Implementing Closely Held Company Buy/Sell Agreements for Operational and Taxation Purposes

Robert F. Reilly, CPA

Valuation analysts ("analysts") often work with legal counsel and tax advisers to design and implement buy/sell agreements for closely held companies. These buy/sell agreements are intended to achieve several operational and taxation objectives—both for the company owners and for the private company itself. This discussion summarizes typical buy/sell agreement structures, ownership transfer funding mechanisms, ownership transferability restrictions, valuation and pricing provisions, and transfer tax planning and compliance considerations.

Introduction

Many closely held companies implement buy/sell agreements with their equity holders. These companies implement buy/sell agreements with the company owners for both operational purposes and taxation purposes.

For purposes of this discussion, the typical operational purposes of a closely held buy/sell agreement are to ensure that:

1. only qualifying parties become—and remain—owners in the closely held company and
2. there are liquidity provisions in place to redeem the ownership interests of those parties who do not qualify as (or who cease to qualify as) company owners.

These operational reasons for implementing the closely held company's buy/sell agreement are sometimes also referred to as administrative reasons or as legal reasons.

For purposes of this discussion, the typical taxation purposes for implementing a buy/sell agreement include the company owner's planning and compliance related to gift tax, estate tax, and generation-skipping transfer ("GST") tax.

This discussion focuses primarily on buy/sell agreements related to closely held tax pass-through entities, including S corporations, partnerships, and limited liability companies ("LLCs"). However, many of the taxation, operational, and valuation issues considered in this discussion also apply to closely held C corporations.

As explained in this discussion, the design and implementation of a closely held company buy/sell agreement involves legal, taxation, and valuation considerations. Therefore, legal counsel, taxation advisers, and valuation specialists often work together in the design and implementation of the buy/sell agreement. These legal, taxation, and valuation professionals may be retained by the individual company owners and/or by the closely held company itself.

First, this discussion summarizes the two primary types of closely held company buy/sell agreements:

1. Cross-purchase agreements
2. Redemption agreements.

This discussion describes the typical ways in which these two types of buy/sell agreements fund the redemption of the company owner's equity interests.

Second, this discussion explains many of the reasons why a closely held company would implement a buy/sell agreement. In particular, this discussion focuses on the taxation planning, compliance, and controversy considerations with regard to closely held company buy/sell agreements.

Third, this discussion focuses on the business and security valuation provisions of the typical closely held company buy/sell agreement. In particular, this portion of the discussion considers the rules and the limitations related to the company owner's reliance on buy/sell agreement valuation formulas for estate tax planning and compliance purposes.

Finally, this discussion uses the term closely held company instead of private company. This discussion assumes that companies that implement buy/sell agreements will not be publicly traded. That is, these companies will be private companies.

In addition, this discussion assumes that, in addition to being private companies, most companies that implement buy/sell agreements are closely held. That is, they have a limited number of equity holders.

It is possible that a large private company may not be closely held. That is, a large private company may have 100 or more equity holders, and these equity holders may not be employees or otherwise directly associated with the private company. Such a private company may still have a redemption-type buy/sell agreement.

But most companies with cross-purchase type buy/sell agreements have 10 or fewer equity holders; and those equity holders are typically current or former employees. It is this latter category of private companies that is the focus of this discussion.

Types of Buy/Sell Agreements

Closely held company buy/sell agreements are typically structured as either cross-purchase agreements or redemption agreements.

The principal objectives of both types of agreement structures are as follows:

1. To restrict the closely held company ownership to intended parties
2. To provide for the liquidity needed for an intended buyer to purchase the company securities from the intended seller at the time of a specified event that triggers such a sale transaction

Although not considered to be the principal objectives of a buy/sell agreement, the agreement will typically specify the following information:

1. Who can be—and who cannot be—a company owner and what events trigger an optional or a mandatory securities transfer transaction
2. A valuation or other pricing formula (or an appraisal procedure mechanism) to determine the price at which the company ownership transfer will take place

Cross-Purchase Buy/Sell Agreements

A cross-purchase agreement is a buy/sell agreement between the individual owners of the closely held company. In the typical funded cross-purchase agreement, each individual company owner purchases a life insurance policy on the life of each other individual owner.

When one company owner dies, the life insurance proceeds are paid to the owner who purchased the insurance policy. The policy owner then uses the insurance proceeds to buy the closely held securities from the estate of the deceased company owner.

Obviously, the use of cross-purchase agreements becomes cumbersome when there are more than a handful of company owners. In addition, the cost of the cross-purchase agreements is often shared disproportionately among the company owners. This cost disparity occurs when (1) some of the company owners are young and in good health—and the life insurance premiums are very low and (2) some other company owners are old and in poor health—and the life insurance premiums are quite high.

There is at least one taxation advantage of the cross-purchase agreement structure. Typically, the buying company owners increase the basis in the closely held company securities by the amount of the money (i.e., the insurance proceeds) that they paid for the transferred equity interest.

However, there are practical problems with the use of the cross-purchase agreement structure—

particularly if there is a larger number of company owners. This agreement structure only works if each company owner has the personal financial resources to pay the insurance policy premiums (and to maintain any cash value in the policies).

Regarding the policy's cash surrender value, such value becomes part of the company owner's bankruptcy estate in the event the owner files for bankruptcy protection. Such a bankruptcy filing could create a problem when it is time to collect on the life insurance policy.

Redemption Buy/Sell Agreements

A redemption agreement is a buy/sell agreement between the various company owners and the closely held company itself. Redemption agreements typically provide that when the company owner dies, the company will buy (redeem) the securities from the decedent company owner's estate.

A redemption agreement may also be structured so that the company itself redeems the company owner's equity interest when the owner becomes disabled, retires, or otherwise leaves the employment of the company.

Redemption agreements can be funded by life insurance policies on the lives of the company owners. The company owns the policies, and the company pays the premiums on the policies. The company uses the insurance policy proceeds to buy the decedent's securities. Alternatively, the closely held company could pay for the stock redemptions out of the general financial resources of the company.

The redemption agreement structure is obviously more practical to administer when the closely held company has more than a handful of owners.

Funding the Security Purchase Transaction

Particularly with regard to cross-purchase agreements, the life insurance policy proceeds provide the funding to purchase the decedent's ownership interest. The life insurance proceeds provide the cash needed to complete the security purchase transaction.

Practically, such insurance policies are a necessary mechanism to ensure that the remaining company owners have the ready cash available to buy the decedent's interest according to the terms of the buy/sell agreement.

The company and the company owners should periodically review the valuation provisions of the buy/sell agreement. In other words, the current owners should periodically test what the agreement buy/sell price is based on the company's current financial fundamentals. That way, the company owners can assess whether they own a sufficient amount of life insurance on each other in order to fund a securities purchase based on the current buy/sell agreement valuation-based price.

If the company owners do not currently own sufficient life insurance policies to fund a current value-based transaction, they should consider buying additional insurance. If such additional insurance is prohibitively expensive, or if some of the company owners are no longer insurable, the company should consider amending the buy/sell agreement.

For example, the agreement could be amended to allow the remaining owners to buy the decedent's securities both (1) with the life insurance proceeds and (2) with notes payable to the decedent's estate (to make up for any purchase price payment shortfall). Of course, the buy/sell agreement has to include a provision that allows for a securities purchase that is financed over time.

When the life insurance proceeds do not provide sufficient liquidity to fund the buy/sell agreement current valuation, the shortfall can be "paid" by promissory notes payable over an extended period of time. Typically, such promissory notes are personally guaranteed by the remaining owners and are secured by the personal assets of the remaining owners.

Such a buy/sell agreement amendment may eliminate the need for the company owners to purchase additional insurance on the lives of older (or unhealthy) fellow owners. However, this amendment (to allow long-term notes) increases the risk of the buy/sell securities transfer transaction both to the decedent owner's estate and to the remaining company owners.

Reasons Why a Closely Held Company May Implement a Buy/Sell Agreement

Of course, the buy/sell agreement valuation provisions can be applied to value the closely held company securities when the company owner dies, retires, becomes disabled, gets divorced, or otherwise triggers a voluntary or a mandatory sale transaction event.

As mentioned above, there are both operational/administrative reasons and taxation reasons why the closely held company owners may enter into a buy/sell agreement.

Some of the reasons why the company (and the company owners) may implement a buy/sell agreement include the following:

1. The agreement allows for a continuity of the company business operations at the time of an owner's employment termination, disability, or death.
2. The agreement liquidity provision creates a market (i.e., a liquidity event) for an ownership interest that may otherwise be nonmarketable.
3. The agreement transferability restrictions prevent the securities from being owned by unwanted investors (e.g., the new husband of the founder's divorced wife).
4. The agreement funding mechanisms (e.g., life insurance proceeds, note payable provisions, etc.) plan for the amount of cash or financing necessary to pay for the ownership interest transfer.
5. The agreement may provide that only family members who are active in the private company can be equity holders—while other family members receive wealth from selling any company securities received through a gift or bequest.
6. The contractual provisions regarding business valuation, ownership restrictions, and transferability restrictions are intended to minimize conflicts among family members (and between family members and the company)—particularly at a time when the company founders may no longer be around to arbitrate such disputes.

Typical Buy/Sell Agreement Provisions

The buy/sell agreement is a contract between either (1) the various company owners or (2) the various company owners and the private company itself. The contract calls for a private sale of (or for an offer to sell) the company securities at certain specified triggering events. The contract provides for the sale (or for the offer to sell) to be priced based on either (1) a valuation formula or (2) another appraisal mechanism.

The transaction triggering events often include the company owner's death, disability, or termination of employment with the company. The triggering events may include the company owner's filing for divorce or filing for bankruptcy protection.

Typical Buy/Sell Agreement Pricing Mechanisms

The buy/sell agreement typically specifies a pricing provision for the transfer of the ownership interest. The pricing provision could be one of the following:

1. An accounting-based formula
2. A valuation-based formula
3. An appraisal process

The reference to an accounting-based formula means that the agreement provides for a price that can be calculated based on the company's financial statements. Typical examples of an accounting-based formula include a per-share or per-unit price based on one of the following:

1. Balance sheet net book value
2. Balance sheet tangible net book value
3. A price discount to net book value (e.g., 75 percent of book value)
4. A price premium to net book value (e.g., 125 percent of book value)

Applying such an accounting-based formula, the agreement should specify the time period for the financial statement measurement (e.g., the latest month-end, the latest fiscal-quarter-end, the latest fiscal year-end). The agreement should specify whether the financial statement should be adjusted or normalized in any way.

And, the agreement should specify whether the financial statement should be audited or prepared in accordance with U.S. generally accepted accounting principles or prepared in accordance with any other accounting standards.

The reference to a valuation-based formula means that the agreement provides for a price that can be calculated based on a formula or an equation that is intended to approximate a current value.

Typical examples of a valuation-based formula or equation include a per-share or per-unit price based on one of the following:

1. A stated pricing multiple times the company's net income
2. A stated pricing multiple times the company's earnings before interest, taxes, depreciation, and amortization ("EBITDA")

3. A stated pricing multiple times the company's revenue

Applying such a valuation-based formula, the agreement should specify the pricing multiple (and any procedure for updating the pricing multiple for changes in market conditions). The agreement should specify what time period over which the financial fundamental should be calculated (e.g., the latest 12-month period, the latest fiscal year-end, the average of the last three fiscal years).

The agreement should specify any provisions for normalizing the company's historical financial results for any extraordinary or nonrecurring item.

And, the agreement should specify whether the company financial statements need to be audited, prepared in accordance with U.S. generally accepted accounting principles, or prepared in accordance with any other accounting standards.

The reference to an appraisal process means that the agreement provides instructions for a price to be determined by an independent valuation professional. The work product of the valuation professional should be intended to reflect a current value for the subject ownership interest. The agreement should provide instructions as to whether the valuation specialist should:

1. be a specific professional service provider—for example, a named accounting firm, valuation firm, or investment banking firm;
2. be a particular type of professional services provider—for example, an unnamed "nationally recognized" accounting firm, valuation firm, or investment banking firm;
3. possess specific professional credentials—for example, a certified public accountant, a chartered financial analyst;
4. comply with specific professional standards—for example, the *Uniform Standards of Professional Appraisal Practice*, the American Institute of Certified Public Accountants professional standards.

Applying such an appraisal-process-based provision, the agreement should specify the appropriate valuation date, the appropriate standard (or definition) of value, the appropriate premise of value. The agreement should provide any specific instructions that the contract counterparties want the valuation analyst to follow. For example, the agreement may specify whether or not the analyst should consider any per-share or per-unit valuation discounts or valuation premiums.

In addition, the agreement should specify the type of work product that the valuation analyst is expected to deliver. For example, do the contract counterparties want a value opinion (or letter) report only? Or, do the contract counterparties require a comprehensive narrative valuation report?

In addition to the operational reasons for the buy/sell agreement, closely held company owners often consider the taxation reasons for implementing buy/sell agreements. These taxation considerations include estate planning, estate tax compliance, and estate tax controversies. The estate tax controversies often relate to the valuation considerations related to the buy/sell agreements (i.e., the value of the company ownership interest in the decedent's estate).

Particularly with regard to per-share or per-unit valuation issues, the estate tax controversies often revolve around the valuation impact of the buy/sell agreement transferability restrictions. Therefore, the following discussion focusses on buy/sell agreement ownership interest transferability restrictions—and particularly how such restrictions affect estate tax valuations.

Buy/Sell Agreement Transferability Restrictions

As mentioned above, one of the typical operational purposes of the buy/sell agreement is to restrict the company owner's ability to transfer the closely held company ownership interest. In particular, the agreement is intended to restrict the company owner's ability to transfer the company securities to unwanted owners.

This objective is contractually accomplished by limiting the circumstances during which the company owner can dispose of the ownership interest. In fact, the buy/sell agreement may also limit the parties to whom the company owner can transfer the subject securities.

That is, the buy/sell agreement may create a limited market (under specified circumstances) for the sale of otherwise nonmarketable securities.

However, that same buy/sell agreement may dictate (1) under what circumstances the company owner may transfer the subject securities and (2) to whom the company owner may transfer the subject securities.

Depending on the terms of the buy/sell agreement, it may be possible for a mandatory transfer or a voluntary transfer on the occasion of a triggering event. That is, when the triggering event occurs, the agreement may:

1. require the remaining owners—or the company itself—to buy the company owner's securities (such an agreement provides for a mandatory purchase of the company securities) or
2. allow the remaining owners—or the company itself—to buy the company owner's securities (such an agreement provides for a right of first refusal to purchase the company securities).

Based on the contractual requirements or restrictions related to the agreement ownership interest transfers, such a buy/sell agreement often influences the valuation of the company owner's equity securities for transfer tax purposes.

It should be noted, however, that an agreement that values the closely held company securities at a fixed price, set when the agreement was first created, will be ignored for transfer price purposes. See, for example, *Bommer Revocable Trust*, T.C. Memo. 1997-380.

It should also be noted that the Internal Revenue Service ("Service") may determine that the buy/sell agreement is actually a device to transfer the company owner's securities to family members for less than full and fair consideration. In that case, the Service may redetermine the value (i.e., ignore the buy/sell agreement-determined value) for transfer tax purposes. For purposes of this discussion, the term transfer tax includes gift tax, estate tax, and GST tax.

The Service may also challenge a buy/sell-agreement-determined value when it determines that the company owner decedent was attempting to transfer the securities for less than full consideration to a nonfamily member. The Service may consider such a transfer to be a disguised gift. See, for example, *Gloeckner*, 152 F.3rd 208 (2nd Cir. 1998).

Internal Revenue Code Section 2703 Requirements

Internal Revenue Code Section 2703 provides the general requirements regarding the valuation of property for transfer tax purposes.

Section 2703(a) provides that the value of a closely held company (or security) is to be determined without regard to:

1. any option, agreement, or other right to acquire or use the ownership interest at a price less than fair market value or
2. any restriction on the right to sell or use the ownership interest.

Exceptions to the Section 2703 General Rule

The general requirements of Section 2703 may not apply if certain conditions are met. The agreement counterparties should carefully adhere to these requirements if the buy/sell agreement is to be used to value the closely held company or securities for transfer tax purposes.

According to Section 2703(b), the Section 2703 general rule does not apply to any option, agreement, right, or restriction that meets all of the following requirements:

- It is a bona fide business arrangement.
- It is not a device to transfer the ownership interest to members of the decedent's family for less than full and adequate consideration.
- Its terms are comparable to similar business arrangements entered into by persons engaged in arm's-length transactions.

It is noteworthy that the company owner's unilateral ability to modify the buy/sell agreement renders it ineffective for purposes of determining the fair market value of the closely held company. See, for example, *Estate of Blount*, T.C. Memo. 2004-116, aff'd, 428 F3d 1338 (11th Cir. 2005). Therefore, the agreement counterparties should carefully consider any proposed modification to the buy/sell agreement before such a change is formally adopted.

Regulation 25.2703-1(b)(3) provides that all of these requirements are met if more than 50 percent of the fair market value of the closely held company subject to restriction is owned—directly or indirectly—by individuals who are not members of the transferor's family.

This regulation only applies if the business interests owned by the nonfamily member owners are subject to the same restrictions as the business interests owned by the decedent company owner.

For purposes of this regulation, members of the decedent's family include the decedent's spouse, ancestors of the decedent or the decedent's spouse, and any other individual who is a natural object of the decedent's bounty.

The regulations do not specify who is a natural object of the decedent's bounty. For example, it is unclear whether siblings and cousins automatically fall within this category.

The determination of "natural object" is based on the relevant facts and circumstances. In general, a long-term personal friend will likely be treated as an unrelated person.

To illustrate this regulation, let's assume that CHC, Inc., is an S corporation. The three founders—Alpha, Beta, and Gamma—each own one-third of the shares of this closely held company.

Let's assume that the three company owners enter into a buy/sell agreement requiring the remaining two owners to buy the ownership interest of a shareholder who retires or dies. The amount paid for the retiring or deceased shareholder's interest is based on a valuation-based capitalized EBITDA formula.

Let's assume that Alpha dies and leaves his shares in the closely held company to his son, Delta. Because more than 50 percent of the closely held company is owned by unrelated individuals, all three requirements under the exception to Section 2703 are considered to be satisfied. Therefore, the fair market value of the decedent's shares in CHC, Inc., can be determined based on the terms of the buy/sell agreement.

As another illustrative example, let's consider Close, LLC. Close, LLC, also has three equal equity holders. The three LLC members are also the three company founders. However, let's assume that Zeta and Eta, two of the LLC members, are sisters.

Let's assume that Zeta passes away and leaves her Close, LLC, units to her children. Based on this set of illustrative facts, the buy/sell agreement will have to meet each of the three Section 2703(b) tests in order for the valuation-based formula in the agreement to determine the estate tax value of the decedent's ownership interest.

That is, with regard to the Close, LLC fact set, the company's buy/sell agreement must:

1. be a bona fide business arrangement,
2. not be a device to transfer the ownership interest to members of the decedent's family for less than fair market value, and
3. provide terms that are comparable to business arrangements entered into by persons engaged in arm's-length transactions.

Satisfying the Section 2703(b) Provisions—the Bona Fide Business Arrangement Provision

Both the statutory language and the Treasury regulations are silent as to the specifics of this Section 2703(b) requirement. It appears that the Section 2703(b) requirement will be met if the taxpayer can show that the purpose of the buy/sell agreement was to maintain a continuity of company management and of family ownership control. See, for example, *Estate of Lauder*, T.C. Memo. 1992-736.

The operational and administrative reasons for executing the closely held company's buy/sell agreement should be well documented. For example, these may be written correspondence between the company owners (or between the company itself) and the company owner's (or the company's) legal or tax advisers.

There are instances where the U.S. Tax Court has held that planning for the future liquidity needs of the company owner decedent's estate is considered to be a bona fide business purpose. See, for example, *Estate of Amlie*, T.C. Memo. 2006-76).

However, the Tax Court (affirmed by the Eighth Circuit) has also held that a closely held company that simply owned marketable securities was *not* a bona fide business arrangement. See, for example, *Holman*, 130 T.C. 170 (2008), *aff'd*, 601 F.3d 763 (8th Cir. 2010).

The Not a Device to Transfer the Securities for Less than Full Consideration Provision

This Section 2703(b) requirement is often simply referred to as the nondevice test. The purpose of this statutory provision is to ensure that the buy/sell agreement is not simply a device to reduce the estate tax value of the closely held company securities. However, neither the statute nor the regulations provide guidance on the specifics of this Section 2703(b) requirement.

In *Estate of Lauder*, however, the U.S. Tax Court provided insight into how this test may be applied. In the *Estate of Lauder* decision, the Tax Court concluded that a buy/sell agreement would be merely a device to reduce estate taxes when:

1. testamentary considerations had influenced the agreement counterparties and
2. the valuation-based formula in the buy/sell agreement did not reflect full and adequate consideration—because it did not set a fair price for the subject ownership interest.

In the *Estate of Lauder* decision, the agreement's valuation-based formula was an adjusted book value formula. The Tax Court concluded that such a valuation formula was arbitrary in nature. Because that buy/sell agreement did not pass the nondevice test, the terms of that agreement did not control the estate tax value of the decedent Joseph Lauder's ownership interest.

When creating a closely held company buy/sell agreement, the company owner—or the company itself—should consider retaining an independent valuation specialist to verify that the valuation formula selected actually concludes the fair market value of the subject ownership interest.

A valuation formula developed by a professional valuation specialist may be more readily accepted by the Service than a valuation formula based on accounting book value or some other arbitrarily determined factor.

The Terms Are Comparable to Third-Party Arrangement Provisions

According to Regulation 25.2703(1)(b)(4), a buy/sell agreement is considered to be comparable to similar arm's-length business arrangements if the agreement is one that could be obtained in a fair bargain among unrelated parties, who are dealing with each other at arm's length.

A buy/sell agreement is generally considered to be a fair bargain if it conforms to the general practice of unrelated parties under negotiated agreements in the same business. Buy/sell agreement contractual terms that mirror any state law default provisions may also help prove that the subject agreement is comparable or at arm's length.

Some of the factors that the company owners may consider in assessing whether the subject buy/sell agreement compares to the fair-bargain standard include the following:

- The expected term of the buy/sell agreement
- The company's current fair market value
- Any anticipated changes in the company's fair market value during the term of the buy/sell agreement
- The adequacy of any consideration given in exchange for the contractual rights granted in the buy/sell agreement

In determining whether the subject buy/sell agreement is comparable to third-party business arrangements, the agreement should follow the general business practices of the relevant industry.

The following guidelines may help to assess whether the agreement follows general business practices:

- Isolated comparable agreements may not be sufficient to establish general business practices.
- If more than one valuation formula or methodology is typically applied in the relevant industry, the buy/sell agreement may not fail the general business practices requirement simply because it only applied one valuation method.
- It is not necessary that the terms of the subject buy/sell agreement parallel the terms of any one particular comparable buy/sell agreement.
- If comparable buy/sell agreements are difficult to find because the subject business is unique, then comparable agreements from similar businesses may be used.

As a practical matter, the company owners (or the company itself) may obtain an expert's opinion as to whether the subject buy/sell agreement is considered to be comparable to the relevant industry standards. The company owner decedent bears the burden of proving that the subject buy/sell agreement meets this Section 2703(b) requirement.

As an additional consideration, it is possible that the actual buy/sell agreement may set a formula purchase price for the company owner decedent's ownership interest that results in a price less than the value ultimately allowed by the Service for estate tax purposes.

This situation may occur because the Section 2703 requirements were not met. In that case, the heirs will receive the lower price for the decedent's ownership interest under the by/sell agreement, even though the estate tax value may be based on the higher value.

Provisions for Grandfathered Buy/Sell Agreements

The Section 2703 provisions do not apply to any buy/sell agreement that was entered into prior to October 9, 1990. Such a "grandfathered" buy/sell agreement may not be substantially modified after that date. This "grandfathering" provision is provided for in Regulation 25.2703-2.

The Service has ruled that changes to the quality, value, or timing of the agreement counterparties' rights for pre-October 9, 1990, agreements were *de minimis* and were not considered substantial modifications. See, for example, IRS Letter Rulings 9652009, 9652010, and 9711017.

The Service has also ruled that clarifying the provisions to buy/sell agreements may not be considered substantial modifications. See, for example, IRS Letter Ruling 200625011.

Summary of Tax-Related Agreement provisions

The agreement counterparties (or the company itself) should consider including the following provisions (either in the buy/sell agreement or in the company's shareholder or partnership or operating agreement) when implementing a buy/sell agreement:

- Establish a predetermined valuation-based formula or methodology.
- Identify the method of—and the source of—the funding for the securities sale, such as cash, life insurance proceeds, or an installment note.
- Require an interim closing of the company's books in order to allocate any items of income and loss to the company owner who disposes of his or her entire interest in the closely held company.
- Require minimum distributions to all company owners in an amount equivalent to the income tax payable on each owner's distributive share of the pass-through entity's income or gain (this provision is particularly beneficial to the pass-through entity's minority ownership interest holders).
- For an LLC or a partnership, require that the entity consider a Section 754 election—however, this election may not be appropriate if the value of the tax pass-through entity's assets has decreased (or is likely to decrease in the future).
- For an LLC or a partnership, address when or whether a third-party purchaser can become a partner/member—instead of an assignee.

Summary and Conclusion

Closely held companies often implement a buy/sell agreement among the company owners both (1) for operational (or administrative) reasons and (2) for taxation reasons. This discussion summarized both types of reasons for implementing the closely held company buy/sell agreement. With regard to the taxation reasons, this discussion focused on closely held tax pass-through entities.

This discussion considered the two principal types of buy/sell agreements: (1) cross-purchase agreements and (2) redemption agreements. This discussion considered the various events that may trigger the sale of the company owner's equity interest under the buy/sell agreement.

This discussion summarized various considerations related to funding the buy/sell agreement securities sale transaction. And, this discussion described typical business or security pricing and valuation provisions within the context of the buy/sell agreement.

Finally, this discussion considered the influence of buy/sell agreement valuation provisions with regard to valuing the company owner's interests for transfer tax purposes. This discussion included both statutory provisions and practical guidelines related to the reliance on the buy/sell agreements valuation provision—particularly with regard to estate tax planning and estate tax compliance.

In the design and implementation of any buy/sell agreement, the closely held company owners (and the company itself) should consult with legal counsel, tax advisers, and valuation specialists. These professionals typically work together to create a buy/sell agreement that will achieve administrative objectives and taxation objectives—both for the closely held company and for the company owners.

Robert Reilly is a managing director of the firm and located in the Chicago practice office. Robert can be reached at (773) 399-4318 or at rfreilly@willamette.com.