

**S CORPORATION STOCK REDEMPTION BUY-SELL  
(INCLUDING DISABILITY)  
(INCORPORATING THE SHORT TAX YEAR TECHNIQUE)**

**APPENDIX**

**VALUATIONS**

How is a fair and reasonable value for a Corporation determined?

Regs. Sec. 20.2031-3 states that the value of a Corporation is determined on the basis of all relevant factors, including:

- ... A fair appraisal, as of the applicable valuation date, of all assets of the business, tangibles and intangibles, including Goodwill;
- ... The demonstrated earning capacity of the business; and
- ... Other factors set forth in paragraphs (f) and (h) of Regs. Sec. 20-2031-2 (e.g., economic outlook of industry, management talent, value of similar listed businesses on any stock exchanges).

IRC Code Sec. 2703 requires that the parties execute a binding buy-sell agreement, entered into at arms-length, in order to establish Federal Estate Tax Values for a deceased Stockholder. The burden of proof is more strenuous for the deceased's estate. Buy-Sells between related parties have always been closely scrutinized on the valuation issue. Code Section 2703 does provide three guidelines, which if met, should go a long way in establishing Federal Estate Tax values:

**I. "BONAFIDE BUSINESS ARRANGEMENT RULE"**

The Agreement must be part of a bonafide business arrangement.

**II. "DEVICE RULE"**

The agreement must not be a device to transfer the property to members of decedent's family for less than full and adequate consideration in money or money's worth.

**III. "COMPARABILITY RULE"**

The terms of the agreement must be comparable to similar arrangements entered into by persons in an arm's length transaction.

The use of a fixed price would not seem to pass muster, unless it was established by an independent appraiser and re-evaluated regularly. Valuation formulas are likely to be the predominant measuring device. The "Comparability Rule" suggests greater reliance will be

placed upon comparison prices and earnings ratios of similar businesses. A number of “Business Valuation” computer programs on the market today should be of great assistance. Professional business appraisers will be used in many cases and have been referred to in the specimen agreement provided herein.

The importance of avoiding costly IRS battles over business valuation is illustrated by a few of the Tax Court contested cases:

VALUE PER SHARE				
CASE	TIME	ESTATE	IRS	COURT
<u>Marjorie Brush</u> , 22 T.C.M. 900 (1963)	3 Yrs	\$ 3	\$ 7	\$ 6
<u>Harry Leyman</u> , 40 T.C. 2369 (1963)	9 Yrs	\$195	\$850	\$630
<u>Barbara Thompson</u> , 18 T.C.M. 801 (1959)	8 Yrs	\$225	\$535	\$284

### ALTERNATIVE VALUATION APPROACHES

Recognizing that no one method best fixes a purchase price, we have listed below several often used alternative valuation methods.

#### **ADJUSTED BOOK VALUE:**

Though the term “Book Value” has in the past been more frequently used, we submit that the term “Adjusted Book Value” should be adopted. “Book Value” is simply all assets less all liabilities as carried on the Corporation books. The difference is that the Corporation’s Independent Appraiser would be required to adjust assets that have been highly depreciated (or carried at low values) to current market values. The American Institute Of Accountants has recommended the use of the term “Adjusted Book Value” and its corresponding adjustments with the abandonment of the “Book Value” method. The latter term has likewise had wide and disparate interpretations by various courts. Hence, the meaning the parties and draftsman intended may not be that finally applied. (Aron v. Gillman, 309 N.Y. 157 (1955).)

It is unlikely that IRS would accept this valuation alone, except under unique circumstances. If “Goodwill” and “Earning Capacity exist, a formula value should be added to Adjusted Book Value.

#### **CAPITALIZED EARNINGS:**

Another valuation method used often for operating companies and service businesses is the “Capitalized Earnings Method”. This approach centers about the firm’s earning ability as reflected by the “Profit and Loss Statement” (adjusted for unusual or non-recurring losses of profits in a particular year). It is akin to the “price/earnings” ratios the IRS is fond of applying in valuation of close corporations. Theoretically, the firm’s earnings are compared to publicly-traded businesses of similar nature and scope and an average price/earnings ratio or

factor is determined. The resulting factor is then multiplied times the firm's average net after tax earnings to arrive at market value.

Typically, a capitalization factor will vary from 5 (for highly-speculative or competitive businesses) to 15 (for businesses with very safe, stable earnings history). Generally, a factor of 10 might be said to be typical of most businesses.

The Agreement "Valuation" clause might then read:

The value of the Corporation shall be determined as follows:

"The Corporation's CPA shall determine the last five-year, average net after tax earnings of the Corporation, up to and including the year of death, disability or retirement of the Stockholder. The resulting sum shall then be multiplied by a capitalization factor of 10. The above-determined amount shall control for all purchase and sale obligations under this Agreement."

#### **GOODWILL CAPITALIZATION FORMULA (A.R.M. 34):**

This formula method is essentially a melding of the two former valuation techniques. That is, the firm's Book Value (again, "Adjusted Book Value" is recommended) is determined. To this "Adjusted Book Value", a value for "Goodwill" is added. In this sense, the term "Goodwill" has been historically used synonymously with "Earning Capacity". Hence, under this formula, a value for Goodwill is determined by capitalizing any business earnings in excess of a reasonable return on Adjusted Book Value to obtain the total, estimated market value. This method would seem appropriate where capital is a material income-producing source.

The original ARM-34 Ruling (2 CB 31), suggested an eight percent (8%) assumed yield on net tangible assets and a multiplier of six (6) for a company with average, cyclical earnings. For speculative earnings, a yield of 10% might be used and a multiplier of 6.6. The steps in "Goodwill Capitalization" then are:

1. Determine Adjusted Book Value;
2. Calculate a fair return on Adjusted Book Value. (i.e., 8% to 10%);
3. Multiply firm's excess earnings over "fair return", as above, by the appropriate capitalization factor. This resulting figure is the presumed "Goodwill Value";
4. Add "Goodwill Value" back to Adjusted Book Value.

The Agreement "Valuation" language to reflect this option might be stated as follows:

"The Corporation's Independent Appraiser shall determine the Adjusted Book Value of the Corporation effective at the end of the month just preceding the death, disability or retirement of the Stockholder. The CPA shall likewise compute the five-year, average after-tax earnings of the Corporation up to and including the year in which Stockholder dies, becomes disabled or retires. Corporation earnings in excess of 8% of Adjusted Book Value shall be multiplied by a factor of 6. The resulting product shall be added to

Adjusted Book Value as earlier-determined and the resulting sum shall be determinative of Corporation value for purposes of this Agreement.”

Although the Service downgrades this formula approach in non-buy-sell, estate tax contests (Rev. Rul. 65-192; Rev. Rul. 68-609), the Tax Court has repeatedly accepted the formula when no better evidence was presented.

### **INCOME TAX TREATMENT TO THE SURVIVING STOCKHOLDERS AND TO THE DECEASED’S ESTATE AND HEIRS:**

With respect to the Surviving Stockholders, under a traditional Corporate Stock Redemption the survivors receive no “step-up” in basis equal to the purchase price in the Agreement. However, under the “short tax year election” described in the Preface, the Surviving Stockholders actually receive a full step-up in basis equal to the insurance proceeds by virtue of S Corporation taxation of life insurance proceeds.

On the other hand, if the business is sold upon the Stockholder’s Disability, Withdrawal or Retirement, the retiring or withdrawing Stockholder should, after TRA ‘86, be entitled to spread his/her tax on gain using Installment Sales Tax Rules (with the benefit of the 28% long term capital gains tax rate), where at least one payment is received after the close of his/her taxable year. (IRC Sec. 453.)

The deceased Stockholder’s estate and heirs receive a “step-up” in basis equal to the purchase price no matter which buy-sell approach is selected. (IRC Sec. 1014 (a).) Thus, there is no income tax implication to the estate or heirs upon receipt of the insurance proceeds under either buy-sell arrangement. (Absent incomplete redemption and family attribution problems under the Stock Redemption arrangement.)

A stock redemption plan for an S corporation that uses accrual accounting would use the same stock redemption agreement appropriate for a C corporation. For S corporation stock redemption agreements, see the various Stock Redemption Buy-Sell specimen document sets (not designated for S corporations) located in the Business Buy-Sell Plans section of InsMark’s Documents On A Disk® and Documents On The Net™ Systems (Versions 20.0 and higher).

An S Corporation that uses cash basis accounting receives unique taxation of life insurance death proceeds in that the pure death protection of the policy proceeds received by the S Corporation automatically increases the basis of each Stockholder proportionate to his/her basis in the corporation -- including shares owned by the deceased Stockholder’s estate. Thus, a Stock Redemption plan for a cash basis S Corporation funded with life insurance is particularly efficient. See the S Corporation Stock Redemption Buy-Sell specimen document set located in the Business Buy-Sell Plans section of InsMark’s Documents On A Disk® and Documents On The Net™ Systems (Versions 20.0 and higher).

Even though the short tax year election is not useful to an S corporation that uses accrual accounting, unlike a C corporation, there is still a partial step-up in basis for the surviving S corporation shareholders when the insurance proceeds accrue to the benefit of the S corporation

at the insured's death. This is based upon the surviving shareholders' percentage ownership in the business.

### **OPTION TO PURCHASE LIFE POLICY ESTATE TAX IMPLICATIONS:**

This Specimen Agreement grants the Stockholder a 30-day option to purchase the life insurance policy on his/her own life from the Corporation or from his/her co-Stockholders upon termination of the Agreement.

Is this option tantamount to an Incidents Of Ownership under IRC Sec. 2042 and could it cause the proceeds to be included in the Stockholder's Estate? The IRS, in a rather questionable ruling, indicated such right was an Incidents Of Ownership. (Rev. Rul. 79-46.) The author does not believe the option granted to the Insured Stockholder under this Specimen Agreement should generate this adverse Estate Tax result, for the following reasons:

1. The Tax Court, in Est. Of John Smith v. Comm. 73 TC 307 (1979), held such a policy contingent purchase option did not constitute such an "Incidents Of Ownership". The IRS subsequently acquiesced in result only. (1981-CB 2.)
2. The option granted the Insured in this Specimen Agreement is limited in time (i.e., 30-days).
3. Other courts have reached similar conclusions as the Tax Court did in Smith:  
Est. Of John Morrow, 19 TC 1068 (1953);  
Est. Of Howard Infante, TC Memo 1970-206;  
Est. Of Anders Jordahl, 65 TC 92 (1975).
4. IRS ruled in 1980 that a Stockholder's right under a stock redemption Agreement to purchase the policy upon his/her life, if he/she ceased being a Stockholder, was likewise not an Incidents Of Ownership. (PLR 8049002.)

Thus, it is submitted that a 30-day Option in the Agreement to purchase life insurance upon one's life from the owner thereof is not tantamount to a right to "prevent cancellation of the insurance policy" as suggested in Rev. Rul. 79-46. Hence, such option should not be construed as an Incidents Of Ownership under IRC Sec. 2042. Nevertheless, the final responsibility for the inclusion of such a purchase option must lie with client's counsel and the ultimate draftsman.