to more informed business decisions, particularly when perspectives are varied.
  - Documentation resulting from best practices can serve as basis for communications and as a record for future reference.
  - Formality and structure adds process and emphasis to decisions, thereby increasing focus and consistency.

- **Increases Appeal and Value of Business**
  - Prospective purchasers or investors are naturally more interested in well-run businesses.
  - There are less pitfalls to kill a deal when a business has engaged in best practices.
  - Purchase price and risk allocation always reflect how a business has been run, whether positively or negatively.

Importance of Best Practices (cont'd)

- **Risk Management**
  - Improves the position of the organization in the face of a variety of threats such as shareholder actions, employee matters, and creditor or other debt-related actions.
  - Enables the organization to better respond to external audits such as those conducted by tax authorities, labor and employment agencies, and other applicable regulatory authorities and agencies.
  - May impact the availability of insurance coverage for certain matters.
  - Sets the tone for the organization thereby reducing the risk of serious operational issues.
  - Generally enhances communication and transparency, thereby increasing employee satisfaction and engagement and decreasing distraction and misinformation.

Importance of Best Practices (cont'd)

- **Preserves Limited Liability Protection**
  - Many of the best practices have roots in preserving the limited liability protection afforded by entities such as corporations, limited liability companies and limited partnerships. Loss of this limited liability protection by "piercing the corporate veil" varies by jurisdiction and is governed by the law of the jurisdiction in which the entity is formed.
  - Most courts apply the following test in some variation: first, a "unity of interest and ownership" such that the corporation and controlling individual (or other entity) are effectively the same legal person; and second, circumstances are such that not allowing the corporate veil to be pierced would "sanction a fraud or promote injustice." *See* General Standards, Law of Corp. Offs. & Dirs.: Rts., Duties & Liabs. § 20:2 (2017); *Aronson v. Price*, 644 N.E.2d 864, 867 (Ind. 1994).
  - Other courts will "apply an arguably more stringent three-pronged instrumentality test, particularly in the context of parent-subsidiary transactions." The three prongs of this test are: (1) complete domination, more than merely majority control, by an individual or other entity over an entity; (2) that individual's or entity's domination was used to engage in conduct that was fraudulent, unjust, or otherwise wrongful; and (3) the plaintiff actually suffered harm as a result. *See* General Standards, Law of Corp. Offs. & Dirs.: Rts., Duties & Liabs. § 20:2 (2017); *accord K.C. Roofing Center v. On Top Roofing, Inc.*, 807 S.W.2d 545, 549 (Mo. Ct. App. 1991).

Importance of Best Practices (cont'd)

- When fraud is not present, courts will evaluate factors present to determine if the "alter ego" doctrine should be applied to pierce the corporate veil, meaning the owners were operating the corporation solely for their personal benefit such that it was merely the alter ego of the individual owner(s). *See DeWitt Trucker Brokers*, 540 F.2d at 685; "Piercing the Corporate Veil" and Disregard of Limited Liability Protection, 1 Ltd. Liab. Co.: L., Prac. and Forms § 2:3 (2017). This is a very fact-specific inquiry and is typically dependent on the presence of multiple factors such as:
  - Undercapitalization of the entity in relation to the purposes of the business undertaking;
  - Failure to comply with corporate formalities and keep records (e.g., failure to maintain minutes, adequate corporate records, confusing records of related entities);
  - Non-payment of dividends while paying sums to the controlling owner(s);
  - Insolvency of the entity-debtor;
  - Commingling of funds and other assets between the dominant owner(s) and the entity (e.g., lack of separate bank accounts, unauthorized diversion of entity funds to other uses such as paying owners' personal expenses);
  - Lack of participation of other officers or directors; or
  - Use of the corporation as a shell or façade for the business of the dominant owner(s) or other entity (e.g., identical equitable ownership in related entities, use of one business to procure assets or services for another business or personal activities).
- The decision to disregard the business entity must "present an element of injustice or fundamental unfairness." *Id.* at 687. This element of injustice is the final prong of most courts' tests, and reiterates that piercing the limited liability veil to impose liability upon an individual or other entity is an equitable remedy.

Maintenance of Books and Records

- **Governance Documents**
  - Current governance documents should be kept in the official “minute book” for the organization.
  - Copies of previous governance documents should be archived indefinitely.
- **Ownership**
  - A register or log of ownership should be maintained on a current basis and should reflect prior transactions impacting ownership.
  - If ownership is certificated, copies of all certificates (both outstanding and cancelled) should be on file with the organization while the original issued and outstanding certificates should be held by the owners.
- **Meeting Minutes and Actions Taken on Behalf of Entity**
  - Copies of all meeting minutes and formal actions taken by owners, directors, officers, managers, committees, etc. should be maintained in chronological order in the official “minute book” for the organization. See below: *Documenting Actions and Distributions.*
- **Delegations**
  - Copies of all formal delegations, and revocations thereof, should be on file with the organization.

Tax Compliance

- **Tax Identification Number**
  - A federal (and state if applicable) tax identification number should be obtained for each entity and should be associated with all bank accounts, credit arrangements, etc. that relate to the entity.
  - Disregarded entities such as single-member LLCs and sole proprietorships should obtain tax identification numbers in certain circumstances such as employment taxes and excise taxes.
- **Entity Tax Returns and Reporting Obligations**
  - The organization should establish clear authority for the preparation, execution and filing of all tax returns as well as compliance with all other applicable reporting obligations. This may be accomplished via officer role descriptions, job descriptions, delegations or a combination thereof.
- **New Partnership Audit Rules**
  - Any entity taxed as a partnership for federal income tax purposes should review its governance documents, policies and procedures in light of the Bipartisan Budget Act of 2015, as amended by the Tax Technical Corrections Act of 2018, which effectively repealed the prior audit procedures applicable to such entities and replaced them with new procedures beginning with tax year 2018. *See* I.R.C. §§ 6221-6255.

Documenting Actions and Distributions

- **Influence of Governance Documents**
  - An entity's governance documents should set forth the requisite approval for actions to be taken on behalf of the entity, as well as any timing, notice and quorum requirements.
  - The organization should consistently follow the requirements and processes set forth in its governance documents.
- **Significant Decisions/Actions**
  - Election of directors, managers, officers, etc.;
  - Declaration of dividends or other distributions;
  - Adoption of benefit plans;
  - Acquisitions and dispositions of significant assets;
  - Credit facilities obtained by the organization;
  - Recapitalizations, redemptions, and issuance of additional ownership interests;
  - Executive compensation including equity incentive plans; and
  - Amendments to governance documents.

Documenting Actions and Distributions (cont'd)

- **How and What to Document**
  - Both minutes of meetings and other forms of taking action such as written consents should be properly documented and maintained in the organization's records.
  - Be Mindful of Level of Detail: Minutes should not be a word-for-word transcript of the events of the meeting. Minutes should generally reflect that matters were discussed and questions raised and resolved, but comments or questions should not be attributed to specific individuals. Minutes should state only facts, not draw conclusions, and should not contain the opinions of the author.
  - Reference Documents Presented for Approval: Minutes and other forms of taking action should refer to all documents presented to the participants for approval. Keep in mind that how a document is described in the minutes impacts the extent of the permanent record. For example, if the minutes refer to a document "attached hereto as Exhibit A," that document is considered incorporated into and made a part of the minutes. When documenting actions, the drafter should consider carefully the specific circumstances and whether a document should be attached as an exhibit to the minutes or described as having been distributed to the participants previously.

Documenting Actions and Distributions (cont'd)

- **How and What to Document (*cont'd*)**
  - Never Include Legal Advice: From time to time, the participants may ask for legal advice from counsel during a meeting. To preserve the attorney-client privilege for this information, the minutes should **<u>not</u>** reflect the legal advice given. However, the minutes should identify the counsel giving the advice, who he or she represents (e.g., the company, the board or the independent directors) and that privileged information was discussed. Depending on the subject matter being discussed, the meeting secretary should consider taking separate minutes of the matters covered by attorney-client privilege and keeping that portion of minutes, marked as a privileged document, separate from the minute book. The primary minutes would reflect that privileged information was discussed and is maintained separately.
  - Record the Vote: If the vote is not unanimous, the vote can be reflected as having been approved, without any qualification, or the dissent or abstention, as applicable, can be noted. It is not necessary to identify who dissented or abstained and the reason for their doing so unless such party so requests.

Documenting Actions and Distributions (cont'd)

- **Document Conflicts of Interest**
  - If a participant has a conflict of interest regarding a matter to be discussed at the meeting, the minutes should reflect any special actions taken by the group or the participant in light of the conflict. Minutes are not required to describe the nature of the conflict of interest, but depending on the specific circumstances, the meeting secretary should consider whether it should be disclosed. Applicable state law and the specific transaction or other matters to be approved are key factors in determining how to handle the conflict and whether it would be necessary for the interested party to leave the room and abstain from voting.
- **Describe Other Business Considered at the Meeting**
  - Minutes should also include any other items listed in the agenda that was distributed before the meeting, as well as any impromptu matters discussed at the meeting.
- **Include Resolutions When Required**
  - Not all actions require resolutions. For example, resolutions are not necessary to approve business reports, updates or committee reports that do not involve taking any additional action. However, resolutions are required to appoint directors and officers and may be necessary or desirable in other circumstances such as to establish or delegate authority and responsibilities; to evidence that corporate action was authorized or taken; or if required by state corporate law or the organization's governance documents.

Checks and Balances

- **Governance**
  - An entity's governance documents should include high level checks and balances such as the relationship between shareholders, directors and officers. Additional checks and balances may be created via committees with a designated area of focus such as finance or executive compensation.
- **Operational**
  - The concept of checks and balances should be carried throughout the operations of the business as appropriate.
- **Authority**
  - The organization should be mindful of actual versus apparent authority and create an appropriate structure with checks and balances to manage each type of authority.
  - Apparent authority is the power of an agent to legally bind the principal in relations with third parties, when the third party reasonably believes that the agent (or other actor) has the authority to act on behalf of the principal, *and* that belief is traceable to manifestations of the principal. *See* RESTATEMENT (THIRD) OF AGENCY § 2.03 (Am. Law. Inst. 2006).
  - In contrast, an agent has actual authority when the agent reasonably believes, based on the principal's manifestations to the agent, that the principal wants the agent to act (at the time that the agent does act) in a way that has legal consequences for the principal. *Id.* at § 2.01.

Checks and Balances (cont'd)

- **Authority (*cont'd*)**
  - Thus, actual authority depends on whether the principal has made a manifestation to the agent, while apparent authority depends on whether the principal has made a manifestation to a third party that leads the third party to reasonably believe that the agent has authority. *Id.* at § 1.03 cmt. b.; *see, e.g., Hawaiian Paradise Park Corp. v. Friendly Broadcasting Co.*, 414 F.2d 750, 756 (9th Cir. 1969) ("In determining whether there was apparent authority, the factual inquiry is the same as in the case of actual implied authority, except that the principal's manifestations to the third person are substituted in place of those to the agent."); *see also Meyer v. Ford Motor Co.*, 275 Cal. App. 2d 90, 102 (Cal. Ct. App. 1969) (stating that a principal's manifestation that creates apparent authority "need not have been [made] in direct contact with the third party" but can be "to the community at large, and may consist of appointing the agent to a particular position").
  - The principal's manifestation can be express or implied and made by written, verbal, or other conduct (including silence). *See* RESTATEMENT (THIRD) OF AGENCY § 1.03.
  - An agent's apparent authority ends when it is no longer reasonable for a third party to believe that the agent has actual authority from the principal. *See* RESTATEMENT (THIRD) OF AGENCY § 3.11(2).

Checks and Balances (cont'd)

- **Authority (*cont'd*)**
  - Terminating actual authority may not be enough, by itself, to end apparent authority held by an agent. *Id.* at § 3.11(1). Because apparent authority depends on the third party's belief, an agent's apparent authority may outlive the principal's termination of actual authority, if the third party is unaware of that termination or otherwise reasonably believes the agent is authorized due to a prior manifestation by the principal. *Id.* at § 3.11 cmt. c; *see also Ophthalmic Surgeons, Ltd.*, 632 F.3d at 37 (citing the RESTATEMENT (THIRD) OF AGENCY § 2.03 comment a, "[a]pparent authority may survive termination of actual authority or of an agency relationship"). This doctrine of "lingering authority" recognizes that it is reasonable for third parties to assume an agent has ongoing authority until the third party has express notice (from the agent or principal) that the agent no longer has authority or a change of circumstances makes it unreasonable to assume the agent still has authority. *Id.*

Consistency with Actual Practices

Alignment between governance documents, policies, procedures and actual practices is critical. It is better to not have them than to have them and not follow them.

Annual Maintenance

- **Benefits of Annual Maintenance**
  - Brings focus to the organization, which is likely to decrease distractions and increase productivity.
  - Creates an internal audit system to highlight matters to be addressed and establishes a prioritization system.
  - Positions the business to better respond to unforeseen events such as the death of an owner or a person key to management.
  - Aids the transition of the business to new ownership and/or management.
  - Assists in preparing for a sale of the business should that opportunity arise.

Annual Maintenance

Annual Maintenance Checklist					
Category	**Topic/Document**	**Location**	**Important Dates**	**Required Attention**	**Action Items**
Governance	Minutes/Consents/Delegations				
	Officers/Directors/Managers/Other Authorized Representatives				
	Committees				
	Registered Agent(s)				
Ownership	Records of Ownership				
	Loans/Contributions Documentation				
	Buy-Sell Documents (agreement/valuation/life insurance)				
Finance	Bank/Investment Accounts (signature/access authority)				
	Credit Facilities (expiration/deliverables/covenants/payments)				
Insurance	Policy Evaluations (types/terms of coverage)				
	Notifications/Renewals				
Primary Operational Contracts	Leases (real/personal property)				
	Software Licenses				
	Required Supply Chain Contracts				
	Major Customer Contracts				
	Marketing/Sales Contracts				
Other	Employee Handbooks, Job Descriptions and Contracts/Non-Competes				
	Intellectual Property Filings/Deadlines				
	Tax Filings/Deadlines				
	Regulatory Filings/Deadlines/Internal Compliance Audits				
	Information Technology Review for Major Operating Systems (administrator/access/disaster recovery)				

Owner Control, Operations and Shareholder Agreements

Owner Communications

- **Active versus Passive Owners**
  - The founder of the business should consider which children should be managing the business in the future and which should not.
  - In many instances, the founder will only want those children who are active in the business to own a controlling interest in the business, but will want to treat all children equally from an economic standpoint.
  - Special considerations can apply where there is a surviving spouse and the children are from a prior marriage.
    - For example, if a QTIP marital deduction trust is used to hold the business interest, who should be the trustee(s)? And how should decisions be made among them?
  - The founder should ***communicate*** his or her decisions concerning this to the affected family members ***during the founder's lifetime*** so that it does not come as a surprise upon the founder's death.

Owner Communications (cont'd)

- **Procedures**
  - The foundational document for business succession planning is generally a ***buy-sell agreement***.
  - A properly structured buy-sell agreement can avoid disputes between children who are active and those who are not active.
  - A buy-sell agreement is an agreement between the owners of a business, or among the owners of the business and the entity, that provides for the mandatory purchase (or right of first refusal) of an owner's equity interest, either by the other owners or by the business itself (or some combination of the two), upon the occurrence of specified triggering events described in the agreement.

Owner Communications (cont'd)

- **Procedures (cont'd)**
  - Such triggering events can include the death, disability, retirement, withdrawal or termination of employment, bankruptcy and sometimes even the divorce of an owner.
  - Buy-sell agreements may be adapted for use by all types of business entities, including C corporations, S corporations, partnerships and limited liability companies.
  - A buy-sell agreement does not have to be a standalone agreement.
    - Indeed, in many cases, buy-sell provisions are contained in existing organizational documents.
    - Depending upon the circumstances, these existing provisions may need to be amended or overridden by a standalone buy-sell agreement if the family's business succession plan is to be successful.

Family Dynamics and Consequences Relating to Control Issues under Governing Documents

- **Practical Issues Relating to Control by Certain Family Members under Entity Agreements**
  - By implementing the founder's wishes, a properly structured buy-sell agreement can avoid disputes between children who are active and want to invest in the business, and those who are not active and would rather have the business pay dividends or make other distributions.
  - For those children who are active in the business, a properly structured buy-sell agreement will allow them to purchase the founder's shares over time and will not cripple their ability to operate the business effectively.
    - Life insurance may provide the funding for this.
  - The buy-sell agreement also provides a mechanism for not having to go into business with siblings (and spouses of siblings) who are not active in the business.

Family Dynamics and Consequences Relating to Control Issues under Governing Documents (cont'd)

- **Practical Issues on Dealing with Restrictions on Transfers Imposed under Entity Agreements**
  - The primary objective of a buy-sell agreement is to provide for the stability and continuity of the family business in a time of transition through the use of ownership **transfer restrictions** and to establish a mechanism to determine the selling price of the owner's interest in the entity.
  - Typically, the agreement prohibits the transfer of ownership to unrelated third parties by setting forth how and to whom shares or other equity interests may be transferred.
  - The agreement can also provide a mechanism for determining the sales price for the equity interests and how the purchase will be funded.

Family Dynamics and Consequences Relating to Control Issues under Governing Documents (cont'd)

- **Practical Issues on Dealing with Restrictions on Transfers Imposed under Entity Agreements (cont'd)**
  - The agreement usually should contain restrictions on owners' voluntary transfers of interests in the business.
  - Transfers may be permitted to an owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions.
  - In contrast, transfers to third parties may be permitted after first offering the interest to the entity or the other owners, either at the price determined under the agreement or at the lower of the price determined under the agreement and the price offered by a third party.

Majority versus Super-Majority Requirements for Certain Actions

- **Provisions Triggering Super-Majority Requirements for Certain Actions**
  - The governing agreement may provide that, except as otherwise specifically provided, the affirmative vote of a majority-in-interest of the owners shall be necessary and sufficient in order to approve or consent to any matters that require the approval or consent of the owners.
  - The affirmative vote of a super-majority (or potentially all) of the owners may be appropriate in connection with major decisions. This could potentially include the following items, among others:
    - Certain financing decisions and loan guarantees;
    - The sale of substantially all of the business’s assets; or
    - The decision to liquidate the business in whole or in part.

Majority versus Super-Majority Requirements for Certain Actions (cont'd)

- **Potential Special Drafting for This in the Client Context**
  - Consider the consequences of conferring effective veto rights upon owners of minority interests in the context of decisions that require a super-majority or unanimous consent of the owners.
  - Possible solutions – "**drag-along rights**" and "**tag-along rights**"
- "**Drag-along rights**" provide that if a certain percentage of the equity interests are being sold to a third party, the selling equity owners have a right to require the remaining equity owners to join in the sale at the same price and on the same terms that apply to the selling equity owners.
- "**Tag-along rights**" provide that if the equity owners of more than a certain percentage of the equity interest have agreed to sell their equity interests to a third party, the other equity owners have the right to join in the sale at the same price and on the same terms that apply to the selling equity owners.

Majority versus Super-Majority Requirements for Certain Actions (cont'd)

- **Potential Special Drafting for This in the Client Context (cont'd)**
  - Furthermore, the agreement may provide for an adjustment in the purchase price if either a certain percentage of the equity interests or a certain percentage of the assets of the entity are sold within a certain period of time.
    - The adjustment would allow the equity owners who have recently sold their interests either to the entity or to the other equity owners the advantage of the increased value of the entity, as determined by the subsequent sale.

Creditor Protection

- **Separate the Business from the Individual**
  - Maintain entity formalities (e.g., segregation of bank accounts) to prevent creditors from "piercing the entity veil."
  - Operate consistently with organizational documents.
  - Avoid holding personal use assets in the family business.
- **"Risky" Business**
  - Use separate entities for each business that has unique risk factors (e.g., airplanes, boats, etc.).
- **Divorce of Owner**
  - Include a provision in the buy-sell agreement to prevent the nonfamily ex-spouse from becoming an owner of the business.
  - Consider providing for filing of divorce as the trigger for removal from office and relinquishment of ownership.

Interim Controls in the Event of Disability

- **Disability of Controlling Owner(s)**
  - How is the term “Disability” defined?
    - Define disability in the operating agreement.
    - Provide a mechanism to establish the disability of an individual in an authority position (e.g., HIPAA releases or process to require individual to be examined).
    - Provide a process to enable resuming control if the disability “improves.”
  - Succession planning in the event of a disability of an owner or key person.
    - Temporary disability.
    - Long-term disability.

Officers and Agents

- **Day-to-Day Operations**
  - An entity need not be managed by its owners. Instead, the owners can delegate to others (including employees) the authority to operate the business.
  - Consider including other key individuals as officers to help run the business. Customize these provisions for each client and type of business.
    - Can provide multiple individuals with signatory authority for ease of operation.
    - Can create a role for junior family members.
  - Member-managed LLC versus manager-managed LLC
    - Consider options most viable based on client situation.
    - Include strategy for succession.

Navigating Transfer Restrictions

- **Permissible Transferees**
  - The agreement usually should contain restrictions on owners' voluntary transfers of interests in the business.
  - Transfers may be permitted to an owner's spouse or children, or to trusts created for their benefit, in order to allow the owners to engage in estate planning transactions.
  - Consideration should always be given to (1) whether consent is required under applicable loan agreements and (2) any special tax considerations (such as with respect to transfers of shares of stock in an S corporation).
- **Implementation of Process if Triggered**
  - In contrast, transfers to third parties (or otherwise non-permitted transfers) may be permitted only after first offering the interest to the entity or the other owners, either at the price determined under the agreement or at the lower of the price determined under the agreement and the price offered by a third party (the "***right of first refusal***").

Effect of Governing Documents on Valuation

- **Control Issues**
  - The absence of control over management operations (including investment and distribution decisions) can affect valuation (i.e., discount for lack of control).
  - Is there a pattern of regular distributions to owners of interests in the entity?
- **Marketability issues**
  - Restrictions on the transfer of interests in the entity pursuant to the terms of the governing instrument can likewise affect valuation (i.e., discount for lack of marketability).
  - Is there an effective market for the equity interest and how long will it take to sell it?

Tax Consequences of Transfers of Entity Interests

- **In General**
  - Careful consideration needs to be given to taking steps to prevent transfers under the agreement from triggering tax consequences
- **Special Concerns with S Corporation stock**
  - The agreement can void transfers that would otherwise result in the termination of the entity's S corporation status.

- **Fixing Estate Tax Values**
  - The value of an asset for federal estate tax purposes is its fair market value at the time of death.
  - *Fair market value* is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."
  - The IRS, for decades now, has expressed concern in the family business context that the price set forth in the buy-sell agreement may not accurately reflect fair market value because using an artificially low valuation would benefit the family by minimizing the amount of any estate tax.
  - A complex body of law has developed in this area.

Tax Consequences of Transfers of Entity Interests (cont'd)

- **Fixing Values for Buy-Sell Agreement**
  - It can be very difficult to use a value in a family business buy-sell agreement other than fair market value and have it respected by the IRS.
  - Significantly, although the value set forth in the agreement is not binding on the IRS, it will be contractually binding on the parties to the agreement, which can cause potentially disastrous results.
  - If the deceased owner's interest in the business that is subject to the buy-sell agreement passes to the deceased owner's surviving spouse under his or her estate planning documents, this can potentially accelerate estate tax to the first spouse's death even though the estate plan has been drafted with formula provisions that are intended to defer all estate taxes until the death of the surviving spouse.
    - This horrific result of accelerating substantial estate taxes to the first spouse's death can occur because estate tax inclusion resulting from buy-sell agreements can create "phantom assets" that are included in the gross estate of the first spouse to die; but because they are not "real assets," they are unable to pass to the surviving spouse to qualify for the federal estate tax marital deduction.
    - This mismatch between gross estate values and marital deduction values could produce substantial estate taxes upon the "first death," in sharp contrast to the client's likely expectation that the marital deduction would shield the husband and wife from federal and state estate taxes until the death of the surviving spouse.

Tax Consequences of Transfers of Entity Interests (cont'd)

- Prior to 1958, the courts generally would respect the price set forth in a buy-sell agreement for establishing estate tax values.
  - As long as the agreement was binding on the owners both during life and at death and was legally enforceable, the agreement price would be respected even if it was significantly lower than actual fair market value.
- In 1958, the IRS issued regulations under I.R.C. § 2031 that were intended to curb perceived valuation abuses.
  - Treasury Regulation § 20.2031-1(b) defines *fair market value* as the price that a willing buyer would pay a willing seller for the property, both with reasonable knowledge of the relevant facts and neither being under a compulsion to buy or to sell.
  - According to Treasury Regulation § 20.2031-2(h), the price set forth in the agreement will be disregarded in determining value for estate tax purposes unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and is not a device to pass the decedent's shares to the natural objects of his or her bounty for less than an adequate and full consideration in money or money's worth.

Tax Consequences of Transfers of Entity Interests (cont'd)

- The regulations under section 2031 were elaborated upon by the courts to establish a four-part test to determine whether the agreement price would be respected for estate tax purposes. The four requirements are as follows:
  1. The agreement sets a fixed price for the shares or one that is determinable by an ascertainable formula.
  2. The agreement is binding both during the deceased owner's lifetime as well as at death.
     - This requirement is satisfied as long as the deceased shareholder's estate is required to sell, even though the other parties are not required to purchase the shares but instead have only a right of first refusal.
  3. The agreement prohibits lifetime transfers at a price higher than the agreement price. Gratuitous transfers during life are permissible provided that the donees become subject to the restrictions of the buy-sell agreement.
  4. The arrangement is a bona fide business arrangement and is not a device to pass the business interests to the natural objects of the decedent's bounty for less than adequate consideration.
     - Historically, courts considered the fourth requirement to be satisfied as long as the price set forth in the agreement reflected actual fair market value at the time that the agreement was entered into, not at the date of the shareholder's death.
     - This was the case even if the price under the buy-sell agreement was substantially lower than the fair market value.
- This four-part test was the *sole* standard for determining whether a buy-sell agreement would be respected for estate tax purposes prior to the enactment of section 2703 in 1990.

Tax Consequences of Transfers of Entity Interests (cont'd)

- **The Impact of Code Section 2703**
  - On October 8, 1990, Congress enacted Code section 2703 to curb perceived valuation abuses in the area of buy-sell agreements.
  - Code section 2703 applies to all buy-sell agreements entered into after October 8, 1990, as well as to those agreements that were entered into prior to October 8, 1990 but substantially modified after that date.
  - Code section 2703 expands on the four-part test already in existence by breaking the fourth part of the test into two requirements and then adding a new third requirement.
  - Under Code section 2703(a), the estate tax value of property shall be determined without regard to (i) any option, agreement or other right to acquire or use the property at a price that is less than the property's fair market value (without regard to such option, restriction or right), and (ii) any restriction on the right to sell or use such property.
    - This means that the general rule under Code section 2703 is that the restrictions on price in a buy-sell agreement or similar provision of any other document will be disregarded in determining the estate tax value of the property.

- **<u>The Impact of Code Section 2703 (cont'd)</u>**
  - Code section 2703(b) provides that such option, agreement, right or restriction will *not* be disregarded for estate tax valuation purposes if the following three requirements are met:
    1. The option, restriction or agreement is a bona fide business arrangement.
    2. The option, restriction or agreement is not a device to transfer such property to members of the decedent's family (expanded to the "natural objects of the transferor's bounty" in the corresponding regulations) for less than full and adequate consideration in money or money's worth.
    3. The terms of the option, restriction or agreement are comparable to similar arrangements entered into by persons in an arm's length transaction.

Tax Consequences of Transfers of Entity Interests (cont'd)

- The first two requirements basically divide the fourth requirement of the test that preceded the enactment of Code section 2703 into two parts, both of which must be satisfied.
- Not only must the option, restriction or agreement be part of a "bona fide business arrangement," but such option, restriction or agreement must also not be merely a "device" to transfer such property to the natural objects of the deceased owner's bounty for less than full and adequate consideration.
- Importantly, the courts have held that these two requirements generally will not be satisfied where the entity does not conduct an active trade or business, but instead holds a portfolio of marketable securities or undeveloped real property.
  - *See Holman v. Comm'r*, 130 T.C. 170 (2008) (entity holding Dell common stock failed to constitute a bona fide business arrangement, or to meet the device test, for purposes of section 2703), *aff'd*, 105 AFTR 2d ¶ 2010-721 (8th Cir. 2010); *Fisher v. United States*, No. 1:08-cv-00908 (S.D. Ind. Sept. 1, 2010) (taxpayer failed to establish a bona fide business arrangement for purposes of section 2703 where the entity's principal asset was a parcel of undeveloped real property).

Tax Consequences of Transfers of Entity Interests (cont'd)

- The third requirement under Code section 2703(b) (the comparability requirement) was without precedent under prior law and effectively eliminates the ability of buy-sell agreements to fix values for estate tax purposes for a family business where the values are substantially lower than true fair market values.
- Code section 2703(b) requires that in order to be binding for estate tax purposes, the terms of the option, restriction or agreement must be "comparable to similar arrangements entered into by persons in an arms' length transaction."
- Treasury Regulation § 25.2703(1)(b)(4) provides that a right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain negotiated among unrelated parties in the same business dealing with each other at arm's length.
  - In determining whether a right or restriction meets the "fair bargain" requirement, the regulations require consideration of such factors as (i) the expected term of the agreement, (ii) the current fair market value of the property, (iii) anticipated changes in value during the term of the arrangement, and (iv) the adequacy of any consideration given in exchange for the rights granted.

Tax Consequences of Transfers of Entity Interests (cont'd)

- The application of the comparability requirement can be particularly challenging for estate planners when preparing buy-sell agreements, as demonstrated by the case law that has addressed this issue.
- In ***Estate of Blount v. Commissioner***, T.C.M. 2004-116, *aff'd in part, rev'd on other grounds*, 428 F.3d 1338 (11th Cir. 2005), the court considered a buy-sell agreement that involved the purchase and sale of stock in a construction company.
  - The IRS argued that the modified buy-sell agreement should be disregarded for estate tax valuation purposes because, among other things, it failed to satisfy all of the three safe harbor requirements under I.R.C. § 2703(b), including the comparability requirement of I.R.C. § 2703(b)(3).
  - The Tax Court agreed with the government, observing that "section 2703(b)(3) requires a taxpayer to demonstrate that the terms of an agreement providing for the acquisition or sale of property for less than fair market value are similar to those found in similar agreements entered into by unrelated parties at arm's length in similar businesses."
  - The court wanted to see as documentary evidence examples of "real-world agreements" containing comparable terms to the buy-sell agreement at issue in that case.
  - The estate, however, failed to meet this burden; and, therefore, the court disregarded the buy-sell agreement for estate tax purposes.

Tax Consequences of Transfers of Entity Interests (cont'd)

- In ***Estate of Smith v. United States***, 94 A.F.T.R.2d 5283 (2004), *rehearing on other issues*, 96 A.F.T.R.2d 6549 (W.D. Pa. 2005), a limited partnership agreement for a limited partnership (the sole asset of which was 100 percent of the common stock of an operating company) contained a right of first refusal (a "ROFR").
  - The ROFR allowed the partnership and/or partners to purchase another partner's interest before it could be sold to a third party.
  - Among other things, the terms allowed promissory notes payable over a period of up to fifteen years bearing interest at the long-term applicable federal rate. Both the taxpayer and the government agreed that the use of an extended payout provision in the event that the ROFR were exercised would have a depressing effect on the value of the limited partnership interest to be purchased.
- The court considered whether the ROFR (including the extended payout provision) satisfied all of the requirements of the safe harbor under I.R.C. § 2703(b).
- Although the court found that the provision was a bona fide business arrangement, the record lacked sufficient evidence to allow the court to determine whether the provision was a device to transfer property for less than full and adequate consideration.

Tax Consequences of Transfers of Entity Interests (cont'd)

- As for the third safe harbor requirement of **comparability**, the court reviewed affidavits of two attorneys that the taxpayer submitted, which stated that extended payout provisions similar to the one in the Smith partnership agreement were common in agreements among unrelated parties.
- However, the court held that in order to satisfy the comparability requirement of I.R.C. § 2703(b)(3), the taxpayer was required to show that, when the agreement was made, it was "one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arms' length."
- Ultimately, the court concluded that the opinions of testifying attorneys were "conclusory in nature" and insufficient to satisfy the comparability requirement.

Tax Consequences of Transfers of Entity Interests (cont'd)

- In light of the foregoing case law, it would seem that the preferred way to proceed from a tax perspective is to base the purchase price in the agreement on one or more appraisals at the owner's death by independent valuation experts using valuation standards that would satisfy the comparability requirements of Code section 2703(b).
- This approach presents the greatest likelihood of being respected by the IRS for estate tax valuation purposes.
  - If the estate planner and/or the family are concerned that the IRS will not respect the appraisals, the buy-sell agreement can include an adjustment clause that would apply if the IRS valuation was different from the appraisal valuation, which would adjust the purchase price under the buy-sell agreement to reflect the valuation as finally determined for federal estate tax purposes.

Tax Consequences of Transfers of Entity Interests (cont'd)

- Three additional points regarding Code section 2703(b) should be noted:
  - **<u>First</u>**, the regulations provide an exception to the requirements of Code section 2703(b) if more than 50 percent of the value of the property subject to the agreement is owned directly or indirectly by individuals who are not members of the transferor's family.
    - Consequently, in such a case, the agreement would have to satisfy only the first three requirements under the case and regulatory law that preceded the enactment of section 2703.

Tax Consequences of Transfers of Entity Interests (cont'd)

- **Second**, Code section 2703 does not apply to agreements that were in place prior to October 8, 1990, unless the agreement was substantially modified after that date.
  - Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value or time of the rights of any party with respect to property that is subject to the right or restriction is considered a substantial modification.
  - In addition, if the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification.
  - Further, the addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless: (i) the addition is mandatory under the terms of the right or restriction; or (ii) the added family member is assigned to a generation (determined under the generation-skipping transfer tax rules of I.R.C. § 2651) no lower than the lowest generation occupied by individuals already party to the right or restriction.

- **Third**, Code section 2703 is to be applied *in addition to and in conjunction with* (and not in lieu of) the traditional four-part test for determining whether a buy-sell agreement will be respected for estate tax purposes. *See* Treas. Reg. § 25.2703-1(b)(3).

Types of Buy-Sell Agreements

- **There are three general types of buy-sell agreements:**
  - a cross-purchase agreement;
  - a redemption agreement; and
  - a hybrid agreement.
- In a **cross-purchase agreement**, the remaining owners are required to buy, or are given a right of first refusal over, the ownership interests of the deceased or withdrawing owner.
- In a **redemption agreement**, the business itself is required to, or is given the option to, buy the ownership interests of the deceased or withdrawing owner.

Types of Buy-Sell Agreements (cont'd)

- In a **hybrid agreement**, the business typically has the first opportunity to purchase the ownership interests of the deceased or withdrawing owner, with any ownership interests not purchased by the business required to be purchased by, or optioned to, the other owners.
  - In addition, if the agreement so provides, this sequence can be reversed between the business and the other owners.
  - Importantly, in the case of a C corporation, the corporation should have the initial obligation to purchase the shares under a hybrid agreement if such purchase obligation is also to be imposed upon the shareholders.
    - Otherwise, if the corporation purchases shares that the other shareholders are obligated to purchase pursuant to the agreement, the shareholders will be deemed to be receiving dividends taxable as ordinary income to the extent that the corporation has earnings and profits.

Types of Buy-Sell Agreements (cont'd)

- **Choosing the Right Type of Buy-Sell Agreement**
  - In choosing among the three broad categories of buy-sell agreements (cross-purchase, redemption or hybrid) the key decision to be made is who should be the purchaser.
    - Will it be the remaining owners (cross-purchase), the entity (redemption), or a combination of the two (hybrid)?

Role of Life Insurance

- **It is essential to consider how the purchase will be funded, and the extent to which life insurance will play a role.**
  - If life insurance will be used and there are multiple owners, a cross-purchase agreement may be cumbersome.
  - The reason for this is that (unless a partnership or a trust is used to own the insurance policy) a typical cross-purchase agreement requires each owner to own a policy on the life of every other owner.
    - For example, if there were five shareholders of a corporation, there would need to be twenty life insurance policies because each of the five shareholders would need to own separate polices on the lives of the other four shareholders.
    - Six shareholders would therefore require thirty policies (6 x (6-1) = 30), unless the shareholders formed a partnership or limited liability company, or established a trust, to own the life insurance policies.
    - The use of a partnership, a limited liability company or a trust can also avoid the “transfer-for-value problem” for income tax purposes.

Role of Life Insurance (cont'd)

- With a redemption agreement, there would only need to be a single life insurance policy on the life of each owner because the business is the only purchaser.
- Prior to the repeal of the corporation alternative minimum tax under the 2017 Tax Act, if the business was a C corporation and a redemption agreement were used, the corporate alternative minimum tax could have potentially applied to render taxable 75 percent of the otherwise non-taxable life insurance proceeds.
  - The corporation alternative minimum tax was repealed under the 2017 Tax Act
- Another factor in determining which type of buy-sell agreement to choose includes who has the ability to pay for the purchase of the ownership interests (the corporation or the owners).

Role of Life Insurance (cont'd)

- The nature of the entity can result in different income tax consequences depending on the type of buy-sell agreement chosen.
  - If the family business is a C corporation, the attribution rules under Code section 318 (which attributes shares owned by certain family members, estates, trusts and businesses to other family members) may result in the redemption not qualifying for capital gains treatment under Code section 302(b) and therefore being treated as a dividend for income tax purposes.
  - In contrast, a cross-purchase agreement will always produce a capital gains transaction, and assuming that the deceased owner's shares have been stepped up to their fair market value upon death pursuant to Code section 1014, there may be little or no gain.
  - Moreover, if the business is an S corporation or a partnership (including a limited liability company that is taxed as a partnership for federal income tax purposes), a redemption agreement would not result in ordinary income to the outgoing business owner or to his or her estate.
    - *See* Rev. Rul. 69-608, 1969-2 C.B. 42.

Role of Life Insurance (cont'd)

- Generally, life insurance proceeds are not subject to income tax unless the policy has been transferred to another person for valuable consideration. *See* I.R.C. § 101(a)(1).
  - Such a transfer would subject the proceeds payable on the death of the insured to income tax to the extent that they exceeded the purchase price and post-transfer premiums paid by the transferee.
  - The transfer-for-value rule, however, does not apply to a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. *See* I.R.C. § 101(a)(2).
- In the case of a corporate cross-purchase agreement, when one of the shareholders dies, the policies that he or she owns on the lives of the other shareholders cannot be sold by his or her estate to any remaining shareholder without triggering the transfer-for-value rule, unless one of the exceptions apply.
  - Use of a partnership will constitute one such exception; thus, a partnership among the shareholders that holds the life insurance policies will avoid the transfer-for-value problem.

Thank You for Your Attention!

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