Minnesota Law Review

1952

Estate Planning and the Sole Proprietor

Leonard M. Strickler

ESTATE PLANNING AND THE SOLE PROPRIETOR

LEONARD M. STRICKLER*

THE purpose of this article is to consider some of the estate planning problems presented by the sole proprietor.[1] The importance in the nation's economic structure of the sole proprietorship becomes obvious when it is realized that of the four million nonfarming business in the United States today, approximately seventy per cent are sole proprietorships.[2]

An extremely vexatious problem facing the estate planner is that of effectively planning the estate of the person whose assets consist primarily of closely-held business interests. The sole proprietor presents the most difficult facet of that problem. Nowhere is the need for intelligent estate planning more necessary than it is in the case of the sole proprietor and nowhere have the death problems been more neglected.

THE LIQUIDATION PROBLEM

Because the sole proprietorship enjoys no legal entity apart from the proprietor, his death terminates the business. His representative has no inherent authority to continue the proprietorship.[3] Upon his death his personal representative is charged with collecting and, in the normal case, with liquidating his assets, satisfying the creditors, and distributing the remaining proceeds according to the dictates of his will or the intestacy statutes. As far as the law is concerned, business assets and liabilities are commingled with and indistinguishable from his personal assets and liabilities.

Forced liquidation of a going business is an unnecessary tragedy. The termination of the business impairs the general economy, leaves loyal employees—deserving a better fate—jobless and, of course, interrupts family income from the business. But, the greatest evil of forced liquidation is that it results in startling estate shrinkage.

Forced liquidation is synonymous with distress prices. Forced

*Member of Minnesota and New York Bars; Lecturer, University of Minnesota Law School.

1. For an excellent and comprehensive discussion of the problems considered in this article, see White, Business Insurance (1949).
2. Small Business Aids No. 481, Dep't of Commerce (March, 1949).
3. 1 Restatement, Trusts § 230, Comment *m* (1935); 2 Scott, The Law of Trusts § 230.4 (1939); 3 Bogert, The Law of Trusts and Trustees § 571 (1946); Holmes, *Business Interests in Estates*, 77 Trusts and Estates 555 (1943); Adelman, *The Power to Carry on the Business of a Decedent*, 36 Mich. L. Rev. 185 (1937); Jacob, *Trusts for Continuing a Decedent's Business*, 18 Iowa L. Rev. 43 (1932).

liquidation and severe, crippling losses lie in the same bed. Forced liquidation is a coerced sale of used goods in a buyer's market. Fixtures often must be thrown in with inventories.[4] Creditors, feeling insecure, press for payment; accounts receivable frequently must be compromised.[5] Even more important, the often valuable intangible assets, such as good will and good credit standing, have absolutely *no* liquidation value. Good will, as a practical matter, could well approach in value or exceed that of the tangible assets. It is a recognized fact that the personal representative who must convert the business assets into money within a reasonable time after his appointment can, in the general case, anticipate collecting but forty to fifty per cent of the date of death value.[6]

Liquidation evils can be obviated to some extent if the representative is fortunate enough to find someone who will buy the business as a "going concern." If so, the estate will, in all probability, realize something on the intangible assets. However, the prospective purchaser of a decedent's proprietorship is a wary animal. He is suspicious that the personal representative, as seller, is exaggerating the profit history and hiding the liabilities. Further, and more important, he fears that the decedent was such a key man in the operation of the business that the business cannot survive his loss. He knows the representative must sell and therefore will keep his offering price low. Frequently, unless the business enjoys manifest good will, selling a decedent's business as a "going concern" only accomplishes liquidation in bulk, and the result is not much better than the results collectively of piecemeal liquidation.

Many methods are used by representatives and proprietors to avoid these liquidation evils. These plans will be considered in four main groups: (1) improvisations by the personal representative

4. The Central West Distributors' Adjustment Bureau has said, "These items, which usually must be disposed of through second-hand dealers, are sold for only a fraction of their original value. If the purchaser of the stock buys the fixtures, he seems to feel that they ought to be 'thrown in' with the stock and consequently will pay but little for them."

5. It has been observed that death dulls the sense of obligation of debtors. 1 CCH Trust and Estate Law Rep. ¶ 2674. In this connection the Retailers' Credit Association has said, "It is about impossible to collect a 'dead man's bills.' People simply will not pay after a store has changed hands. A 50% collection is unusual; 25% would be nearer the actual figures."

6. "A small newspaper, worth $20,000 as a going concern and with equipment well worth that full amount, without regard to good will, might understandably have to sell for as little as $4,000 unless there is ample time to search for a successor editor and publisher." Small Business Aids, *supra* note 2. The National Association of Retail Credit Men (Indiana Office) states, "There is a shrinkage of about 50% between the value at the death of the owner and the time of actual sale."

upon the sole proprietor's death, (2) testamentary devices, (3) inter vivos arrangements other than a buy and sell agreement and (4) the buy and sell agreement. Of all these plans, a buy and sell agreement between the proprietor and a key man funded by life insurance is normally the only really adequate solution.

I. IMPROVISATION BY THE REPRESENTATIVE

Unauthorized Continuation

We have seen that forced liquidation results in drastic estate shrinkage. Often, the representative to avoid this evil will continue the business without testamentary or court authority. The imprudent representative who does so exposes himself to considerable liability. He is playing a losing game. He is individually liable for any debts contracted in the course of the business,[7] and he is without a right of indemnity.[8] The gain realized from the continuation of the business belongs to the estate[9] while any loss falls upon him.[10] Generally, he will not be allowed any additional compensation for running the business.

As a practical matter, of course, many representatives continue a business without authority with impunity, because neither creditors nor heirs object. Nevertheless, that fact does not militate against the well-recognized conclusion that unauthorized continuation of the business by the fiduciary is a hazardous venture.

Consent of the Heirs

If the heirs consent to the representative's continuation of the business, the representative is afforded some measure of protection, even in the absence of court or testamentary authorization, for the consenting heirs are estopped from surcharging him for losses incurred in the continuation.[11] A minor heir, however, cannot consent to an unauthorized continuation.[12] There is nothing to prevent a consenting heir from withdrawing his consent. And, of course, the representative is nevertheless liable to the consenting heirs for

7. Eufaula National Bank v. Manassas, 124 Ala. 379, 27 So. 258 (1899); Hallock v. Smith, 50 Conn. 127 (1882); Martin Bros. Co. v. Peterson, 38 S. D. 494, 162 N. W. 154 (1917). *See* A. Y. Goetzmann Co. v. Gazett, 172 Minn. 68, 71, 214 N. W. 895, 896 (1927).
8. *In re* Moore, 72 Cal. 335, 13 Pac. 880 (1887); Campbell v. Faxon, 73 Kan. 675, 85 Pac. 760 (1906).
9. *In re* United States Mortgage and Trust Co., 114 App. Div. 532, 100 N. Y. Supp. 12 (1st Dep't 1906); *see* Swaine v. Hemphill, 165 Mich. 561, 566, 131 N. W. 68, 70 (1911).
10. *In re* Shinn's Estate, 166 Pa. 121, 30 Atl. 1026 (1895).
11. Swaine v. Hemphill, 165 Mich. 561, 131 N. W. 68 (1911).
12. Gilligan v. Daly, 79 N. J. Eq. 36, 80 Atl. 994 (1911).

losses resulting from his dishonesty or negligence. The consent of the heirs cannot operate to the prejudice of decedent's creditors nor relieve the representative from his individual liability to the new business creditors. However, their consent will give him a right of indemnification.[13]

RIGHTS OF CREDITORS

Notwithstanding the fact that the heirs may have consented to an otherwise unauthorized continuation, it is often necessary for the representative to secure the consent of the decedent's creditors as well; if they press for payment, liquidation may be unavoidable. A distinction should be drawn between estate creditors, or decedent's creditors, and the new trade creditors of the post mortem continuation.[14] The rights of the estate creditors extend to all of the estate assets, including any employed in the continuation of the decedent's business; whereas, the trade creditors, operating on the representative's personal liability to them, can reach the estate assets only through the representative's right of indemnification.[15]

The representative who continues a business is entitled to indemnity, insofar as the new business debts are concerned, only out of the assets properly employed in the business. For example, if the representative is limited either by testamentary or court authorization or by consent of the heirs to utilizing, in continuing the business, only those assets embarked in the business by the decedent, his right of indemnity is limited to those assets.[16] It follows then that the trade creditors, in reaching the estate assets through the representative's right of indemnity, are likewise limited to those assets.[17]

If the estate creditors consent to the representative's continuation, they subordinate their claims to the new trade creditors at least insofar as the assets properly utilized in the business are concerned.[18] If the representative secures consent from the heirs

13. As a general rule, a fiduciary is entitled to indemnity out of the estate for expenses properly incurred in its administration. The heirs' consent renders continuation, insofar as they are concerned, proper.

14. For an excellent discussion, see 3 Bogert, The Law of Trusts and Trustees § 575 (1946).

15. The business contracts are the representative's contracts, not the estate's.

16. 1 Restatement, Trusts § 244, Comment *i* (1935); 2 Scott, The Law of Trusts § 244.4 (1939).

17. Laible v. Ferry, 32 N. J. Eq. 791 (1880); Frey v. Eisenhardt, 116 Mich. 160, 74 N. W. 501 (1898); 2 Restatement, Trusts § 268, Comment *h* (1935); 2 Scott, The Law of Trusts § 268.2 (1939).

18. *In re* Ennis' Estate, 96 Wash, 352, 165 Pac. 119 (1917).

and estate creditors sufficiently broad in scope to risk the entire estate assets in the continuation of the business, his right of indemnification extends to those assets, and the trade creditors can reach those assets through that right.[19]

Although consent of the heirs will not protect the representative against individual liability on the trade contracts, he will be so protected if he is fortunate enough to obtain an agreement from the proposed creditors to look only to the estate assets and not to him personally.

Manifestly, consent of the creditors will not insulate the representative from liability to the heirs for unauthorized continuation if the latter have not consented. It is submitted that, as a practical matter, it is often difficult for the representative to secure the operative consent of *all* the estate creditors and *all* the heirs. Without it, he might be forced to liquidate, at least in part.

CONTINUATION UPON COURT AUTHORIZATION

The decisions are not uniform as to whether or not a court, without statutory permission, may authorize continuation of the business.[20] However, many states, recognizing the forced liquidation evils, by statute permit their probate courts to authorize a personal representative to continue a decedent's business even in the absence of a testamentary authorization.[21] The scope of the authority will vary with the court and the statute.[22]

The court authorization will not operate to the prejudice of decedent's creditors nor will it relieve the representative of individual liability for the debts contracted in the continuation;[23] but it does give him a right of indemnification. Because of the fact that he incurs this individual liability even with court authorization, the cautious representative might refuse to seek or exercise the authority. The right of indemnification is not always a suffi-

19. Willis v. Sharp, 113 N. Y. 586, 21 N. E. 705 (1889).

20. *Compare* Powell v. North, 3 Ind. 392 (1852) *with* Tompkins v. Weeks, 26 Cal. 50 (1864).

21. For a good discussion of the various statutes, see Adelman, *The Power to Carry on the Business of a Decedent,* 36 Mich. L. Rev. 185 (1937), reprinted in part in 3 Bogert, The Law of Trusts and Trustees § 579 (1946).

22. *E.g.,* the Minnesota statute reads: "Upon a showing of advantage to the estate the court, with or without notice, may authorize a representative to continue and operate any business of a decedent or ward for the benefit of his estate, under such conditions, restrictions, regulations, and requirements, and for such period of time as the court may determine." Minn. Stat. § 525.40 (1949).

23. Anglo-American Direct Tea Trading Co. v. Seward, 294 Mass. 349, 2 N. E. 2d 448 (1936).

cient inducement. He runs the risk that upon his accounting, the probate court will disallow the indemnification on the grounds that the representative acted imprudently, negligently or dishonestly, or on the grounds that he violated the terms and conditions of the court's authorization.[24]

II. TESTMENTARY DEVICES

There are several conventional schemes of testamentary disposition of the business whereby the proprietor may avoid to some extent the forced liquidation evils. His will may include a clause authorizing the executor to continue the business or it may provide for continuation by his heirs. The testator may direct that his business be incorporated or placed in a testamentary trust.

Testamentary Authorization for Continuation

Some businesses by their very nature cannot survive the proprietor, *e.g.*, a personal service proprietorship, and thus continuation is impossible. Some others, such as a speculative trading business, are unsuitable for fiduciary management. However, it should be apparent that, if for no other reason than to relieve his executor of the necessity of accomplishing an immediate and compulsory liquidation and to permit him time to look around for a purchaser who will pay the "going concern" value, the sole proprietor normally should draw a will[25] containing an authorization for his executor to continue the business.

The authorization must be found in direct, explicit and unequivocal language.[26] Unless otherwise expressly directed or limited in the will, the authority only permits conduct of the business in the usual manner.[27] Although there is authority to the contrary, as a general rule the executor who, pursuant to testamentary authorization, continues the business, is not entitled to extra compensation for so doing in the absence of testamentary permission

24. Estate of Onstad, 224 Wis. 332, 271 N. W. 652 (1937).

25. Oral authority given to the executor during decedent's lifetime is ineffective. *In re* McCollum, 80 App. Div. 362, 80 N. Y. Supp. 755 (2d Dep't 1903); *In re* Ennis' Estate, 96 Wash. 352, 165 Pac. 119 (1917).

26. Willis v. Sharp, 113 N. Y. 586, 21 N. E. 705 (1889); Clark v. Tennessee Chemical Co., 167 Ga. 248, 145 S. E. 73 (1928).

27. *In re* Gorra, 135 Misc. 93, 236 N. Y. Supp. 709 (Surr. Ct. Kings Co. 1929). In the absence of testamentary permission, the personal representative generally has no authority to incorporate the business. Heap v. Heap, 258 Mich. 250, 242 N. W. 252 (1932); *In re* Doelger, 164 Misc. 590, 299 N. Y. Supp. 565 (Surr. Ct. N. Y. Co. 1937), *rev'd on other grounds*, 254 App. Div. 178, 4 N. Y. S. 2d 334 (1st Dep't 1938).

or the agreement of all persons interested in the estate.[28] The courts will construe the normal authority as permitting the representative to carry on the business only with the funds invested in it at the time of the testator's death so that only those funds are subjected to the hazards of the continuing business—not the general assets of the estate.[29] The authorization, if strictly followed, will relieve the executor of liability to those claiming under the will in case losses are incurred in conduct of the business without his fault or negligence.[30]

In view of the fact that the executor has very narrowly circumscribed powers insofar as continuing and managing a business left by a decedent even in the presence of the normal testamentary authorization, provisions in the will grainting such authority should be carefully drawn. The executor should be afforded unlimited discretion as to whether to continue the business or to sell, and the price and terms of the sale. For obvious reasons, the testator in authorizing continuation should not require it.[31] Further, a clause directing the executor to carry on the business until it ceases to earn a designated rate of profit is unwise. The clause might require sale at a most disadvantageous time. Authorization clauses permitting continuation only until an advantageous sale can be made also disturb executors. The first offer might not appear at the time to be advantageous and yet no better offer may come along. On the other hand, the executor might consider an early offer advantageous but be plagued by the probability or possibility that a subsequent offer would be more advantageous.

It sometimes becomes necessary to keep the estate open beyond the normal period of administration in order to make the most desirable disposition of the business. However, the executor should keep in mind that if he sells the business after the optional valuation date for federal estate tax purposes, there is the danger that the purchase price might be less than the estate tax value.[32]

28. *In re* Gorra, 135 Misc. 93, 236 N. Y. Supp. 709 (Surr. Ct. Kings Co. 1929); 3 Bogert, The Law of Trusts and Trustees § 578 (1946). *Contra:* Lane v. Tarver, 153 Ga. 570, 113 S. E. 452 (1922); *In re* Broome's Estate, 162 Cal. 258, 122 Pac. 470 (1912) (Statute permitted court to award extra compensation.).

29. Smith v. Ayer, 101 U. S. 320 (1879); Laible v. Ferry, 32 N. J. Eq. 791 (1880).

30. *In re* Guglielmi's Estate, 138 Cal. App. 80, 31 P. 2d 1078 (1934); Conant v. Blount, 141 Fla. 27, 192 So. 481 (1939).

31. The probate court might relieve the executor of the burden upon application if continuation were detrimental to the estate.

32. The estate tax valuation is normally the fair market value as of the date of death; if the executor elects the optional valuation date, it is the fair market value as of the date one year after death except where the

Certain other administrative clauses should receive the careful consideration of the will draftsman, *i.e.*, problems in connection with scope of business assets, manner of conducting business, allocation between principal and income, etc., should be covered in the will. A "boiler plate" along the lines of that recommended in the section on the testamentary trust situation, below, should be utilized with the appropriate changes.

The executor, even with continuation authority, becomes individually liable on the trade contracts.[33] He is not obligated to carry on the trade and incur that risk; of course, he is entitled to indemnity out of the assets embarked in the business for liabilities incurred within the scope of his authorization.[34] It is manifest that an authorization to continue the business cannot operate to the prejudice of the decedent's creditors.[35] As was discussed above, the new trade creditors normally may reach only the trade assets unless the testator's will expresses an intention to bind his general assets for the debts of the continuing business.[36]

CONTINUATION BY THE HEIRS

The average sole proprietor, when first presented with the question, wants his widow or his son to carry on the business after his death. In order to accomplish the plan, the testator will either provide that the executor will continue the business until such time as he can turn it over, or the testator will make a specific bequest of the business[37] to the desired heir.

Notwithstanding the fact that the first alternative might be premised on a somewhat unrealistic assumption, *i.e.*, that the executor will be able to carry on the business successfully in the interim,[38] both alternatives assume, and require for their success, that the widow or the son will be desirous and *capable* of managing

property is disposed of during the year, in which case it is the value as of the date of its disposition. Int. Rev. Code § 811(j); U. S. Treas. Reg. 105, §§ 81.10, 81.11.

33. Hewitt v. Beattie, 106 Conn. 602, 138 Atl. 795 (1927); State Bank of Orlando & Trust Co. v. Cummer Lumber Co., 105 Fla. 522, 141 So. 602 (1932).

34. *In re* Houston's Estate, 205 Cal. 276, 270 Pac. 939 (1928); Anglo-American Direct Tea Trading Co. v. Seward, 294 Mass. 349, 2 N. E. 2d 448 (1936).

35. Estate of Onstad, 224 Wis. 332, 271 N. W. 652 (1937).

36. See note 19 *supra*, and text.

37. A specific bequest of a business raises some problems that should be covered in the will, *e.g.*: What assets are to be embraced in the bequest? Does the testator intend the specific legatee to pay the date of death obligations of the business, or are they to be satisfied out of the general assets of the estate?

38. See note 59 *infra*, and text.

the business when the time comes for her or him to take it over. As a general rule both requirements are not present.

If the heir who attempts to run the business is incapable, not only might he lose or bankrupt the business through his mismanagement, he exposes the balance of his inheritance and all his remaining personal assets to the creditors, as well. If the heir engages a manager, the heir's income is reduced. Further, the manager is a potential competitor; once he becomes familiar with the business, he may leave it to start his own, drawing with him some of the old customers. However, if the testator is satisfied that the widow or son is capable of conducting the business in that he or she could command the confidence of his customers, the loyalty of his employees, and the credit support necessary to continue the business successfully, the business should be left financially unimpaired insofar as is possible to the widow or the son.

In order to meet the cash requirements of the normal administration expenses, federal and state estate and inheritance taxes and the personal and business debts of the proprietor, it is often necessary for the business to be at least partially liquidated to raise money. Inventory reductions, the pressure from the personal and business creditors occasioned by their insecurity, and the other ramifications of a partial liquidation are frequently accompanied by a clogging of credit channels. Banks and other sources of credit hesitate to extend credit until the heir has proved that he or she can run the business successfully. Those factors, when considered in connection with the often independently crippling effect of the loss of the proprietor's management factor, place a tremendous burden upon the widow or son to keep the business going, much less realize the income from it that was enjoyed by the decedent.

Therefore, if it is the desire of the testator to leave his business to his widow or to his son, he should assure himself that there will be sufficient liquidity in his estate, without impairing the business, to cover the administration expenses, the taxes, existing personal and business debts, and also to replace the diminished income from the business following his death and otherwise compensate the business for his loss. An insurance policy on his own life with the proceeds payable to his estate is normally the best way of assuring the necessary liquidity.[39]

If it is the testator's desire to leave the business to his son, the widow's dower rights or statutory share must be considered. Gen-

39. See note 57 *infra*, and text.

erally the proprietorship constitutes the major asset in the testator's estate. If the widow will not consent to the disposition of the business to the son, it may be necessary for the proprietor to purchase additional life insurance to satisfy her share. That insurance should be payable to his estate. Normally, life insurance proceeds payable directly to the widow as beneficiary are not considered in determining whether or not she has received her required share, since the proceeds never became part of the husband's probate estate.[40] And even if that problem is solved, leaving the business to one of several heirs will certainly result in shortchanging the remaining heirs unless life insurance again be utilized to equalize the shares.

Testamentary Directions to Incorporate

The testator may direct his executor to incorporate his business.[41] His will could provide for an outright bequest of the stock[42] or for the establishment of a trust with the stock as the corpus. The variations are infinite. Often the direction to incorporate is accompanied by a bequest of some of the stock to key employees in order to induce them to stay in the business for the benefit of the legatees of the remaining stock.[43] Or perhaps the testator may confer upon the key employees merely an option to buy the stock.[44] If the testator desires to retain complete control in or for his family, he may provide for distribution of non-voting stock to the employees. If minor legatees are involved, the testator should perhaps provide that distribution of the stock to the minors

40. Farmer's Loan and Trust Co. v. McCarty, 100 Conn. 367, 124 Atl. 40 (1924).

41. There is no doubt that a testamentary direction to the executor to form a corporation and transfer to it decedent's business in exchange for stock is valid. Rohrlich, Organizing Corporate and other Business Enterprises § 13.02 (1949); Cahn, *Estate Corporations,* 86 U. of Pa. L. Rev. 136 (1937).

42. The lapse between death and incorporation will not cause such a bequest to illegally postpone vesting or suspend the absolute power of alienation. *In re* Julliard, 238 N. Y. 499, 144 N. E. 772 (1924); *In re* Noll, 273 N. Y. 219, 7 N. E. 2d 108 (1937).

43. *In re* Noll, 273 N. Y. 219, 7 N. E. 2d 108 (1937).

44. A restricted stock option should be considered. Prior to the 1950 Revenue Act the rule was that an employee who exercised an option to buy stock from his employer corporation realized taxable income (not capital gain) at the time the option was exercised to the extent that the market value of the stock, at the time the option was exercised, exceeded the option price. CIR v. Smith, 324 U. S. 177 (1945). Int. Rev. Code § 130A, added by the 1950 Act, provides that in respect to a restricted stock option satisfying the Section, no taxable income is realized at the time the option is exercised. Profit on a subsequent sale of the stock is taxed as capital gain, except for the portion of the gain that is taxed as ordinary income under § 130A(b).

shall be deferred until majority, and that the stock will either be voted by the testator's fiduciary or deposited in a voting trust.

If it is the testator's intention that his employees manage the corporation for the benefit of the family, it might be pointed out that experience has shown that the arrangement often breeds ill will between the testator's family and the key men. Key employees feel that they have responsibilities disproportionate to their interest and control in the corporation. Management interference by the family frequently creates dissension and presents an obstacle to successful continuation of the business. The family, normally being completely dependent upon the old employees for the successful continuation, and in a situation where it is not too familiar with the operation of the business, sometimes has a tendency to resent and distrust them. If, on the other hand, complete control is vested in the family, the problem is still present of whether or not it is desirous and capable of properly managing the business.

Placing the stock in trust for the benefit of the family is often feasible, especially if the business is an established and substantial enterprise. Certain problems in this connection are beyond the scope of this article but warrant the serious consideration of the estate planner, *e.g.*: How far will the probate courts and the laws on corporation permit testamentary directions to control corporate operations? How much will the probate court interfere with the internal administration of the corporation? May the trustee in addition to his statutory compensation draw a salary from the corporation? Will the probate court respect the corporate entity for purposes of the trustee's accounting? What latitude does the trustee-director have in refraining from declaring dividends or in setting up reserves for contingencies and depreciation out of income at the expense of the income beneficiary of the trust? What impact do the laws respecting trustee's investments have upon the estate corporation? How far will rules against unauthorized accumulation of income affect dividend policy? What are the rights of creditors and minority stockholders insofar as the estate corporation is concerned?

The tax burden on corporate income often deters the formation of estate corporations. Since a corporation is a separate tax entity, the income of a business conducted in the corporate form is subjected to the "double tax."[45] Generally, the corporation pays a tax on its income at corporate rates, and secondly, when the

45. The possibility that the corporate excess profits tax may still be in effect, or may be reimposed, should receive consideration.

corporate earnings are declared out as dividends,[46] the dividends are ordinary income in the hands of the stockholders upon which another tax must be paid at individual rates.[47] From an income tax standpoint, a testamentary trust to continue the unincorporated business for the benefit of the testator's family might be more advisable. The testamentary trust should not be held to be an "association" taxable as a corporation for income tax purposes.[48]

THE BUSINESS AS THE PRINCIPAL OF A TESTAMENTARY TRUST

The proprietor in his will may relegate his business to a testamentary trust for the purpose of providing a permanent income for the members of his family.[49] He should define clearly in the instrument what assets and liabilities are to be embraced by the term "my business," and in this connection, whether or not the trustees can employ non-business trust assets in the business. Also, if the testator is setting up both a marital deduction trust and a conventional testamentary trust, the will should indicate of which trust the business is to become the corpus. The income-rigidity and termination aspects inherent in the former trust would dictate against its selection, all things being equal.

The testator should furnish his testamentary trustee with such information about the internal organization of the business, the capabilities and limitations of his employees, and any other information with respect to customers, credit channels and normal vicissitudes of his business as would help the trustees in their management.

Administrative clauses should be sufficiently broad and flexible so as to induce the fiduciaries' acceptance of the trust and to clarify

46. Of course the earnings could be channeled out as salary if the members of the family work for the corporation; the salary paid them is deductible by the corporation but is income in their hands.

47. See Knapp and Warren, Forms of Business Organization and the Federal Tax Laws (P.L.I., rev. ed. 1951); Which is Best Taxwise—Corporation? Partnership? Sole Proprietorship? (C.C.H., 1952 ed.).

48. A trust for the continuation of a business has been held not to be an "association." CIR v. Guitor Trust Estate, 72 F. 2d 544 (5th Cir. 1934). A testamentary trust would appear to be outside the scope of Morrissey v. CIR, 296 U. S. 344 (1935). In that case the Supreme Court, in holding a trust to conduct a business to be an "association" in which the beneficial interests were easily transferable and the holders thereof had limited liability, ruled that when persons associate in a joint enterprise, transact business for profit and use an organizational form possessing corporate attributes, such business form will be treated as an "association" for income tax purposes. See Smith, *Associations Classified as Corporations Under the Internal Revenue Code,* 34 Calif. L. Rev. 461 (1946).

49. It must be remembered that, in setting up the trust, the rule against perpetuities and the rule, if any, against unauthorized accumulations of income of the jurisdiction the law of which governs the validity of the trust must be respected.

their task.[50] Construction proceedings are expensive. In addition to the normal clauses, such as the power to retain the testator's investments and invest in non-legals, the "boiler plate" should contain several other specific powers. In the first place, as was pointed out previously,[51] the trustees should have unlimited discretion to continue the business or to sell. If the testator sets up his business in a testamentary trust, it would probably be his intention that the trustees continue the business for the duration of the trust. But notwithstanding that desire, he should not direct them to continue it. Also, the will should leave the trustees unfettered insofar as the price and terms of sale are concerned.

The compensation problem should be covered in the will. In the normal case, extra compensation should be permitted, perhaps based upon a percentage of gross sales or net profits. A provision should be included dealing with the powers of successor or alternate fiduciaries.[52] The trustees should have broad and liberal delegation rights insofar as engaging and compensating managers, employees, and agents generally, or in carrying on the business in partnership with others. A business trust often presents difficult income-principal problems; the trustees should be afforded as much discretion as is permissible in allocating receipts and charges between principal and income.[53] They should be permitted to change the purpose of the business or the manner of conducting it and to incorporate and vote the stock by proxy or by deposit in a voting trust. Some thought should be given to the inclusion of an exculpatory clause insofar as one is not expressly illegal[54] or against public policy.[55]

In short, choose the trustees carefully, but give them as much latitude as the law will allow.

Liquidity and Management

Is should be re-emphasized that in order for any continuation plan to be successful, there must be both sufficient estate liquidity and available competent management. Although the testator takes the pains to authorize the continuation of his business in order to avoid the forced liquidation evils, liquidation, or at least partial

50. See MacNeill, *Disposition of Business Interests,* 87 Trusts and Estates 495 (1948).

51. See note 31 *supra,* and text.

52. Normally powers such as these discussed would survive, but the point should be covered in the will. See 2 Scott, The Law of Trusts § 196 (1939).

53. Be cautious if the business is to be put in a marital deduction-power of appointment trust.

54. See N. Y. Decedent Estate Law § 125.

55. See 1 Restatement, Trusts § 222 (1935).

liquidation, may be necessary in order to raise sufficient cash to satisfy federal estate taxes, state inheritence or estate taxes, probate and administration expenses, and the date-of-death business and personal debts of the decedent.[56] The executor must also raise sufficient capital to offset the loss of the key man value of the decedent.

How may the testator assure himself that his estate will be sufficiently liquid to accomplish these purposes, remembering that, as a general rule, most proprietors have the bulk of their assets tied up in the proprietorship? For one thing, the testator can do nothing. He can hope that the executor will be able to borrow the money—a dangerous gamble, for loans are often the hardest to get when they are needed the most. Too, the proprietor, during his lifetime, might attempt to build up cash reserves, perhaps by setting up a sinking fund. The task is not facilitated by present day income taxes. Of course, the availability of the money committed to building up the reserve is lost or impaired for other business purposes. The money utilized in the sinking fund is exposed to business creditors. More important, the entire plan may be frustrated by the premature death of the proprietor.

One way the proprietor can be assured that his estate will be sufficiently liquid is to take out life insurance on his own life with the proceeds payable to his estate. Normally, the premiums will be considerably less than the sinking fund deposits. There is reluctance on the part of some testators to take out life insurance to meet these estate expenses, since the insurance proceeds are includible in their

56. A Department of Commerce publication, in discussing the death problems of the sole proprietor, states: "Whatever disposition is to be made of the business, there will be need for funds. Debts, taxes and administrative costs have to be met. Income for the family has to be provided. If the family is continuing the business, someone will probably have to be hired to manage the business; working capital will be needed, at least for a period of readjustment. If employees are to take over, funds for their purchase of the business have to be made available, at least in part. If the business is sold outright, working capital will be needed for the transition period and possibly some funds provided to meet the probable discounting of assets which accompany such a sale.

"Most of these funds are needed quickly—more quickly than they could be provided by the sale of the business unless through a forced sale, in which case there would almost certainly be a loss. The tax needs are urgent and cannot be avoided or postponed. Credit needs are apt to be even more urgent, if the business is to be maintained during the transition period. Depending on the type of business involved, there is apt to be an immediate need for working capital. A grocery, for example, dealing in perishable goods, requires quick action and capital for immediate use. A warehouse or iron foundry, or plant of unusual nature, might find it so difficult to find a buyer that extensive funds are needed to tide the business over the period of seeking a successor." Small Business Aids No. 481, Department of Commerce (March 1949).

estates for estate tax purposes.[57] Therefore, in order to provide liquidity in a given amount, the testator might have to take out insurance in, perhaps, one and one-half times that amount.

However, insurance to provide liquidity might be analogized to a contract[58] between the testator and his date of death creditors whereby the testator agrees to pay a small sum annually on account of the estimated date of death cash requirements, and the creditors agree to waivé the unpaid balance if the testator dies before he has met all the necessary installments. But even more conclusive is the argument that the dollars utilized in buying the insurance would presumably have found their way into his estate anyway. The amount by which the proceeds exceed the premiums paid is a profit which is only reduced in part by the increase in estate taxes resulting from the inclusion of the proceeds in the testator's estate.

The next fundamental axiom is that these continuation plans are no better than the competency of the fiduciary-manager selected. The testator can give his executor permission to continue the business, but he cannot give him the ability. He cannot inculcate into the executor the drive, the business acumen and the managerial ability that characterized the testator's success. The executor is on the spot. Heavy odds oppose his successful continuation for very long.[59] He must step in cold at a moment's notice and take over a going business with which, normally, he is completely unfamiliar. Creditors will be pressing for payment and debtors will want to compromise accounts receivable. Customers, realizing the probable temporary status, will tend to transfer their business elsewhere. Also, substantial damage to the business may be incurred during the hiatus between the testator's death and the time of qualification and appointment of the executor. Suffice to repeat, extreme care must be utilized in the choice of the fiduciary to continue the business.

III. SOME INTER VIVOS ARRANGEMENTS

Ante Mortem Incorporation

It may be feasible for the proprietor during his lifetime to incorporate his business. This device affords him considerable flexi-

57. U. S. Treas. Reg. 105, § 81.26.
58. See Trachtman, Estate Planning 80 (P.L.I., rev. ed. 1950).
59. "Experience gives no great assurance that a new hand, taking over the business under these circumstances, will administer it successfully. There is a substantial risk, except in abnormal times, that the business will be continued at a loss." Jacob, *Trusts for Continuing a Decedent's Business*, 18 Iowa L. Rev. 43 (1932).

bility and precludes interruption of the business upon his death. He may give the stock to members of his family. He might provide that the stock that is to be given to the minors be deposited in a voting trust with himself and another as voting trustees during the minority of the children.[60] He can give away a block of stock to a key employee or group of employees to induce them to stay with the business and insure its successful continuation after his death for the benefit of his family.

The employer might offer his employees or members of his family a restricted stock option plan pursuant to Int. Rev. Code § 130A[61] in lieu of or in combination with the gift of stock. A common arrangement is for the employer, who ordinarily does not want to lose control during his life, to sell or make a gift of non-voting stock to the employees and concurrently enter a stock purchase agreement with them as to at least enough of his stock to provide his estate with sufficient liquidity to meet the date of death obligations. On the other hand, it might be more feasible for him, depending upon the circumstances, to enter a stock purchase agreement with the employees as to all of the stock retained by him; or he might enter a stock retirement agreement as to all or part of his stock.[62] The problems inherent in a stock purchase or stock retirement plan are beyond the scope of this article.

Generally, a gift of stock by the employer to his family will effectuate estate tax savings, provided that he lives three years after making the gift, for he would thereby exclude the distributed stock from his estate. The 1950 Revenue Act rendered a gift of a business interest more attractive in that it provided that no gift made more than three years before death could be taxed as a gift in contemplation of death,[63] and thus removed the threat of lengthy and costly litigation which often previously resulted from lifetime gifts.[64] And even if the gift were subsequently found to have been made in contemplation of death, the gift to his wife would normally qualify for the *estate* tax marital deduction. An estate tax

60. Whether or not such a device would be completely effective would depend upon the age of the minors. Most states by statute limit the duration of a voting trust, *e.g.*, Minn. Stat. § 301.27 (1949), imposes a limit of 15 years.

61. See note 44 *supra*.

62. Int. Rev. Code § 115(g)(3) provides that stock redemptions, satisfying the Section, to pay death taxes will not be taxed as ordinary dividends.

63. Int. Rev. Code § 811(1).

64. However, most states still retain the rule that any gift within two years of death is presumptively in contemplation of death, *e.g.*, Minn. Stat. § 291.101(1), (3) (1949).

credit would be allowed for the gift taxes paid, without regard to the question of who was donee.

The employer would be entitled to the *gift* tax marital deduction insofar as the gifts to his wife are concerned.[65] Insofar as the gifts to third persons are concerned, his wife can join in the gift so as to afford him the advantage of double annual exclusions and a double lifetime exemption.[66] A redistribution of the corporate income by way of gifts of stock to relatives other than the employer's wife (a gift to her would not effect income tax savings in view of the income-splitting provisions of the 1948 Revenue Act) should accomplish income tax savings to the family group since presumably the donees of the stock would be in lower brackets than the employer.

FAMILY PARTNERSHIPS

The proprietor might consider entering a family partnership in view of the possible income tax advantages. The 1951 Revenue Act has made it clear that a bona fide gift of a capital interest to create a partnership, if capital is a material factor in the production of partnership income, will result in a recognized partnership for income tax purposes.[67] If the donees are minors, it might be desirable to place their partnership interests in trust during their minority.[68] It is suggested that the proprietor and the members of the family enter a buy and sell agreement with the key employees as to the entire partnership interests, or at least the interest he retains, to be operative upon his death. The partnership buy and sell agreement presents problems beyond the scope of this article.

INTER VIVOS TRUST

Although a trust is not one of the conventional forms of busi-

65. Int. Rev. Code § 1004(a)(3); U. S. Treas. Reg. 108, § 86.16a. The donor can deduct one half of the interest transferred to his spouse, if the gift qualifies, *e.g.*, if the husband during the calendar year transferred $100,000 to his wife, the marital deduction would be $50,000. From the remaining $50,000, the donor could deduct the $3,000 annual exclusion and the $30,000 life-time exemption, if not already used up, leaving a net taxable gift of $17,000.

66. Int. Rev. Code § 1000(f); U. S. Treas. Reg. 108, § 86.3a. The gift, for the purposes of the gift tax, would be considered as made one-half by each spouse, *e.g.*, it is possible for one spouse to make an outright gift of $66,000 to a third person in one year without incurring a gift tax.

67. The proprietor might have to pay a gift tax, but the resulting income tax savings over the years should more than compensate for it.

68. However, if the income of the trust for the benefit of the minor is to be accumulated during his minority, the gift in trust would not be entitled to the annual exclusion since it is a gift of a future interest. Int. Rev. Code § 1003(b)(3); U. S. Treas. Reg. 108, § 86.11. CIR v. Diston, 325 U. S. 442 (1945).

ness organization, the proprietor might seriously consider the advisability of setting up a trust during his lifetime for the benefit of his family. If the trust satisfies the Internal Revenue Code, certain tax advantages will accrue to the settlor, *i.e.,* the family income tax burden would be reduced if the beneficiaries of the trust were in lower brackets than the settlor[69] and the business would not be included in the settlor's estate for estate tax purposes.

However, the type of trust necessary to secure the above tax advantages would not appeal to the average sole proprietor. In the first place the income of the trust will be taxable to him if the trust is revocable, that is, he has a power to revest the corpus in himself within the meaning of Int. Rev. Code § 166,[70] or if under the *Clifford* doctrine he would be regarded in effect as the owner of the trust[71] or if he has retained an interest in the income in that it may be distributed to or used for his benefit within the meaning of Int. Rev. Code § 167.[72]

Further, the corpus of the trust will be includible in the settlor's estate for estate tax purposes if, in brief, the transfer[73] was intended to take effect in possession or enjoyment at or after the settlor's death,[74] or was in contemplation of death within the purview of Int. Rev. Code § 811[75] or if the settlor reserved a power to alter, amend, revoke or terminate the trust.[76]

Thus, the settlor should strip himself of all substantial incidents of ownership in both the corpus and the income lest the

69. If the settlor divests himself of all substantial rights in the income and the corpus of the trust, the income will not be taxed to him, but rather to the trustee or beneficiaries. Int. Rev. Code §§ 161, 162 and 163. See Gornick, Partnerships, Estates and Trusts 24 *et seq.* (P.L.I., rev. ed. 1948).

70. U. S. Treas. Reg. 111, § 29.166-1.

71. Int. Rev. Code § 22(a); U. S. Treas. Reg. 111, § 29.22(a)-21. The Supmere Court's *Clifford* Doctrine, enunciated initially in Helvering v. Clifford, 309 U. S. 331 (1940), taxes to the settlor the income from an irrevocable trust even though the income is payable to someone else, if for the purposes of Int. Rev. Code § 22(a) he is regarded in substance as remaining the owner of the corpus. The Treasury Regulations define the factors which will render the income of the corpus taxable to the settlor. In general, the settlor is taxable on trust income if he has reversionary interest after a relatively short term, power to determine or control beneficial enjoyment of income or corpus, or administrative control. See Casner, *The Amended Clifford Regulations,* 85 Trusts and Estates 249 (1947); Casner, *Taxation of Income Under T. D. 5488,* 84 Trusts and Estates 233 (1947).

72. U. S. Treas. Reg. 111, § 29.167-1. Section 167 concerns itself with retention of an interest in the income; § 166 relates to retention of an interest in the corpus.

73. Except, of course, bona fide transfers for full and adequate consideration; if there is consideration, the transfer will be taxed only to the extent that the consideration is inadequate. Int. Rev. Code § 811(i).

74. Int. Rev. Code § 811(c); U. S. Treas. Reg. 105, §§ 81.17, 81.18.

75. Int. Rev. Code § 811(1); U. S. Treas. Reg. 105, § 81.16.

76. Int. Rev. Code § 811(d); U. S. Treas. Reg. 105, §§ 81.19, 81.21.

income be taxed to him. To keep the corpus of the trust out of his estate for estate tax purposes, the settlor should not retain any income from or reversionary interest in the trust; he should not retain the power to alter, amend or revoke the trust, nor should he have the trust measured by his life or create any interest which becomes possessory at his death.[77] Generally, the sole proprietor would not want to go that far.

Notwithstanding the fact that the proprietor might not obtain for himself either income or estate tax savings, it may nevertheless be advantageous for him to settle his business in a revocable trust for the benefit of his family during his lifetime. A revocable trust has much to recommend it. It can be utilized to prevent interruption of the business at his death. It can keep the business assets out of probate and consequently save administration expenses. It affords the settlor an opportunity to acquaint the trustee-manager with the operation of the business under the owner's supervision and to evaluate the trustee's ability.[78] The revocable trust can be made to qualify[79] for the estate tax marital deduction on the settlor's death;[80] or, on the other hand, it may be used to save the "second tax," *i.e.*, preclude estate tax impact upon distribution of the corpus on termination.[81]

It should be remembered that if a trust is created as a vehicle for carrying on a business, it in all probability will be classified as an "association,"[82] taxable as a corporation, within the rule of *Morrissey v. CIR.*[83] However, tax considerations alone should not control the estate planner.

77. See Trachtman, Estate Planning 139 et seq. (P.L.I., rev. ed. 1950).

78. Also, it can be used to assure unified control and at the same time relieve the wife of management problems, keep the business in the family in the event the wife remarries and, if set up as a spendthrift trust, may be used as a hedge against the children's anticipated inability to manage money.

79. To obtain the estate tax marital deduction in respect to an inter vivos trust, the trust must qualify as of the settlor's death, rather than as of the date of the transfer. Since the trust would presumably become irrevocable on the settlor's death, the trust would qualify at that time.

80. A gift in revocable trust will not qualify for the gift tax marital deduction, since it is a transfer of a "terminable interest." Int. Rev. Code § 1004(a)(3)(B); U. S. Treas. Reg. 108, § 86.16(b).

81. The settlor might provide that the trust is to continue after his death with his widow to enjoy the income for her life and upon her death, the corpus is to be distributed to the settlor's children. The only estate tax payable is that on the settlor's death; had the property passed by outright bequests from the settlor to his wife and from his wife to their children, a second estate tax on the same property would be imposed on the wife's death.

82. Nee v. Main Street Bank, 174 F. 2d 425 (8th Cir. 1949).

83. See note 48 *supra*.

IV. BUY AND SELL AGREEMENT

The best solution normally available for the estate planning problems of the sole proprietor is that of the buy and sell agreement funded by life insurance.[84] Basically, the plan contemplates an agreement between the sole proprietor and his key employee,[85] whereby the sole proprietor binds himself and his estate to sell and the employee binds himself to buy, at a stipulated price, the business upon the death, or possibly the retirement, of the sole proprietor. To fund the agreement, the key employee takes out life insurance on the sole proprietor's life in an amount equal to the value of the business.

Every buy and sell agreement must be carefully tailored to the requirements of the parties. If, as often said, "No will has a brother," then no buy and sell agreement has a second cousin. In the remainder of this article many suggestions are made concerning the contents of a buy and sell agreement. Of necessity these suggestions are generalizations, and should be so regarded.

Benefits of the Insured Buy and Sell Agreement

Benefits to the Proprietor's Estate

The buy and sell agreement avoids the severe losses of forced liquidation and the multitude of problems inherent in any attempt to continue the business. The sole proprietor's estate will receive the full going concern value of his business in cash at a time when cash is needed. The agreement facilitates prompt and efficient administration of the proprietor's estate. The wife and family of the proprietor have been relieved of oppressive business responsibilities and future business liabilities. They have been provided with cash rather than a speculative business investment. And what testator, who had bequeathed his wife and family a balanced portfolio of good securities, would direct them to liquidate the bequests and buy a business the day after the death of the man who had built it up?

Further, a properly drawn agreement will operate to peg the value of the business for estate tax purposes and thus preclude the possibility of excessive estate taxes, or in the alternative, costly and lengthy litigation.[86]

84. "In the light of the various expedients now open to him, no business man should be so busy minding his own business as to neglect making provisions for what will happen to it when he is no longer here to mind it." Mannheimer and Friedman, *Buy/Out Agreements,* Proc. Ninth Estate Planners Forum of Solomon Huber Associates 32 (1951).

85. Often a group of employees will join as purchasers.

86. See note 148 *infra,* and text thereto.

Benefits to the Purchasing Employee

The benefits to him are obvious; *i.e.*, the agreement underwrites his business future. Since the employee is the logical purchaser, the insurance provides an easy way to acquire the business upon the retirement or death of the proprietor; it eliminates dissension and stalemate with the proprietor's heirs—which might occur, in the absence of a funded agreement, during the course of negotiations for purchase.

Benefits to the Business during Proprietor's Life

The buy and sell agreement, assuring continuation, has a stabilizing effect on the business and strengthens the firm's credit. Since the key employee now has a stake in the business, and since even those employees who are not parties to the agreement have more confidence in the continuation of their jobs,[87] the agreement should improve the efficiency and work-product of the employees, thereby increasing the profits and reducing the responsibilities of the sole proprietor.

FUNDING THE AGREEMENT

For the plan to be effective, a means must be devised of assuring that at the time of the proprietor's death the key employee has sufficient money to purchase the business. Rarely will he have enough personal capital, and it is hazardous for the employee to assume that at the time he needs the money he will be able to borrow it. The employee might fund the agreement by making periodic deposits in a sinking fund. However, such a scheme is unrealistic in view of the earnings siphoned off by high income taxes and in view of the fact that the proprietor's death before the fund is complete will frustrate the plan. The parties might agree that the purchaser will pay for the business with a series of installment notes. Long term notes are a poor substitute for cash, as far as the estate is concerned, for they afford neither security nor liquidity. The notes may not be met if the business cannot successfully survive the loss of the key man value of the proprietor, and, aside from that, the notes place an undue burden on the successor. He, in all probability, would have to employ others to replace the proprietor, which of course would reduce his earnings, and a substantial part of any surplus would have to be used to meet the notes.

87. However, it should be admitted that as a practical matter it is sometimes necessary to keep the agreement concealed from the employees who are not permitted to become parties to the agreement in order to avoid a morale problem.

The most satisfactory method for funding the agreement is with insurance on the life of the proprietor, assuming, of course, that he is insurable. His death, the fact which gives rise to the need for the money, operates to furnish the money. The annual premium payments are small compared to the annual payments necessary to maintain other funding devices, rarely running over five per cent of the face value of the policy.

PURCHASE PRICE

The parties must decide whether the business is to be purchased on a net basis or on a gross basis, *i.e.*, whether the purchaser is to buy the tangible assets and good will of the business, or the tangible assets and good will less the business liabilities. For example, a proprietorship may have assets and good will valued at $50,000 and business debts of $10,000. If the business is to be purchased on a gross basis, the purchase price would be $50,000, whereas, if the employee is to purchase the business net, the purchase price would be $40,000. The gross basis is certainly to be preferred, especially if the agreement can be fully funded with life insurance. The proprietor's estate receives not only the net going concern value of the business in cash, but also enough additional cash to discharge immediately the proprietor's business obligations. The employee, on the other hand, will own the business free of the proprietor's business debts.

If the net basis is used, the purchaser normally would be required to give the proprietor's estate an assurance that the business obligations would be satisfied, for the estate remains liable for them. The agreement should provide what type of assurance the estate is to get. First of all, it should require the purchaser to assume all the business debts, becoming thereby primarily liable and relegating the estate to the position of a surety. The agreement might provide also that the purchaser will, when possible, obtain from the business creditors general releases running to the estate. Some agreements permit the proprietor's executor, in his discretion, to refrain from going through with the sale if he is not reasonably satisfied that the purchaser can protect the estate from the business creditors.[88] Though not too practicable, the possibility of joint control might be considered. That is, the executor would have an equal voice in all major business decisions until such time as the business debts were satisfied. At any rate, the problem warrants

88. Of course, if such discretion is deposited in the executor, the agreement will not peg the value of the business interest for estate tax purposes. See note 148 *infra*, and text thereto.

consideration since the estate in all probability would have to be kept open as long as creditors had outstanding claims.

In view of the advantages of the gross basis method, it should be utilized ordinarily, despite the fact that the agreement cannot be fully funded with insurance. The agreement would provide for the disposition of the excess of the value of the business interest over the insurance proceeds, as will be developed below.

VALUATION

An important problem, and generally without regard to the question of whether the gross basis or net basis is used, is that of determining the purchase price. Since one of the stated purposes of the buy and sell agreement is to assure the decedent's estate of getting the full going concern value of his business interest, it is clear that the valuation clause merits considerable time and thought. Neglect it and you obviously will effect inequities. The value of the business may be determined by a number of methods; however, the valuation clause should be tailored to the business involved. A method that might be appropriate for one type of business may be completely unrealistic for another. Some of the more common valuation methods are discussed below.

Arbitrary Price

At the time the agreement is executed, the parties, under this method, place an arbitrary valuation on the business and provide for periodic revision, at least annually. The plan has in its favor simplicity and certainty; however, it is not recommended. In the first place, the periodic revisions are often neglected[89] even though the lawyer, the trustee, if one is used, and the life underwriter remind the parties. To obviate this objection somewhat, it often is provided that the last stated price shall govern unless more than two years have elapsed since it was agreed upon. The agreement will provide that if a longer period has elapsed, the value will be fixed by some alternate method, *e.g.*, one of the capitalization formulas or, perhaps, adjusting the last stated figure to reflect changes to date of death. However, a stronger criticism of this method is that periodic revisions necessitate periodic meetings of the minds of the proprietor and the employee in regard to the question of value. Since the proprietor will naturally argue a high figure while

89. Or, even worse, one party may refuse to take part in a revision when required. See Chase Nat. Bank v. Manufacturer's Trust Co., 265 App. Div. 406, 39 N. Y. S. 2d 370 (1st Dep't 1943).

the employee will argue a low one, at least a minor disruption in their relationship is inevitable.[90]

Independent Appraisal

Another common device for measuring value is that of independent appraisal after death. The provision generally calls for three appraisers, one to be appointed by the estate, another by the purchaser, and the third to be chosen by those two. The primary objection to the method is the inevitable delay involved in the procedure. Considerable time often elapses before all three appraisers are appointed and arrive at a common valuation. An alternate appraisal plan that would avoid the excessive delay, in the main, is that of appointing in the instrument a sole appraiser, such as a bank. If appropriate, explicit instructions to the appraiser or appraisers should be contained in the agreement as to the valuation of bad debts, contingent liabilities, patents, good will, trade-names, and other intangible assets.

Book Value .

The parties might provide that the purchase price shall be the net value of the business assets as shown by the last financial statement of the business prior to the proprietor's death. Often the agreement will provide that the book value will be adjusted to date of death, perhaps by adding six per cent per annum from the date of the last statement until the time of death. Another variation is to require that a statement be taken as of the date of death. If so, the agreement should provide who is to prepare it and should contain such instructions as to the valuation of particular assets as are deemed appropriate. Frequently, the proprietor will not regard book value as a fair value, primarily because it does not reflect any of the intangible assets such as good will.

Tax Value

Sometimes the agreement will provide that the value of the business for the purposes of the sale is to be the value arrived at for federal estate tax purposes. The time lag before a value will finally be determined is apparent and therefore the clause should be avoided. Further, since a buy and sell agreement with a valuation clause of this nature cannot freeze the value of the business interest for estate tax purposes, an important attribute of a carefully drawn business purchase agreement has been forfeited.

90. The sole proprietorship buy and sell agreement must be distinguished from the partnership agreement or stockholders' agreement. In the latter two, the revision procedure might cause less disturbance since each party stands to profit from a low price if he is the survivor but to lose if he is not.

A.R.M. 34[91]

A.R.M. 34 sets out one of the more popular formulas purporting to determine a value for good will; it is a prototype of all the formulas, most of which operate on the relationship between the tangible assets and the demonstrated earning power. However, a word of caution is appropriate. The fact that a proprietorship has enjoyed earnings exceeding those normally attributable to its tangible assets does not conclusively indicate the existence of good will. Abnormally high earnings might be traced to the managerial and income producing ability of the owner. Any formula as applied to a sole proprietorship which attempts to project historical profits should be carefully scrutinized. Obviously the formula's validity varies directly with the predictability of the past profits.[92] Good will does not attach to a business if its success depends solely upon the owner.[93]

Of course, many proprietorships do enjoy good will, in that profits in excess of a fair return on the tangibles can be anticipated notwithstanding the owner's death. If so, the proprietor will want that asset considered in computing the purchase price. The parties to the buy and sell agreement, in determining whether or not any good will in fact exists, or if it does, to what extent, should evaluate carefully past earnings and future prospects. Sometimes the agreement will fix the value of good will as an arbitrary percentage of book value. More often a formula such as A.R.M. 34 is used—a formula frequently applied by the Internal Revenue Bureau in valuing the intangible assets of a closely held business.

The method proposed by A.R.M. 34 is to take the average earnings of the company over a period of years, preferably not less than five, attribute an earning rate of ten per cent to the average tangible assets for the period, and then capitalize the remainder of the earnings in excess of ten per cent at the rate of twenty per cent to determine the value of good will. A.R.M. 34 also recognized that if the business was rather stable and not subject to violent fluctuations, for example, the manufacture or sale of standard articles of

91. 2 Cum. Bull. 31 (1920).

92. The Tax Court in Estate of A. Bluestein, 15 T. C. 770, 787 (1950) pointed out that ". . . the emphasis in valuation of good will should be placed on the relation between the tangible assets and profits but only to the extent that those profits would survive a change in the management of the business. . . . It is important to remember then, that when the purchaser of a business pays a price for good will, he is not paying for the profits in the past in excess of a fair return on tangibles, but for those profits of the future."

93. Howard B. Lawton, 6 T. C. 1093, 1100 (1946).

daily necessity, the return on the tangible assets might be reduced from ten per cent to eight per cent and the capitalization of the return upon the intangibles might be reduced from twenty per cent to fifteen per cent.

In applying the formula to the sole proprietorship situation, an amount representing the compensation value of the proprietor should be deducted from average net earnings before the surplus over the allowed return on the tangibles is capitalized to determine the good will valuation.[94] Obviously his management value cannot survive his death. Comparable management ability will have to be substituted; its cost will modify future profits. An application of A.R.M. 34 might be illustrated. Assume that the formula in the buy and sell agreement fixes $7,000 as the proprietor's wage value and that a return of eight per cent is to be attributed to the tangibles and the surplus earnings capitalized at fifteen per cent. Assume, further, that the average value of the tangible assets of the business for the five years prior to the valuation date was $50,000, and its average annual earnings for such period amounted to $15,000. The good will value of $26,666.67, which would then be added to the date of death book value to compute the purchase price, would be computed as follows:

Average value of tangible assets		$50,000.00
Average net profits	$15,000.00	
Management factor	7,000.00	
	$ 8,000.00	
8 per cent return on tangible assets	4,000.00	
Earnings attributable to intangibles	$ 4,000.00	
Capitalization of surplus earnings at 15 per cent		$26,666.67

The above formula is subject to infinite variations. The period during which the earnings are to be averaged may be varied, but it should be long enough to equalize fluctuations. Any extraordinary fluctuations in earnings should be discounted in whole or in part. The interest rates should be varied with the stability of the particular business and with the comparative returns on similar businesses.

Straight Capitalization

Under this method the average net profits (after subtracting

94. An argument might be made that for consistency's sake an income tax factor should be subtracted from earnings before they are capitalized; in valuing the stock of a corporation, it is the earnings after taxes that are capitalized. However, the argument has never been accepted by the Bureau. See Powell, *Estate Tax Valuation,* The Estate Tax Handbook 403 (1951).

the proprietor's management value) for a given period, generally five years, are capitalized at a rate provided in the agreement. The rate may vary from five per cent to fifteen per cent, depending upon the stability of the business. The capitalized value, thus determined, is the total value of the business, including both the tangible assets and the good will. Thus, for example, if the average net earnings for the five years prior to the proprietor's death averaged $50,000 and the capitalization rate specified in the buy and sell agreement was ten per cent, the capitalized value of the business would be $500,000.

Years' Purchase of Excess Profits

The number of years and the determinative rate may be varied, depending upon the magnitude of the good will, but the following is an example of the application of a formula calling for a three years' purchase of the profits (less management factor) in excess of ten per cent on the net tangible:

Year Preceding Sale	Net Assets	Profits	10% of Net Assets	Excess Profits
3rd	$100,000	$14,000	$10,000	$ 4,000
2nd	80,000	13,000	8,000	5,000
1st	100,000	18,000	10,000	8,000
			Good Will	$17,000

Valuing Patents, Mining Royalties and Leaseholds

One other common formula should be considered. Since assets such as patents, mining royalties and leaseholds do not have unlimited life, the purchaser, in addition to realizing a return on the assets, must get back his capital investment during the life of the asset.

In valuing assets of this nature, the Bureau has often used Hoskold's formula. That formula assumes that out of the earnings a sinking fund to return capital would be set up at one rate of interest and a determination of the present value of the prospective income would be made at another rate of interest. A derivation of Hoskold's formula is as follows:

Present value of $1.00 per annum in n years, interest on capital being at one rate, r^1, and for redemption another rate, r per cent $= \dfrac{1}{\dfrac{r}{Rn-1} + r^1}$

$$Rn=(1+r)n$$

In this situation also, the interest rate should be varied according to the stability of the investment.[95]

DIFFERENCE BETWEEN PROCEEDS AND PURCHASE PRICE

Rarely will the product of the valuation formula and the proceeds of the insurance policy coincide in amount. In the event the proceeds exceed the purchase price, two possible solutions present themselves. Frequently the agreement will provide that the proceeds of the insurance shall constitute the minimum purchase price. Such a provision would be preferred by the proprietor for he would know in advance the minimum amount payable to his estate. The other solution is to provide that the excess of the proceeds over the purchase price shall be paid to the purchaser. Obviously, the purchaser would prefer this disposition since the amount of the excess would help compensate for the loss of the key man value of the proprietor.

Of course, in the ideal situation, the agreement will be fully funded. However, if the purchase price should exceed the proceeds and the purchaser cannot cover the disparity immediately with cash, three methods suggest themselves for providing for payment of the balance.

Notes

The purchaser may give the estate a series of interest-bearing notes secured, ordinarily, by a mortgage on the business. The amount of the notes should be set in the agreement, with the number of notes varying with the balance. The parties to the agreement should set the amount of each note at a low enough figure so as not to interfere with the purchaser's successful operation of the business, nor to impair his credit.

Limited Partnership

Another method is to provide that a limited partnership be formed,[96] with the executor or the legatee of the excess as the limited partner, and the unpaid balance constituting his capital contribution. Generally, the buy and sell agreement will require that the articles of limited partnership provide that the purchaser, the general partner, draw a salary of a specified amount and the balance of the profits be shared in proportion to the respective capital contributions, with the further restrictions that the general

95. See 10A Mertens, Law of Federal Income Taxation § 59.111 (rev. ed 1948).

96. This device can be used only if the limited partnership is countenanced by local statutes.

partner pay over all or a designated percentage of his share of these profits periodically to the limited partner in retirement of the latter's interest. As a further protection to the limited partner, he is frequently afforded the right to dissolve and wind up the partnership if a designated amount of profits are not realized for a stated number of years, ordinarily two.

Incorporation

A device common to many agreements is a provision requiring that the business be incorporated upon the proprietor's death. The estate or the legatee of the excess would normally receive non-voting stock, preferred both as to cumulative dividends and as to assets upon dissolution, in an amount representing the excess of the purchase price over the insurance proceeds. The purchaser would receive the common. The agreement should provide that a further agreement be entered requiring the corporation to retire periodically the preferred stock insofar as there are sums legally available, or the purchaser to purchase periodically the preferred stock out of his dividends. Also, the agreement should require that the articles of incorporation provide that if there is no dividends on the preferred stock for a stated number of years, generally two, the preferred stock shall have exclusive voting power until such time as there are no dividends in arrears.

OWNERSHIP AND PREMIUM PAYMENTS

Normally, the agreement contemplates the employee's applying for and owning the insurance policy, as well as paying the premiums. Often the agreement will require him to transfer the policy to a trustee.[97] To avoid any possibility of inclusion of both the insurance proceeds and the business interest in the proprietor's estate for estate tax purposes,[98] the proprietor should not have any of the incidents of ownership of the policy. It is equally clear for the same tax reasons that the employee should pay the premiums; but aside from the tax factor, common sense dictates such a result, for the employee is the one who is to pay the purchase price for the business.

Frequently, however, the key employee will be unable to carry the annual premium necessary to assure a completely funded agreement. If that is the case, several alternatives are available. The employee might buy such insurance as he can carry; the agreement

97. In any event, the agreement should *obligate* the employee to pay the premiums.
98. See Part V below.

would provide that if at the proprietor's death the purchase price exceeds the policy proceeds, one of the alternatives discussed in the preceding section would be utilized. Or the owner, if able, could help the employee meet the premiums necessary to fully fund the agreement by making annual loans. Upon the proprietor's death, the purchaser would pay the estate the purchase price plus the amount of the loans. But to repay the loans, the employee would have to take out insurance in excess of the value of the business or be burdened with running the business and at the same time paying off substantial debts—or, depending upon the terms of payment, might not even own the business outright.

A solution often preferred is to increase the employee's salary to allow him to carry a substantial part, if not all, of the necessary insurance.[99] The increase in salary, if reasonable, is deductible for income tax purposes by the proprietor so that he will be out of pocket less than the full amount of the increase. With the loan device he is out of pocket the entire amount of the loans at the time they are made (although subsequently his estate will be repaid); and the loan device entails the burden to the employee mentioned above.

The proprietor often asks, "Why should I assist the employee in paying the premiums? Why shouldn't I use the money to purchase my own life insurance so that at my death I can pass on to my family both my business interest and the amount of the insurance?"[100] The validity of this objection is in direct proportion to the amount of assistance necessary for the proprietor to afford the employee. If the employee can carry a substantial part of the load himself, it is wise for the proprietor to give him the additional assistance necessary to consummate a fully funded buy and sell agreement, with its benefits to the business, the employees, the proprietor and his estate.

BENEFICIARY NOMINATION[101]

A problem that should receive the consideration of the parties, the attorney, and the life underwriter, is that of who should be named beneficiary of the insurance policy.

The Employee

Naming the purchaser of the business the beneficiary has much to recommend it. In the first place, he has paid the premiums and,

99. Wage Stabilization Board permitting, of course.
100. See 15 Mo. L. Rev. 320 (1950).
101. For an excellent discussion, see Laikin, *Settlement Options and Survivor Purchase Agreements,* 4 J. Am. Soc'y Chartered Life Underwriters 199 (1950).

in the second place, it puts the purchase money in the hands of the person who must make the purchase. The nomination should insure an efficient purchase and sale. The designation of the employee, however, does involve a possible risk to the proprietor's estate. If the employee is insolvent at the proprietor's death, the proceeds might be consumed by his creditors; the estate will have lost a guaranteed purchaser.

Proprietor's Estate

The proprietor's estate should not be named as beneficiary. In the first place, an imbalance is created. The decedent's representative is in possession of both the proceeds and the business interests. There is much room for dissension and delay. Secondly, the insurance proceeds are exposed to the decedent's creditors. Thirdly, there is the possibility, although remote, that in view of the fact that the insurance proceeds are includible in the decedent's estate for federal estate tax purposes,[102] the proceeds *and* the business interests will be taxed.[103] Fourthly, on the strength of the celebrated *Legallet* case,[104] the insurance proceeds might be excluded for income tax purposes from the purchaser's cost basis of the business assets acquired through the buy and sell agreement. Finally, such a nomination should not be used unless the agreement specifies that the proceeds shall constitute the minimum purchase price. Since the proceeds are includible in the decedent's estate for estate tax purposes, although an amount against which, in the carefully drawn agreement, the estate may credit the value of the business interest, if the proceeds exceed the purchase price and the agreement specifies that the excess should revert to the purchaser, the estate would be paying estate taxes on an amount it never received.

The Deceased's Heirs

Often the proprietor will desire that his wife or family be named as beneficiary since he can then take advantage of the settlement options in the policy and thus integrate the business insurance with his personal insurance. However, since the settlement options can be availed of under another plan, and since designation of the heirs presents certain disadvantages, it should not be utilized. It defeats one of the purposes of the buy and sell agreement—the exchange of the proprietorship for estate liquidity.

102. See note 132 *infra*, and text.
103. See note 137 *infra*, and text.
104. 41 B.T.A. 294 (1940). See discussion below in Part V.

If the executor needs funds, he would have to go to the wife or family. Such a beneficiary nomination also creates somewhat of an imbalance, for the wife has the proceeds, the executor the business interests, and the purchaser but a contractual right, albeit in all probability specifically enforceable. Furthermore, the *Legallet* case here again poses the question of whether or not the insurance proceeds will be included in the purchaser's cost basis. It might be argued, as well, that the transaction is in fraud of creditors for immediately prior to the decedent's death he owned a business, whereas on his death the agreement requires that the business be conveyed to the purchasing employee—and yet the insurance proceeds by-pass the estate and go directly to the wife or family. Also, in the absence of a will, the intestate distributees might contend that the nomination of the wife has deprived them of their lawful share of the intestate's estate. Even if there is a will and the widow is named beneficiary of the proceeds, she might argue that inasmuch as the proceeds are not considered in computing her statutory share, she is also entitled to a share in the business assets.[105] A delay in transferring the business to the purchaser, whether caused by interference of the estate creditors, the intestate distributees or the widow, might be disastrous to the successful continuation of the business.

Corporate Trustee

The preferred beneficiary designation is that of a corporate trustee. Normally, the policy is also assigned to it. As a disinterested and responsible stakeholder, it can insure that the buy and sell agreement is completely and smoothly carried out. During the proprietor's life it will notify the purchaser that premium payments are due and remind the parties to make the periodic valuation revision, if a valuation clause of that type is used in the agreement. Upon the death of the proprietor, the trustee will file proof of death, collect the proceeds, and, according to the terms of the agreement, dispose of any key man policy held by the proprietor. The trustee will supervise the application of any valuation formula in the agreement, and if there is a disparity between the insurance proceeds and the amount of the business interest, it will see that proper disposition is made of the excess. The widow is apt to be more satisfied that she is getting equitable treatment

105. She obviously would not succeed for the buy and sell agreement is non-testamentary. *In re* Estate of Soper, 196 Minn. 60, 264 N. W. 427 (1935). See Grahame, *The Insurance Trust as Non-Testamentary Disposition*, 18 Minn. L. Rev. 391 (1934).

if the transfer is consummated by a disinterested third party. The corporate trustee is suggested in preference to the individual trustee since its continuous existence eliminates the possibility of problems in connection with alternates or successors; its experience in these matters is valuable and the cost is reasonable.

The designation of a corporate trustee as beneficiary does not necessarily preclude utilization of one of the settlement options. Many of the insurance companies will permit an arrangement whereby the insurance company holds the proceeds, subject to the trustee's right of withdrawal for a limited time to meet cash demands upon the estate; upon a release from the trustee, the insurance company will pay the proceeds according to a settlement option selected by the trustee or by the parties to the buy and sell agreement.[106] The trustee would be under a duty to withdraw the proceeds in favor of the purchaser if for any reason the agreement were not fulfilled. Although the implications of the *Legallet*[107] case are not clear, its holding should not extend to the trust situation.

Type of Insurance

Since the employee who must pay for the policy presumably does not have unlimited income, it is generally advisable to use low cost policies, such as term or ordinary life. However, where practicable, an annuity or endowment policy or an ordinary life policy with some retirement income plan should be used, since money could then be made available to purchase the business from the proprietor should he desire to retire during his lifetime. In addition to the life insurance the agreement could be collaterally funded with income disability or non-cancellable health insurance to provide installment payments of the purchase price in the event the proprietor becomes disabled.[108]

Restrictions on Use of Policy

If the purchaser is to be the owner and the beneficiary of the insurance policy, the agreement should contain a restriction preventing him from borrowing upon, assigning, pledging, or otherwise dealing with the policy without the consent of the proprietor.

106. See Business Purchase Agreements Funded with Life Insurance, New York Life Ins. Co. 17 (1952); Davis, Life Insurance and Business Purchase Agreements 11 (1950).

107. 41 B.T.A. 294 (1940).

108. Since the value of the business will certainly vary during the proprietor's life, a provision should be included in the agreement for adding, substituting or withdrawing policies upon the joint consent of the parties.

This provision is obviously unnecessary if the agreement provides, as recommended, that the policy is to be assigned to a trustee.

The agreement should contain an obligation on the part of the purchaser to keep up the premium payments; it might provide that in the event of default the proprietor may pay the premium with a right of reimbursement.[109]

KEY MAN INSURANCE

Frequently, the proprietor will apply for and pay the premiums on key man insurance on the life of his employee-purchaser with the proceeds payable to the proprietor, for the death of the employee will frustrate the purchase plan as well as be a severe loss to the business.

DISPOSITION OF POLICIES

The agreement contemplates, of course, that the employee will survive the proprietor. But the agreement should provide what disposition is to be made of the policy paid for by the employee in the event the employee predeceases the proprietor, or the agreement is for any reason terminated. It is customary to afford the proprietor an option to buy the policy on his life at a price reflecting either the premiums paid or the cash surrender value. It is important that the agreement give this right to the proprietor, for the passage of time may have caused him to become uninsurable.

A similar option in favor of the employee effective upon the death of the sole proprietor should be included with respect to any key man insurance held by the proprietor on the life of the employee. However, the agreement should require that if the employee exercises the option, he is to keep the policy in force and use it as additional security for any unpaid balance of the purchase price.

Buying the policy effects a "transfer for value" but, since the insured is the purchaser, the proceeds on his death will not be subject to income tax.[110]

POWER OF ATTORNEY

The agreement should contain a broad power of attorney, running from the proprietor to the purchaser, to insure against an

109. Even if the proprietor were forced to avail himself of the clause, the reimbursement feature should preclude the proceeds from being proportionately includible in his estate on the ground that he paid the premiums. See Mannheimer and Freidman, *Buy/Out Agreements*, 91 Trusts and Estates 16, 17 n. 9 (1952). At any rate, the point is in all probability academic. See the discussion below on the Double Tax.

110. See note 119 *infra*, and text thereto.

interruption of the business upon the proprietor's death. An interruption until such time as the executor could qualify might have disastrous effects on the business. Since this power of attorney would be coupled with an interest, it would, in most jurisdictions, survive the proprietor's death.

POST-MORTEM PROFITS

A carefully drawn buy and sell agreement will facilitate transfer of the business to the purchaser. But, even with such an agreement there is often an unforseen delay, and in any event, the business cannot be transferred until the executor qualifies and is appointed. During the delay the employee would be running the business pursuant to the power of attorney contained in the agreement. The agreement should provide who is to receive the profits earned during that time; most agreements award them to the purchaser.

PROPRIETOR'S WIFE AS A PARTY TO THE AGREEMENT

Unless the proprietor's wife is a part owner of the business, it is not necessary that she join in the agreement; but it might be better practice to have her join. It is advisable that the wife be apprised of the agreement; also, in the event she is named beneficiary of the insurance policy, her joining in the agreement would preclude any contention that she was entitled to her statutory share of the business interest as well as the insurance proceeds.[111]

AMENDING, REVOKING OR TERMINATING THE AGREEMENT

The agreement should provide that the parties by their joint action may at any time amend or revoke the agreement. If a trustee is involved, his consent would have to be secured if the amendment substantially changes his duties. The agreement should perhaps provide for automatic termination[112] in the event of total disability or death of the purchasing employee prior to consummation of the agreement, discharge of the purchasing employee pursuant to the terms of the agreement, bankruptcy of either party,

111. Although it is not necessary from a legal standpoint that the buy and sell agreement be mentioned in the proprietor's will, such mention is nevertheless recommended. The reference will put both the executor and the heirs on notice that the proprietor's business is subject to a purchase agreement, and the executor will be aware of his duty in consummating it.

112. If the proprietor has a minor son and desires the protection of a binding buy and sell agreement during his minority, but wants to be free to leave the business to his son if that should prove feasible, it might be provided that the agreement will automatically terminate upon the son's reaching a specified age, unless prior to that time the proprietor serves notice on the purchaser of his election to keep the agreement in force.

or lapse of the insurance funding the agreement.[113] If the employee is not afforded an option to purchase the business in the event the proprietor desires to sell it during his lifetime, there should be a provision for automatic termination upon sale or liquidation of the business by the proprietor. Some provision for a termination bonus to the employee might be considered, for he will have been paying premiums and will have been deprived of the opportunity to purchase the business.[114]

Certain vexatious problems are presented if the purchasing employee becomes disabled, dies, withdraws, or is discharged. If he dies, the key man insurance to some extent would compensate the proprietor for the frustration of the buy and sell agreement. Often the proprietor will want to work out a new funded buy and sell agreement with another employee. If the proprietor still is insurable, this can be accomplished, but often the intervening years will have deprived him of his insurability. The question then becomes, how may the new employee take over the original policy without incurring serious tax consequences. If the new employee buys the policy from the former employee, his estate or the proprietor (who had exercised his purchase option), the proceeds will be taxable income to him on the proprietor's death.[115] The agreement could require the defaulting employee to assign the policy without consideration to the new employee if the proprietor is uninsurable; or if the trust device is used, the trustee would continue to hold the policy for the benefit of the successor who would assume future premium payments. However, by that solution the first employee forfeits the amount of premiums he has paid.

Depending upon the purchase price, the uninsurable proprietor might consider buying the policy from the first employee and then transferring it to the new employee. If the new employee gives no valuable consideration, the proceeds should not be income. The proceeds would be includible in the proprietor's estate for estate tax purposes on the grounds that it was a gift intended to take

113. The agreement should contain a provision to the effect that if both the purchaser and the proprietor die as a result of a common disaster, the buy and sell agreement will be terminated and the proceeds from the funding insurance policy or the key man policy will be paid to the estate of the premium payer.

114. The buy and sell agreement should provide that the key employee will continue to work for the proprietor so long as the proprietor is conducting the business. The agreement should protect the employee against capricious discharge by the proprietor and contain a compensation formula; ordinarily it would be inequitable to freeze his salary. Some profit sharing arrangement will usually prove satisfactory.

115. See note 119 *infra*, and text thereto.

effect at death,[116] but the business interest should be excluded pro tanto.

V. SOME GENERAL TAX CONSIDERATIONS

In setting up or modifying the insured buy and sell agreement, the estate planner must constantly consider tax ramifications. A brief mention is here made of some of the more prevalent considerations.

FEDERAL INCOME TAX

Deductibility of Premiums

The premiums paid on life insurance to fund a buy and sell agreement are not deductible by the premium payer, nor can the employer deduct as an ordinaary and necessary business expense premiums paid on key man insurance, since he is the beneficiary of the policy.[117]

Proceeds of the Policy

Unless the policy has been transferred for value, the proceeds received by reason of the *death* of the insured are not taxable income to the beneficiary.[118]

Transfer of Policy

If the policy is transferred to someone other than the insured for valuable consideration, only the amount of the proceeds that equal the consideration plus the premiums paid by the purchaser are income tax exempt. This is true whether the proceeds are received upon surrender or upon maturity of the policy.[119] The transferor's basis for determining gain or loss on the sale of the policy is normally the cost of the policy, that is, premiums paid less dividends received. The difference between the net premiums and the amount received on the sale of the policy is not deductible as a loss.[120] If the insured realizes a gain upon the sale of the policy to a third person, the gain is taxable; it would appear to be a capital gain for the purpose of section 117 of the Code.

Surrender of Policy

If a life insurance policy is surrendered during the lifetime of the insured, the excess of the surrender value received over the

116. See note 74 *supra*, and text thereto.
117. Int. Rev. Code § 24(a)(4); U. S. Treas. Reg. 111, § 29.24-3.
118. Int. Rev. Code § 22(b)(A); U. S. Treas. Reg. 111, § 29.22(b)-1.
119. Int. Rev. Code § 22(b)(2); U. S. Treas. Reg. 111, § 29.22(b)(2)-3.
120. Century Wood Preserving Co. v. CIR, 69 F. 2d 967 (3d Cir. 1934); Keystone Consolidated Publishing Co., 26 B.T.A. 1210 (1932).

cost is taxable income.[121] Any loss incurred upon the surrender is not deductible.[122] The gain received on the surrender is taxable as ordinary income; it is not a capital gain for the purposes of section 117 since it is not regarded as a sale or exchange.[123]

Gift of Policy

If a life insurance policy is transferred and the transfer is not for a valuable consideration, as by a gift, the proceeds paid at death would be exempt from income taxation.[124]

Gains to the Estate

The proprietor's estate ordinarily should realize no taxable gain on the sale of the business pursuant to a buy and sell agreement, since the estate's basis "shall be the fair market value of such property at the time of such acquisition."[125] If the agreement is the result of an arm's length transaction, the fair market value normally will approximate the contract price.

However, for a while it seemed that the consummation of a binding buy and sell agreement would involve income tax disadvantages to the estate because the Treasury's General Counsel stated that the sale resulted in a capital gain equal to the difference between the *decedent's* cost basis and the purchase price.[126] That, fortunately, is no longer the case.[127]

Purchaser's Cost Basis

The cost basis for the business acquired by the purchaser would be the price he has paid if he bought the assets on a "gross basis." If he purchased the business "net," the purchase price plus the amount paid in discharge of the decedent's business debts constitutes his basis. The *Legallet* case[128] raises a doubt as to whether or not the insurance proceeds could be included in the cost basis of the purchaser if the proceeds of the policy were made payable to either the proprietor's estate or his personal beneficiaries.

In that case, Legallet procured a policy, to fund a buy and sell agreement, on the life of his partner O'Neill, payable to O'Neill's

121. Int. Rev. Code § 22(b)(2)(A).
122. Standard Brewing Co., 6 B.T.A. 980 (1927); I.T. 1944, III—1 Cum. Bull. 145 (1924).
123. Ralph Perkins, 41 B.T.A. 1225 (1940); G.C.M. 18233; 1937—1 Cum. Bull. 147.
124. U. S. Treas. Reg. 111, § 29.22(b)(2)-1.
125. Int. Rev. Code § 113(a)(5).
126 Special Ruling, No. 10, 1944.
127. T.D. 5459, 1945 Cum. Bull. 193; U. S. Treas. Reg. 111, § 29.126-1 (1).
128. 41 B.T.A. 294 (1940).

wife, as did O'Neill on Legallet's life. The premiums were paid by the partnership, charged against profit and loss, and thus paid equally by the partners. O'Neill died, and the proceeds of the policy were paid directly to his wife; Legallet received credit in the amount of the proceeds on his debt to Mrs. O'Neill for the purchase price of the partnership assets. Having sold some of the business assets, Legallet contended that the cost basis for income tax purposes should include the amount paid under the policy to Mrs. O'Neill. But the court held that because the insurance proceeds were not received by Legallet nor paid by him to Mrs. O'Neill, they could not be included in the cost basis of the partnership interest acquired. Notwithstanding the fact that the case is of questionable soundness, it *should not* be controlling if the premiums were paid by the employee; but there is no assurance that it *will not.*

FEDERAL GIFT TAX

A gift tax attaches if the insured pays the premiums on a life insurance policy, the proceeds of which are payable to a beneficiary other than his estate,[129] unless the insured retains, for example, the power to change beneficiaries or borrow upon the policy.[130] However, he will be deemed to have made a gift when he surrenders these retained rights. Even though the transfer of the policy may be taxed as a gift, the proceeds may still be taxable in the insured's estate on the grounds that he paid the premiums or that it was a transfer in contemplation of death or one intended to take effect at death. Of course, a credit would be allowed against the estate tax for the gift tax paid.

The taxable value of a gift of life insurance is its fair market value as of the date of the gift.[131] It might be valued at the cash value, total premium value or replacement cost, depending upon the circumstances.

FEDERAL ESTATE TAX

The proceeds of life insurance will be includible in the insured's estate for federal estate tax purposes if any of the following three situations exist:

1. If the proceeds of the policy are payable to the insured's estate, *i.e.*, his estate, executor or administrator, and without regard to the question of who owned the policy or paid the premiums.[132]

129. This rule, however, does not extend to the naming of a trustee as beneficiary.
130. U. S. Treas. Reg. 108, § 86.2(a)(8).
131. U. S. Treas. Reg. 108, § 86.19(a).
132. Int. Rev. Code § 811(g)(1).

2. If the proceeds are not payable to the insured's estate, they are nevertheless includible if the insured paid the premiums directly or indirectly.[133]

3. And even if the proceeds are not payable to the insured's estate and even if the decedent did not pay the premiums directly or indirectly, the proceeds are still includible if at the date of death the decedent possessed any of the incidents of ownership in the policy.[134] Incidents of ownership can perhaps be defined as any economic interest in or control over the policy or its proceeds, such as the right to receive the proceeds, name the beneficiaries, surrender, cancel, assign or pledge the policy.[135]

If the proceeds are includible in the insured's estate only because he paid the premiums, only that proportion of the proceeds attributable to his premium payments will be taxable. If the proceeds are includible because the insured had incidents of ownership, the proceeds will be fully taxable even though he paid no premiums. If the insured during his lifetime transferred the policy absolutely and unconditionally for adequate consideration, the proceeds are not includible in his estate. If the consideration was less than the value of the policy at the time of the transfer, the proceeds are taxable in the proportion that the premiums paid by the decedent bear to the total premiums paid.[136]

The Double Tax

The fear has been expressed[137] that there is a strong possibility that where the proceeds of the insurance policy are includible in the proprietor's estate, both the business interest and the proceeds will be includible for federal estate tax purposes. It seems certain now, however, that if the agreement clearly provides that the proceeds are to be credited as all or part, as the case may be, of the purchase price, the business interest will be replaced in the taxable estate pro tanto to the extent of the proceeds. Thus, the taxable estate will include either the amount of the proceeds or the business interest, whichever is larger. The Tax Court in the

133. Int. Rev. Code § 811(g)(2)(A).
134. Int. Rev. Code § 811(g)(2)(B).
135. U. S. Treas. Reg. 105, § 81.27(c)(2).
136. However, the amount paid directly or indirectly by the decedent must be reduced by a sum which bears the same ratio to the amount paid by the decedent as the consideration received by the decedent for the transfer bears to the value of the policy at the time of the transfer. Int. Rev. Code § 811(g)(2), (3).
137. Fahr, *The Business Purchase Agreement and Life Insurance*, 15 Law & Contemp. Prob. 319, 333 (1950).

Dobrzensky,[138] *Mitchell,*[139] *Tompkins,*[140] *and Ealy*[141] cases has refused to tax both the insurance proceeds and the business interest in the decedent's estate. The Bureau has indicated that such is a proper result,[142] and the Commissioner has acquiesced in the *Tompkins* case.[143] At any rate, to avoid the needless risk of double taxation it is desirable to have someone other than the insured own the policy and pay the premiums.

Effect of the Buy and Sell Agreement upon Estate Tax Valuation

The proprietorship will be taxed in the decedent's estate at its fair market value. Determining the market value of a closely held business interest is a difficult task indeed. The Treasury Regulations define it in effect as the price a willing buyer would pay a willing seller, each with reasonable knowledge of the facts and neither being under any compulsion to trade.[144] The definition is impossible of application;[145] the valuation the Commissioner will place on the business is singularly unpredictable.[146] Valuation fights are lengthy, costly and too infrequently won by the taxpayer. An enlightening article[147] contains the results of several studies in this area. The first study was of sixty-two valuation cases; sixty-five per cent of the cases established a value claimed by the government, only ten per cent were decided in favor of the taxpayer and the remainder were compromised at a figure substantially higher than that claimed by him. The other was a study of twenty-four cases. The average period of time needed ultimately to fix the estate tax value was in excess of four years, the shortest period was one and one-half years and the longest was almost eight years. Is it any won-

138. M. W. Dobrzensky, 34 B.T.A. 305 (1936).
139. John T. H. Mitchell, 37 B.T.A. 1 (1938).
140. Ray E. Tompkins, 13 T.C. 1054 (1949).
141. G. S. Ealy, P-H 1951 TC Mem. Dec. ¶ 51, 137.
142. Special Ruling, Nov. 24, 1947, by D. S. Bliss, Deputy Commissioner, wherein the *Mitchell* case was approved. This ruling is quoted at length in Danzig, *Taxes—Insurance and Stockholder-Survivor Agreements,* 28 Taxes 213, 215 (1950).
143. 1950-1 Cum. Bull. 5.
144. U. S. Treas. Reg. 105, § 81.10(a).
145. In Victoria L. Cotton, 15 P-H TC Mem. Dec. 587, 590, 591 (1946), the court pointed out that "... neither of these imaginary individuals [a willing buyer and a willing seller, neither under compulsion] has ever existed," and then quoted the statement of an expert appraiser: "Market value must be an estimate. . .. It is based on the conception of a transaction which did not take place between two persons who do not exist.'"
146. However, Hackett, in *The Fate of Business Interests in Estates,* 89 Trusts and Estates 107 (1950) states: "As a general rule, ... taxing authorities usually *claim* as tax value the higher of book and a capitalized earnings value, and the ultimate 'compromise' is seldom lower than the mean of the two values."
147. *Ibid.*

der that owners of closely held business interests search for a way to freeze the estate tax value?

Although it is frequently said that a buy and sell agreement will control the valuation of the business interest for estate tax purposes, such is not always the case. A *properly* drawn agreement will peg the value. In the first place, the agreement must restrict the right of the proprietor to dispose of his business interest during his lifetime. In *Claire Giannini Hoffman*[148] and *Estate of James H. Matthews*[149] it was held that the agreements involved were ineffective to peg valuation for the agreements did not contain provisions which would have prevented the decedent from disposing of his interests at any time prior to his death. Both of the agreements were regarded as testamentary in nature since the purchaser's right came into existence only upon the decedent's death.

In *Wilson v. Bowers*,[150] *Lomb v. Sugden*,[151] *CIR v. Bensel*[152] and *Estate of John T. H. Mitchell*,[153] the agreement valuations were held controlling for estate tax purposes. In each case the agreement contained a restriction which prevented the decedent from disposing of his business interests during his life; the purchaser was assured of his right of purchase and the decedent was prevented from ever getting more than the agreement price.

A first offer restriction, *i.e.*, if the proprietor desires to sell during his life he shall first offer it to the employee at the offeror's price, and if the offer is declined, the proprietor is free to sell to anyone at a price no less than the offering price, will not satisfy the lifetime restriction requirement of these cases.[154] The agreement should require that if the proprietor desires to sell the business during his lifetime, he must first offer it to the employee at the same price the agreement contemplates for the sale upon the proprietor's death. Thus, as a practical matter, the decedent could never receive more than the agreed price.

The second requirement is that the agreement be bona fide and the result of an arm's length transaction, especially where the purchaser is the natural object of the proprietor's bounty. The courts of course will not permit the agreement to operate as a device to

148. 2 T.C. 1160 (1943).
149. 3 T.C. 525 (1944).
150. 57 F. 2d 682 (2d Cir. 1932).
151. 82 F. 2d 166 (2d Cir. 1936).
152. 100 F. 2d 639 (3d Cir. 1938).
153. 37 B.T.A. 1 (1938).
154. Although such a restriction will not fix the estate tax value, it will have a depressing effect. Worcester County Tr. Co. v. CIR, 134 F. 2d 578 (1st Cir. 1943).

pass property at depressed tax values to the decedent's heirs.[155] In *Estate of Armstrong*[156] it was held that the option price was not conclusive as to values since the agreement was suggestive of a gift or legacy. On the other hand, the agreement was effective in *CIR v. Bensel,*[157] even though the agreement was between father and son, since it was the result of an arm's length transaction and was based upon adequate and full consideration, adequacy being determined as of the date of the agreement. There should be no donative intent. The price should be a fair and reasonable price. Although the proprietor should be concerned with freezing the value, he should not occupy himself mainly in setting a low valuation[158] for estate tax purposes for the estate tax rates are not yet one hundred per cent and, further, if the Commissioner does not accept the valuation, the cost of possible litigation might easily outweigh the savings on estate taxes.

Thus, the estate should be required to sell; the employee should either be bound to buy or have a binding option;[159] the agreement should be the result of an arm's length transaction and the purchase price fair and reasonable; and the proprietor should be precluded from disposing of his business interests during his life without first offering it to the employee at a price not higher than

155. Estate of Samuel H. Straus, 18 P-H TC Mem. Dec. 391 (1949).

156. 146 F. 2d 457 (7th Cir. 1944).

157. 100 F. 2d 639 (3d Cir. 1938).

158. If the option is given in whole or in part for services to be rendered and the option price is less than the market price, the purchaser might possibly be subjected to immediate income tax liability, or he might be taxed on the difference between the market and option price at the time of exercise. These possible income tax liabilities are suggested by CIR v. Smith, 324 U. S. 177 (1945). See note 44 *supra,* and Bowe, Life Insurance and Estate Tax Planning 89 (1950).

Further, since the abnormally low price will be the purchaser's cost basis, the income tax impact on a subsequent sale might perhaps cost the purchaser more than the additional premium necessary to cover a fair purchase price.

159. That is, if he chooses to buy, the estate must sell at the price specified in the agreement. The option should not be allowed to run longer than a year from decedent's death so that in the event it is not exercised, the executor can liquidate the business or sell it as a going concern and still avail himself of the optional valuation date under Section 811(j) of the Code. See Mannheimer and Friedman, *Buy/Out Agreements,* 91 Trusts and Estates 16, 17 (1952). Bushman, *Valuation of Close Corporation Securities,* 90 Trusts and Estates 228, 234 (1951), recites a recent case in this connection. A large block of stock in a close corporation was subject to a binding ninety day option at a price lower than the fair market value. The executor unfortunately chose the optional valuation date; since the option was not exercised, the stock on the critical date was not subject to any restriction and so was valued accordingly.

the price fixed in the agreement for sale in event of the proprietor's death.[160]

This rule as to restricting value was evolved by the federal courts in estate tax cases. The estate tax, of course, is imposed on the transfer by the decedent and is measured by the value to the decedent's estate of the property transferred. A buy and sell agreement would limit the value the estate can receive for the business interest. New York imposes an estate tax and follows the federal rule as to pegging values.[161] However, several states,[162] imposing inheritance taxes, have refused to be bound for tax purposes by a restrictive business purchase agreement. White[163] points out that the rule can be justified on the ground that the inheritance tax is levied on the value of the interest received from the decedent. A buy and sell agreement cannot affect that value.

160. See, for a comprehensive discussion, Ness, *Federal Estate Tax Consequences of Agreements and Options to Purchase Stock on Death,* 49 Col. L. Rev. 796 (1949). See also *May v. McGowan,* 97 F. Supp. 326 (W.D. N.Y. 1950) (an interesting case in which a zero valuation was upheld); Estate of Albert L. Salt, 17 T.C. No. 13 (1951); Montgomery's Federal Taxes, Estates, Trusts and Gifts 684 *et seq.* (1952).

161. *In re* Miller's Estate, 191 Misc. 784, 79 N. Y. S. 2d 372 (Surr. Ct. 1948).

162. See Minoff v. Margetts, 14 N. J. Super. 30, 81 A. 2d 369 (App. Div. 1951); Schroeder v. Zink, 4 N. J. 1, 71 A. 2d 321 (1950); *In re* McLure's Estate, 347 Pa. 481, 32 A. 2d 885 (1943); *In re* Cowles' Estate, 36 Wash. 2d 710, 219 P. 2d 964 (1950).

163. White, *The Impact of Local Law on Buy and Sell Agreements,* 1951 Proc. Ninth Estate Planners Forum of Solomon Huber Associates 1, 16 (1952).