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PAYING THE PRICE:
Valuing Businesses in Buy-Sell Agreements

The rejoicing at IRS national headquarters must have lasted into the wee hours of the morning when, almost 20 years ago, Congress added to the Internal Revenue Code some valuation rules which have come to be known, simply, as "Chapter 14." "At last," they thought. "What we've said for years is now formally part of the law: We can ignore the price set in a buy-sell agreement among family members and make our own independent determination of the value of the company." (It doesn't take much to make an IRS agent happy.)

The statutory excuse which Congress gave to the Service to ignore the agreement is Code section 2703, which comes in two parts. Part one says that, in deciding whether a transfer tax is owed, IRS can value an asset without regard to anyone's legal right to acquire or use the asset at a price less than its fair market value. (The "transfer" taxes are the gift tax, the estate tax and the generation-skipping transfer tax.)

The second part of the section says, "BUT -- if the agreement meets three tests, then it's brought back into play and its price is conclusive." Test one: Is it a "bona fide business arrangement?" Test two: Is the agreement a "device" to transfer property to the "natural objects of the transferor's bounty" at a bargain? And test three: Are its terms <u>comparable</u> to <u>similar</u> arrangements entered into in <u>arm's</u> <u>length</u> deals? (No -- that's not a typographical error. The Code really does say "<u>comparable</u> to <u>similar</u> arrangements," as if it were possible to find something <u>comparable</u> to <u>different</u> arrangements.)

These rules are effective for agreements entered into or <u>substantially</u> <u>modified</u> after October 8, 1990. As a general guideline to the daily conduct of business people in ordering their affairs, if a contemplated change in an existing agreement seems to be a "substantial modification," it probably is.

Regulations interpreting and explaining <u>all</u> of Chapter 14 were finalized early in 1992. The courts have worked long enough with the statutory and regulatory materials by now for estate owners and their advisors to be fairly comfortable in understanding the parameters of the law.

Still, caution is appropriate. It makes sense to assume, first, that very few family agreements will pass the three-part arm's length test and, second, that the price terms of most family agreements will be ignored for transfer tax purposes. It's also appropriate to keep in mind that section 2703 is not limited to buy-sell agreements. It allows IRS to ignore <u>any</u> "option, agreement, or other right" -- language which might be broad enough to include, for example, leases between family members or private annuities.

An illustration might aid in understanding the consequences of section 2703. Ellen Entrepreneur and her son, Eddie, own all outstanding shares of Environmental Enterprises, Inc. In the event of her death, a buy-sell agreement allows Eddie to purchase his mother's 20,000 shares at $750 per share. Ellen's will utilizes her 2023 "exemption" of $13,610,000 from estate tax and leaves everything else in trust for her husband, Elvin. The will directs her executor to apportion administrative expenses and estate taxes among her beneficiaries in proportion to their inheritances.

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Here's what happens at Ellen's death when IRS says her interest in the company is worth $16 million ($1,000,000 more than the agreement calls for):

* The person who acquires the interest pays only what the agreement requires, not the greater amount assessed by IRS. In our example, Eddie can enforce in state court his right to buy the shares for $15,000,000. That's all he'll pay. (Ironically, if he's a "good guy" and yields to family demands to pay the IRS-assessed price, he may have made a taxable gift to the other estate beneficiaries.)

* Estate tax will be payable on the "excess" company value. If Ellen's will takes a conventional approach to distributing assets between her husband's trust and the trust which uses up the $13,160,000 exemption, some of her shares in the family company must go to her husband's trust. Because of section 2703, at least $1,000,000 worth of stock will not qualify for the marital deduction. The family will pay at least $400,000 in avoidable estate tax as a result.

* Some beneficiaries could wind up paying taxes triggered by inheritances distributed to other beneficiaries. Let's say that Ellen survives her husband and is, in turn, survived by her three children. The will divides the estate equally among the children and, as before, charges the taxes proportionately. Eddie gets one-third of the estate, pays one-third of the taxes and gets the additional $1,000,000 of company stock. His siblings pay some estate tax which Ellen undoubtedly would have wanted Eddie to pay.

In order to minimize these results, formal appraisals have replaced educated guesses when it comes time to value family businesses. In addition, every family buy-sell agreement and the will of every owner of a closely-held business must now take account of the implications of valuation disagreements between the IRS and family members involved in the business. Estate planning documents must now explain how to reallocate:

-- assets among all beneficiaries if some beneficiaries receive an unintended "windfall" because of the application of section 2703 to a property right and

-- additional taxes resulting from an IRS revaluation.

Like the rest of Chapter 14, section 2703 tells estate owners that they may not use essentially artificial legal structures in order to reduce the values used for transfer tax purposes. It does not give IRS *carte blanche* to assign any old value to the family business once the buy-sell agreement has been put aside by section 2703. IRS must still use a rational, recognized method of valuing the company. And estate owners are still free to structure their companies to take advantage of techniques like minority discounts which have the effect of substantially depressing value and keeping valuable dollars from going to Washington, D.C. -- where, from time to time, new legislation is proposed to make the rules of Chapter 14 even harder on the owners of family businesses.

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