1967

A Closer Look at Disability Buy-Outs for the Close Corporation

Minn. L. Rev. Editorial Board

Notes

A Closer Look At Disability "Buy-Outs" For The Close Corporation

I. INTRODUCTION

Agreements to repurchase the stock held by the estate of a deceased shareholder have been widely adopted by close corporations. A more recent extension of this practice is an agreement to repurchase the interest of a shareholder who, due to accident or illness, becomes disabled to such a degree that he can no longer participate actively in the affairs of the business. Many of the most persuasive reasons advanced for providing for the orderly disposition of the stock of a deceased shareholder apply with equal force to the stock of a disabled shareholder.[1]

The disability of a shareholder-officer of a close corporation may put the other shareholders in an undesirable predicament. Without his salary, the disabled shareholder may oppose any program of expansion which would reduce the funds available to pay the dividends which are the only return on his investment. Furthermore, if dividends are not forthcoming, he may attempt to sell his stock outside the present corporate structure to a buyer unacceptable to the remaining shareholders. On the other hand, if the disabled shareholder does not demand dividends or sell his interest,[2] he will be in a difficult position since, while he will participate in the appreciation in value of the business as it grows, he will not be able to realize present benefit from his investment.

A prearranged agreement for the repurchase of stock can eliminate shareholder dissent, allow the corporation to return the shareholder's appreciated capital to him for reinvestment in assets with a greater present yield, and leave the benefits of continued growth of the business to those responsible for it. However, the disability buy-out agreement is not necessarily desirable in all cases. It is the purpose of this Note to examine some of the considerations of corporate and tax law which must be

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1. On the basis of actuarial tables the chance of a shareholder between the ages of 30 and 50 becoming disabled is 2 to 3 times greater than the chance of his dying. W. HARMELIN & R. OSLER, BUSINESS USES OF HEALTH INSURANCE 1 (1960).

2. This may not be a matter of choice since a minority interest, presuming that is what the disabled shareholder has, is not a readily marketable commodity. *See* 2 F. O'NEAL, CLOSE CORPORATIONS § 7.23 (1958); Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866, 897 (1961).

weighed to determine the feasibility and desirability of such an agreement and to propose guidelines where a disability buy-out agreement is feasible.

II. CORPORATE INTERESTS IN PLANNING

A. Corporate Law Problems

Because corporations must act within a statutory framework limiting the scope of permissible activities, the planner must remain within that framework in attempting to formulate a workable disability buy-out agreement. Statutory limitations are imposed on the funds allocable to repurchase and the methods available to obtain additional funds both before and after the agreement becomes operative. While all states grant a corporation the right to repurchase its own stock,[3] they also regulate and restrict such repurchases.[4] Typically, the corporation can repurchase only out of "surplus"[5] or some fraction thereof.[6] Thus, in order to be financially prepared to buy out a disabled shareholder, the corporation must have surplus, or even earned surplus, equal to the agreed or fair value of the largest shareholder's interest. Even if this requirement can be met, the desirability of maintaining the liquidity necessary to permit easy conversion to cash decreases as the value of the shareholder's interest rises.

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3. *See* 1 ABA-ALI Model Bus. Corp. Act. Ann. § 5, ¶ 2.03 (Supp. 1966); *see generally* Kessler, *Share Repurchases Under Modern Corporation Laws*, 28 Fordham L. Rev. 637 (1960).

4. *E.g.*, Cal. Corp. Code §§ 1706-08 (1955); Del. Code Ann. tit. 8, § 160 (1953); Ill. Rev. Stat. ch. 32, § 157.6 (1965); N.Y. Bus. Corp. Law § 513 (McKinney 1963).

5. The definition of this term varies among jurisdictions and between lawyers and accountants. The Model Business Corporation Act adopts the following definitions:

> (k) "Surplus" means the excess of the net assets of a corporation over its stated capital [defined in subsection (j)].
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> (l) "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation . . . after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. . . .
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> (m) "Capital surplus" means the entire surplus of a corporation other than its earned surplus.

ABA-ALI Model Bus. Corp. Act. § 2 (1960).

6. *See, e.g.*, Cal. Corp. Code § 1707(c) (1955); Md. Ann. Code art. 23, § 32(b)(3) (1957); N.Y. Bus. Corp. Law § 513(a) (McKinney 1963); N.C. Gen. Stat. § 55-52(c)(1965)("surplus"); Tex. Bus. Corp. Act. art. 2.03C (1956) (*but see* art. 2.03D) ("earned surplus"); Cunningham, *Stock "Buy-Out" Plans: Selections and Drafting*, 18 Md. L. Rev. 277, 287 (1958); Kessler, *supra* note 3, at 653. *But see* Scriggins v. Thomas Dalby Co., 290 Mass. 414, 195 N.E. 749 (1935).

Arguably, the surplus can be obtained by a capital reduction prior to the time of the buy-out.[7] However, a capital reduction must conform to statutory requirements which may limit the amount[8] and the manner of such reduction.[9] Furthermore, the allowable uses of a capital reduction surplus may be limited by statute.[10]

Statutory problems may also arise in attempts to restore surplus by cancellation of the repurchased shares.[11] For example, although the shares are repurchased out of earned surplus under statutory requirements, the subsequent cancellation of the stock will create capital reduction surplus, not earned surplus. Hence, further repurchase with those funds will not be allowed under some state statutory restrictions. Even where any type of surplus may be used for repurchase, the cancellation of the repurchased stock will reduce capital only by the par or stated value of the shares; the excess of the purchase price over the par or stated value will not reappear in the surplus account.[12]

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7. Cunningham, *supra* note 6, at 287.

8. The Model Business Corporation Act defines stated capital:

> . . . the sum of (1) the par value of all shares of the corporation having a par value that have been issued, (2) the amount of the consideration received by the corporation for all the shares of the corporation without par value that have been issued, except such part of the consideration thereof as may have been allocated to capital surplus in a manner permitted by law, and (3) such amounts not included in clauses (1) and (2) . . . as have been transferred to stated capital of the corporation. . . .

ABA-ALI MODEL BUS. CORP. ACT § 2(j) (1960).

9. *E.g.*, CAL. CORP. CODE § 1904 (Supp. 1966) (both director and shareholder vote); DEL. CODE ANN. tit. 8, § 244(b) (Supp. 1966) (retirement by lot or exchange of shares).

10. *E.g.*, CAL. CORP. CODE § 1907 (1955) (fair value of assets is 1¼ times debts and liabilities); MINN. STAT. § 301.39 (1961) (limited by existence of any preference). Capital reduction surplus is not part of the earned surplus, *see* TEX. BUS. CORP. ACT arts. 2.03C & 2.03D (1956), and therefore will not be available for share repurchase in those states limiting repurchases to amounts out of earned surplus. *But see* CAL. CORP. CODE § 1906(a) (1955) (providing for limited use of capital reduction surplus for repurchase).

11. In most states the surplus account is reduced by the cost of the shares. The net assets are then usually defined so as not to include treasury stock. A few others adopt the position of the Model Business Corporation Act § 5 and restrict surplus by the repurchase price. Hackney, *The Financial Provisions of the Model Business Corporations Act*, 70 HARV. L. REV. 1357, 1392 n.168 (1958).

12.

> To the extent that earned surplus or capital surplus is used as the measure of the corporation's right to purchase its own shares, such surplus shall be restricted so long as such shares are held as treasury shares, and upon the disposition or cancellation of any such shares the restriction shall be removed pro tanto.

ABA-ALI MODEL BUS. CORP. ACT § 5 (1960). This provision leaves unclear whether the removal of the restriction applies to the full price per

The use of a pre-repurchase capital reduction or subsequent share cancellation raises the additional problem that neither is an automatic source of cash. The reduction of capital does not transfer funds into the cash account; it simply reduces the amount of the asset cushion that the corporation is required to maintain for the benefit of its creditors. Consequently, if the corporation does not have liquid assets equal to the amount of the surplus, the surplus is usable only to the extent that nonliquid assets can be converted into cash.

In determining the feasibility of a buy-out agreement in light of the funding problems mentioned, the potentially detrimental consequences of not adopting the buy-out agreement must also be considered. Several states, for example, have statutes which provide a disabled minority shareholder with some rights against the majority.[13] Although these statutes are generally negative in effect, even a threat to invoke them can influence the majority to act to the detriment of the corporation. In addition, if the disabled shareholder holds a majority interest, the minority will be faced with a nonparticipating shareholder who, under corporate law, has control of the business. Even a holder of fifty per cent of the stock can deadlock the corporation so that dissolution may be the only answer.[14]

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share or only to the amount by which the stated capital has been reduced. The latter view seems to be the more logical approach.

13. The Minnesota Business Corporation Act provides that a two-thirds vote is necessary to amend the articles of incorporation. MINN. STAT. § 301.37(3)(2)(a) (Supp. 1966). In Aiple v. Twin City Barge & Towing Co., 274 Minn. 38, 143 N.W.2d 374 (1966), plaintiff owned 34% of the voting stock of the defendant corporation and had effectively blocked all attempts to increase capital for expansion by amending the article. He brought suit to enjoin the establishment of a subsidiary whose stock was to be used to increase capital. The lower court's judgment granting the injunction on the ground that the corporation could not do indirectly what the statute prevented it from doing directly was upheld. The supreme court admitted the minority shareholder was probably asserting his rights to the detriment of the corporation, but it held to the view that the state law gave him that right. *Id.* at 45-46, 143 N.W.2d at 379. For similar statutory provisions see ILL. REV. STAT. ch. 32, § 157.53(c) (Supp. 1966); N.J. STAT. ANN. § 14: 11-2 (1939); *see generally* R. STEVENS, CORPORATIONS 670 (2d ed. 1949). Other states allow provision for high voting and quorum requirements in corporate charters and bylaws. *E.g.*, CAL. CORP. CODE § 816 (1955); DEL. CODE ANN. tit. 8, § 102(g)(4) (1953). In addition, many states have imposed on the majority shareholder a fiduciary duty to refrain from arbitrarily acting to the detriment of the minority interest. *E.g.*, Helms v. Duckworth, 249 F.2d 482, 486, 487 (D.C. Cir. 1957); *see generally* 2 F. O'NEAL, CLOSE CORPORATIONS § 8.07 (1958).

14. *See* 2 F. O'NEAL, *supra* note 13 § 9.02.

There is hope for a workable solution to the problems raised by the statutory restrictions on funding and the detrimental consequences under corporate law of failing to adopt a buy-out agreement. Both courts and legislatures are beginning to recognize the basic differences between public and close corporations and the need for less stringent governmental control of the latter.[15] For the present, however, strict application of local corporate law to the particular facts and circumstances of each case is necessary since there is no assurance all courts and legislatures will adopt this attitude or extend it to the disability buy-out agreement.

B. THE PROBLEMS OF CORPORATE TAXATION

In most cases, the close corporation will be able to finance a stock repurchase of any size only out of past or future accumulations of earnings.[16] As a result, there is the possibility that the accumulated earnings tax[17] will be applied to these funds.[18] The purpose of the tax is to penalize a corporation for sheltering its shareholders from tax liability by retaining earnings otherwise available for dividend distribution.[19] However, the tax is not self-assessing. A corporation is not required to pay the tax until the Internal Revenue Service has determined that the corporation was "formed or availed of" for the purpose of avoiding tax on the shareholders.[20] Although this determination is ultimately subjective, some measure of objectivity is derived from section 533(a), which provides that accumulations "beyond

15. *See, e.g.*, Chambers v. Beaver-Advance Corp., 392 Pa. 481, 492, 140 A.2d 808, 814 (1958); Kauffman v. Meyberg, 59 Cal. App. 2d 730, 140 P.2d 210 (1943); N.Y. BUS. CORP. LAW § 620 (McKinney 1963); N.C. GEN. STAT. § 55-24(a) (1960); S.C. CODE ANN. §§ 12-11.1 to -31.2 (Supp. 1964); Folk, *The Model Act and the South Carolina Corporation Law*, 15 S.C.L. REV. 275, 281 (1963); Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 33 N.C.L. REV. 26, 45 (1954); *see generally* F. O'NEAL, *supra* note 13.

16. *See* Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866 (1961).

17. INT. REV. CODE of 1954, §§ 531-37 [hereinafter cited as INT. REV. CODE]. For a detailed discussion of the accumulated earnings tax, *see generally* 7 J. MERTENS, FEDERAL INCOME TAXATION §§ 39.01-.58.

18. For some small corporations the accumulated earnings tax will pose no problem since § 535(c)(2) of the Code provides a basic credit of $100,000 against accumulations. However, when applied, the effect of the tax is severe. The present rate is 27.7% of the first $100,000 and 38.5% of the excess. INT. REV. CODE § 531.

19. INT. REV. CODE § 532(a).

20. INT. REV. CODE § 532; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 218 (1966) [hereinafter cited as B. BITTKER].

the reasonable needs of the business" are presumptive evidence of the prohibited purpose, subject to the corporation's right to prove the contrary. Thus, in determining whether the possible accumulated earnings tax liability constitutes a sufficient risk to make a disability buy-out agreement inadvisable, two issues must be faced: whether repurchase of a disabled shareholder's stock is a sufficient business need to avoid the presumption of the prohibited purpose, and whether, with or without the presumption, the redemption will bar a finding that the underlying motivation is tax avoidance.[21]

The question of what constitutes a reasonable business need is complex and unsettled.[22] Where evidence concerning business need is offered by the corporation, a finding for the Commissioner represents a substitution of judicial judgment for that of the corporate directors. The courts have shown considerable reluctance to make this substitution, at least when determining questions under state corporation laws.[23] Some of this reluctance has carried over into the accumulated earnings tax area.[24] As a result, the Tax Court has intermittently passed completely over the reasonable business needs issue and ruled directly on the proscribed purpose question.[25] However, most of the cases have been won or lost on the reasonable needs issue, with the losing party usually conceding defeat.[26] The concession is encouraged by section 535(c)(1), which allows a credit against the tax for that part of the accumulation retained for the reasonable needs of the business. Designed to eliminate the all-or-nothing approach to applying the tax under prior law,[27] this section would seem to require a finding on the issue of reasonable need for the accumulation.[28]

The question whether a disability buy-out agreement is a reasonable need of the business has not been faced by the courts,

21. The presumption created in favor of the government by § 533 (a) does not work in reverse. Thus a finding of a reasonable business need does not in itself bar a finding against the taxpayer on the ultimate question of purpose. *See* Herwitz, *supra* note 16, at 870, 876.

22. On what constitutes a reasonable need, *see generally* J. MERTENS, *supra* note 17, at §§ 39.31-.47.

23. 5 W. FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2104, at 481-88 (rev. vol. 1967).

24. Treas. Reg. § 1.537-1(a) (1959) states that the standard to be applied is that of the "prudent businessman." *See* R. Gsell & Co. v. Commissioner, 294 F.2d 321, 326 (2d Cir. 1961).

25. Herwitz, *supra* note 16, at 920.

26. B. BITTKER 219.

27. S. REP. No. 1622, 83d Cong., 2d Sess. 72 (1954).

28. *Cf.* John R. Scripps Newspapers, 44 T.C. 453 (1965).

and the Code and regulations shed little light on the problem.[29] Attempts to draw analogies to cases involving other types of stock redemption yield no conclusive answers as each case rests on its own particular set of facts and circumstances, and each is in some way distinguishable from the disability buy-out situation. *Emloid Company v. Commissioner*[30] has often been cited as evidence of judicial recognition of the reasonable need for stock repurchase agreements.[31] However, *Emloid* involved a credit against accumulations for a debt incurred to purchase life insurance to fund a death buy-out. Therein, it was certain that partial ownership of the corporation would change hands at death and, therefore, there was a definite need to facilitate the change. In both *Mountain State Steel Foundries, Inc. v. Commissioner*[32] and *Penn Needle Art Company*,[33] the imposition of the tax was disallowed where the earnings were used to repurchase the interests of living shareholders, but shareholder dissension existed at the time the buy-out was arranged in each case.[34] With a disability buy-out agreement, there is no certainty a shareholder will become disabled or if he does, that he will dissent from existing management policy or try to sell his stock. Thus the contingent disability of a shareholder may be held an unrealistic hazard, provision for which would not be a reasonable need of the business.

A further problem arises if the corporation is sufficiently

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29. The Code states that reasonable needs include reasonably anticipated needs. INT. REV. CODE § 537. The regulations do not deal specifically with accumulations to retire stock. *See* Treas. Regs. §§ 1.537-1 to -3 (1959). The reasonableness of the accumulation will depend on the facts of the particular case. Treas. Reg. § 1.537-2(a) (1959). Accumulations for unrealistic hazards are not reasonable. Treas. Reg. § 1.537-2(c) (1959).

30. 189 F.2d 230 (3d Cir. 1951).

31. *See, e.g.*, Spindell, *How the Emloid Case Reversal Upholds Business Insurance Agreements*, 93 J. ACCOUNTANCY 578 (1952); Young, *Stockholders' Agreement and Federal Taxation*, 8 J. AM. SOC'Y C.L.U. 154 (1954). The language usually referred to is: "Harmony is the essential catalyst for achieving good management; and good management is the *sine qua non* of long term business success." Emloid Co. v. Commissioner, 189 F.2d 230, 233 (1951).

32. 284 F.2d 737 (4th Cir. 1960).

33. 17 CCH Tax Ct. Mem. 504 (1958).

34. In *Mountain State*, no funds were accumulated until dissolution was threatened and the dissenters had exchanged their stock for notes given by the corporation to cover the repurchase price. In *Penn Needle*, funds had been accumulated for other purposes and were applied to redemption of the stock only after dissent had developed. Some doubt has been cast on *Mountain State* as authority for accumulations to repurchase. Herwitz, *supra* note 16, at 920-22.

strong financially, absent prior accumulations, to repurchase the stock over a fairly short period of time subsequent to a disabling accident or illness.[35] The corporations best able to provide in advance for buy-outs are those most likely to be taxed for doing so on the grounds that the provision was unnecessary.

These considerations suggest a possible distinction between the treatment to be accorded pre- and post-redemption accumulations.[36] Where the corporation gives notes to the shareholder for his stock and then accumulates funds to pay off the obligation thus incurred, it is arguable that the accumulation should be treated as one to pay off a bona fide debt of the corporation, and, therefore, a reasonable business need.[37] However, merely reversing the sequence of events may prove insufficient to redeem an accumulation which would otherwise be held unreasonable, especially if there is no evidence of actual shareholder dissent or of disadvantageous sale at the time of the redemption.

Under the terms of the statute, the presence or absence of a reasonable business need is not in itself the determinative question.[38] Even if there is no reasonable need, the tax will not apply absent a finding of a purpose to avoid income tax on the shareholders. Thus the uncertainty that the corporation faces in establishing the reasonable need for a disability buy-out need not affect the agreement's usefulness as a corporate planning device so long as the agreement negates the existence of the proscribed purpose. Unfortunately this is not necessarily the case. Once again the decisions have little precedential value outside the context of their own facts and circumstances. Facts probative of purpose in one case may be inconsequential in another.[39]

The basic problem with the disability repurchase, as with

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35. *Cf.* B. BITTKER 220-21. In such a case it may be argued that the accumulations were unnecessary.

36. *See* B. BITTKER 233; Herwitz, *supra* note 16, at 901. *But cf.* Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957).

37. Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), appears to treat a post-redemption debt as such. *See* B. BITTKER 233.

38. *See* Herwitz, *supra* note 16, at 870. *But see* note 26 *supra* and accompanying text.

39. One factor which appears to be generally treated as significant is the past dividend record of the corporation. *See* Bachrach, *Redemption May Not Prove Unreasonable Accumulation of Surplus; New Rules Emerging*, 10 J. TAXATION 84 (1959); *cf.* World Publishing Co. v. Commissioner, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911, *rehearing denied*, 336 U.S. 915 (1949). *But cf.* B. BITTKER 217.

other stock redemptions, is that it allows the corporation to distribute earnings and profits otherwise subject to dividend tax treatment at capital gains rates. This may constitute a basis for finding a tax avoidance motive within the meaning of section 532.[40] This raises two preliminary questions: Is the purpose of the seller or the remaining shareholders to be imputed to the corporation, and to what extent must the proscribed purpose have motivated the transaction?

It is obvious that in a close corporation any attempt to differentiate between the objectives of the corporation and the objectives of its shareholders will in all probability prove futile.[41]

However, since the accumulated funds pass to the individual shareholder whose stock is redeemed, and he alone receives the benefit of the capital gain treatment, it is difficult to find a basis from which to infer the existence of the proscribed purpose on the part of the other shareholders. Thus if the purpose attributed to the corporation is that of the remaining shareholders, the tax may be avoided, but if it is that of the selling shareholder, the corporation's position is more doubtful.

This suggests that a distinction may be drawn between redemption of a majority and a minority interest.[42] General corporation principles indicate that the purpose attributable to the corporation should be that of those who control it.[43] Hence, if the shares repurchased constitute a majority of the stock outstanding, then the corporation must defend the selling shareholder's motive. This is a defensible result since the majority is in a position to cause the corporation to act for its benefit,[44] and the minority shareholders, absent some special circumstances, have no legally protectable interest in maintaining existing corporate policies.[45]

If the corporation must defend the motives of one who may bring it within the section 532 proscription, it is material to determine the extent to which the proscribed purpose must be shown to exist. Here also the cases conflict. The First Circuit's decision

40. B. BITTKER 230.

41. *See* Prunier v. Commissioner, 248 F.2d 818, 821 (1st Cir. 1957); Lewis v. Commissioner, 176 F.2d 646, 650 (1st Cir. 1949); Herwitz, *supra* note 16, at 918.

42. *See* Herwitz, *supra* note 16, at 909-18; *cf.* Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958).

43. Herwitz, *supra* note 16, at 929.

44. For restriction on the majority's ability to so act, see Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957).

45. Herwitz, *supra* note 16, at 911.

in *Young Motor Company*[46] represents what would appear to be the preferred position.[47] The Tax Court in *Young* adopted the position that the proscribed purpose need be only one among other legitimate purposes.[48] However, the court of appeals reversed, adopting a dominant or principal purpose test[49] subsequently accepted by the Tax Court.[50] However, other circuits have applied a standard closer to that first adopted by the Tax Court in *Young*, requiring that the motive need be only one of the purposes for such an arrangement to fail.[51] The only reasonably certain conclusion which can be reached is that tax avoidance need not be the sole purpose for the tax to be applied, but it must at least be more than an incidental reason for the repurchase.[52] Applying these considerations to stock redemptions, Professors Bittker and Eustice have concluded:

> Because the importance of the redemption to the corporate business activities is often tenuous or debatable . . . the unsettled state of the law suggests caution in relying on the pro-taxpayer decisions, especially if the contemplated redemption is not likely to occur until a distant future date . . . . If the redemption . . . is required by a shareholder agreement to retire the shares of any party thereto upon his death or retirement, it seems even more vulnerable.[53]

These admonitions apply with equal force to the disability buy-out.[54]

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46. 281 F.2d 488 (1st Cir. 1960), *rev'g and remanding* 32 T.C. 1336 (1959); Young Motor Co., 21 CCH Tax Ct. Mem. 711 (1962), *rev'd and remanded*, 316 F.2d 267 (1st Cir. 1963); Young Motor Co., 23 CCH Tax Ct. Mem. 113, *aff'd*, 339 F.2d 481 (1st Cir. 1964).

47. Herwitz, *supra* note 16, at 876.

48. 32 T.C. at 1345.

49. 281 F.2d at 491.

50. 23 CCH Tax Ct. Mem. 113.

51. *E.g.*, Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961). For a discussion of the purpose requirement see J. MERTENS, *supra* note 17, §§ 39.26-.27.

52. B. BITTKER 216.

53. *Id.* at 231.

54. Note also that even if the redemption of stock standing alone does not justify imposition of the accumulated earnings tax, it may be a factor in determining whether the overall accumulations of the corporation go beyond the reasonable needs of the business. *See* Frenco, Inc. v. United States, 234 F. Supp. 317 (D. Md. 1964); Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737, 745 (4th Cir. 1960). Moreover, since the accumulated earnings tax may be imposed after the buy-out, the planner drafting the agreement should make some provision to allocate the loss between the shareholders and the corporation. Otherwise, the disabled shareholder is the only one who has participated in the distribution of the accumulation, and yet absent such a provision, he will not be affected by the payment of the tax.

An additional tax problem for the corporation is the possibility that the remaining shareholders will be deemed to have received a dividend by virtue of the fact that their interests have been enhanced by the elimination of the disabled shareholder's stock. However, such a determination has been foreclosed for the present. Revenue Ruling 59-286[55] states: ". . . [T]here is no authority affirmatively supporting the proposition that a redemption of one shareholder's shares, at fair market value, constitutes a dividend to a remaining shareholder."[56] Under this ruling the transaction may be taxed as a dividend only if it is determined to be in substance a purchase by the remaining shareholders, financed by the corporation.[57]

III. SHAREHOLDER INTEREST IN THE BUY-OUT

A. CORPORATE LAW PROBLEMS

A persuasive argument to induce a minority shareholder to enter a buy-out agreement is the problem he would face in attempting to compel the corporation to pay dividends.[58] Courts are reluctant to interfere with the internal affairs of corporate management, and it is well-settled doctrine that the payment of any dividends lies in the discretion of the directors.[59] With this burden to overcome, the shareholder may feel that it is better to plan in advance to have the value of his assets returned to him in the event he is no longer able to participate actively in the management of the business.[60]

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55. 1959-2 CUM. BULL. 103.

56. *Id.* at 105.

57. *Id.*

58. *See generally* F. O'NEAL, CLOSE CORPORATIONS § 8.08 (1958); Comment, *Dividends in Closed Corporations,* 56 NW. U.L. REV. 503 (1961).

59. *E.g.,* Moskowitz v. Bantrell, 190 A.2d 749 (Del. 1963); Lockley v. Robie, 301 N.Y. 371, 93 N.E.2d 895 (1950); H. BALLANTINE, CORPORATIONS § 231 (rev. ed. 1946); F. O'NEAL, *supra* note 58, at 112; *see* Cashman v. Petrie, 14 N.Y.2d 426, 428, 201 N.E.2d 24, 25, 252 N.Y.S.2d 447, 448 (1964) (dictum) (citing cases).

60. This consideration will weigh particularly heavily if the corporation has elected to be taxed as a small business corporation under Subchapter S. *See* INT. REV. CODE §§ 1371-77. Such an election means that each shareholder will be taxed on the undistributed taxable income of the corporation according to his proprietary interest. INT. REV. CODE § 1373. Once an election is made a shareholder cannot withdraw his consent, and it can be revoked only by the consent of all the shareholders. *See* INT. REV. CODE § 1372(e)(2); Treas. Reg. § 1.1373-3(a) (1956). Thus a shareholder may find himself unable to compel distribution and yet forced to pay his share of the taxes on the earnings the corporation holds.

However, the statutory restrictions on the funds available to repurchase stock may adversely affect a shareholder's willingness to be bound by a buy-out agreement. Whatever the financial position of the corporation at the time the agreement is entered into, an absence of the required surplus at the time the agreement becomes operative will render performance impossible. Additional problems arise if the purchase is to be by installments. The surplus test may have to be met as the installments fall due as well as at the time the buy-out becomes operative.[61] Thus, if the corporation is unable to meet the surplus requirement, the shareholder will have surrendered his stock and yet be unable to compel payment for it. He can either do nothing and hope the corporation's financial condition improves, or attempt to force the return of his stock. If he adopts the latter course, he will probably be able to recover only the unliquidated shares unless he can return the payments already made. Such a transaction will impair his voting rights, especially if his original holding was fifty per cent or more of the stock.[62]

The same type of double test may be applied in cases of insolvency,[63] although the magnitude of the insolvency problem is mitigated by two factors. If the shareholder takes notes for his stock and the corporation becomes insolvent, it has been held that the note holder will stand between the general creditors and the other shareholders in order of preference,[64] one step

61. *E.g.*, Kleinberg v. Schwartz, 87 N.J. Super. 216, 208 A.2d 803 (App. Div.), *certification granted*, 45 N.J. 33, 210 A.2d 779 (1965); Cutter Labs, Inc. v. Twining, 221 Cal. App. 2d 302, 34 Cal. Rptr. 317 (1963); Burk v. Cooperative Fin. Corp., 62 Wash. 2d 740, 384 P.2d 618 (1963).

62. Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 HARV. L. REV. 303, 315 (1965).

63. *E.g.*, *In re* Trimble Co., 339 F.2d 838 (3rd Cir. 1964); *In re* Fechheimer Fishel Co., 212 F. 357 (2d Cir. 1914); Herwitz, *supra* note 62. Insolvency may mean either that the corporation is unable to pay its debts as they come due (the equity sense), or that its assets do not equal its liabilities (the bankruptcy sense). Kessler, *Share Repurchases Under Modern Corporation Laws*, 28 FORDHAM L. REV. 637, 643 (1960). The Model Business Corporations Act defines insolvency in the equity sense. ABA-ALI MODEL BUS. CORP. ACT § 2(n) (1960). Some states refer specifically to both types of insolvency. *See, e.g.*, MD. ANN. CODE art. 23, § 32(c) (1957); TEX. BUS. CORP. ACT art. 2.03(f) (1956).

64. *In re* Dawson Bros. Constr. Co., 218 F. Supp. 411 (N.D.N.Y. 1963); Baxter v. Lancer Indus., Inc., 213 F. Supp. 92 (E.D.N.Y. 1963); *In re* Fechheimer Fischel, 212 F. 357 (2d Cir. 1914); *see also* R. STEVENS, CORPORATIONS 286 n.53 (2d ed. 1949); Herwitz, *supra* note 62, at 319; Kessler, *supra* note 63, at 673. At least one case has held that the note holder is entitled to share equally with the general creditor. Wolff v. Heidritter Lumber Co., 112 N.J. Eq. 34, 163 A. 140 (Ch. 1932). However, in that case the corporation could have paid cash as it had sufficient surplus at the time of the repurchase.

above where he would have stood had he not sold the shares for the notes. In addition, given the normal marketability of a minority interest in a closed corporation, if there is no bankruptcy action, the shareholder is in no worse position than he would have been had he retained his shares.

The restriction or cancellation of surplus used to repurchase stock[65] raises an additional problem: at what point and to what extent is the surplus to be restricted or cancelled—up to the full price at the time of purchase, or up to each installment as paid?[66] If the latter, then the shareholder should require that some restriction be placed on the otherwise unrestricted surplus, otherwise the funds sufficient to pay off his notes may be distributed to the other shareholders.[67]

B. TAX CONSEQUENCES TO THE SHAREHOLDER

One benefit which may result from a stock repurchase is the realization by the shareholder of all or part of his share of the earnings of the corporation at capital gains rather than ordinary income tax rates. This will be possible only if the return can be categorized as a distribution in exchange for stock under section 302[68] and not a distribution of property under section 301.[69]

65. Hackney, *The Financial Provisions of the Model Business Corporations Act*, 70 HARV. L. REV. 1357, 1392 n.168 (1958).

66. Herwitz, *supra* note 62, at 316.

67. This type of protection by restriction should be given careful consideration by the planner. In addition to restricting surplus, it may be advisable to limit dividends, salaries, and the issuance and redemption of preferred stock while the installment obligation to the disabled shareholder remains outstanding.

68. Section 302 provides that a redemption will be treated as an exchange if it qualifies under one of the tests of § 302(b), *i.e.*, (1) not essentially equivalent to a dividend, (2) substantially disproportionate as to the shareholder as that term is defined in § 302(b)(2)(c), or (3) a complete termination of the shareholder's interest. *See generally* D. HERWITZ, BUSINESS PLANNING 476-81 (1966).

69. An alternative with the same effect would be treatment of the redemption as a partial liquidation under § 346. However, that section is not generally applicable to a disability buy-out situation. In order to qualify as a partial liquidation a redemption must be either part of a plan to completely liquidate the corporation or not essentially equivalent to a dividend, effected pursuant to a plan, and occur either in the year the plan is adopted or the following one. Treas. Reg. §§ 1.346-1(a)(1)-(2) (1960). Further, § 346(b)(1) and the case law in the area indicate that contraction of the business is a primary factor in determining whether there has been a partial liquidation of the corporation. This will probably not be the case with a disability buy-out. *See* Bittker, *The Taxation of Stock Redemptions and Partial Liquidations*, 44 CORNELL L.Q. 299, 307 n.2 (1959) (criticizing the use of this factor); Chommie, *Section 346(a)(2): The Contraction Theory*, 11 TAX L. REV. 407 (1956).

The specific tests under section 302(b), disproportionate redemption and termination of interests, must be applied first.[70] Section 302(b)(2) clearly sets out the necessary percentages and limitations for a redemption to be classed as disproportionate. It is obvious that if the corporation repurchases all of the shareholder's stock at one time, the result is both a substantially disproportionate purchase and a termination of the shareholder's interest. However, if the shareholder sells only part of the shares at any one time, each sale must meet the percentage requirements of section 302(b)(2). If the repurchase does not qualify under sections 302(b)(2) or (3) the shareholder is still free to argue that the redemption is not essentially equivalent to a dividend under section 302(b)(1).

The major problem in dealing with sections 302(b)(2) and (3) is that under section 302(c)(1) the attribution rules of section 318(a)[71] are to be applied "in determining the ownership of stock for purposes of this section [302]." Thus if the close corporation's stock is held within a family group, as is often the case, or if part of the stock is held by a trust of which the shareholder is a beneficiary, or if held by a partnership or other corporation with which he is associated, all or part of the stock so held will be deemed owned by him in determining whether or not the redemption is disproportionate[72] or a termination of his interest.[73] The net result may be that it is impossible for the

70. Ballenger v. United States, 301 F.2d 192, 194-95 (4th Cir. 1962).

71. Section 318(a) provides for attribution in the following cases:
1) stock owned directly or indirectly by or for an individual's spouse, children, grandchildren, or parents is constructively owned by him;
2) stock owned by an estate, trust, partnership, or corporation is constructively owned by a beneficiary, member, or 50% shareholder, in proportion to his interest.
3) stock owned by a beneficiary, member, or 50% shareholder is constructively owned by the estate, trust, partnership, or corporation.

Further, under the operating rules of § 318(a)(5), stock constructively owned under any of the above is considered actually owned for purposes of reapplying those rules except that rule (1) cannot be reapplied and stock constructively owned under rule (3) cannot be reattributed under rule (2).

72. The attributions rules will be applied to both the determination of a 50% voting stock holding after redemption under § 302(b)(2)(B) and to making of the disproportionate redemption test under § 302(b)(2)(C). Treas. Regs. §§ 1.302-3(a)(3) (1960), 1.318-1(b)(3) (1962).

73. A further complication is introduced by § 318(a)(5) which, with two notable exceptions, provides for a second step in attributing stock ownership. If stock is held by a trust for the benefit of a shareholder's spouse, children, or parents, the ownership is attributed to them under § 318(a)(2)(B). Under (a)(5) this ownership is deemed to

redemption of the stock of a particular shareholder to qualify under either subsection. However, there are ways to avoid this problem.

Under section 302(c)(2) the application of section 318(a) is waived in the case of a redemption otherwise qualifying as a complete termination of the shareholder's interest, provided certain conditions set out in the subsection are met.[74] The purpose of the waiver is to allow a shareholder in good faith to sever his interest in the corporation with the benefit of capital gains treatment. However, the conditions imposed are stringent to prevent abuse of the privilege.[75] Any attempt to retain the shareholder in a nominal officer or directorship capacity, continue his participation in an income continuation plan,[76] or have him return to active participation in the affairs of the corporation within ten years will render the waiver inapplicable.

There are two further and, in some cases, more severe limitations on the use of the waiver. First, it applies only to a section 318(a)(1) situation—family attribution—and not to (2), (3), or (4), to and from partnerships, estates, trusts, corporations, and covering options. As a result, one who has stock ownership attributed to him by virtue of his connection with an estate, partnership, or corporation cannot avail himself of the waiver provision.[77] The regulations also provide that the creditor interest a shareholder may retain under the subsection means one that is not subordinated to those of general creditors.[78] Thus, taking notes of the corporation in exchange for stock may not qualify for the benefit of section 302(c)(2).

Another possible solution to the section 318 problem may be provided by section 302(b)(1). As previously mentioned,

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be actual for the purpose of attributing those shares to the stockholder in question. *See* Thomas G. Lewis, 35 T.C. 71, 78 (1960) (stock ownership attributed from husband to wife and then to estate of wife's mother).

74. These conditions are numerous and complex. They include a 10-year limitation on reacquiring an interest, and the time and circumstances of the acquisition of the redeemed stock. INT. REV. CODE § 302 (c)(2).

75. H.R. REP. No. 1337, 83d Cong., 2d Sess. 36 (1954); S. REP. No. 1622, 83d Cong. 2d Sess. 45 (1954).

76. *See* Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 33 n.72 (1956), contending that § 302(c)(2)(A)(i) has a continued financial interest as its primary concern and is not intended to prohibit continued office holding per se.

77. *See* Rev. Rul. 59-233, 1959-2 CUM. BULL. 106.

78. Treas. Reg. § 1.302-4(d) (1960).

a redemption which fails to qualify under the specific tests may still receive capital gains treatment if it is not essentially equivalent to a dividend. Generally, one of two tests is used in determining dividend equivalency, although the line between them is often clouded.[79] The "net effect" test considers whether the results of the redemption and the hypothetical results of a dividend replacing the redemption would have been essentially the same from the shareholder's point of view. If so, the payment is considered substantially equivalent to a dividend and taxed as ordinary income.[80] The "legitimate business purpose" test combines the net effect test with a consideration of whether the redemption was motivated by a corporate or a shareholder purpose.[81] In view of the fact that the shareholder has given up his right to future earnings and his voting power, it would seem that a disability buy-out would qualify under the net effect test. If this is the case it would clearly qualify under the more liberal legitimate business purpose test as well.

By qualifying as not essentially equivalent to a dividend, a redemption otherwise taxable as a dividend under section 318 may receive capital gains treatment, since section 302(c)(1), applying section 318(a) to section 302, states that it "shall apply in determining the ownership of the stock" and unlike (b)(2) and (3), (b)(1) does not refer to, or by its terms depend on, the extent of subsequent ownership. The possibility of a construction of (b)(1) requiring no reference to section 318(a) has been foreclosed by regulations providing that constructive ownership under that section is one of the facts to be considered in determining dividend equivalency.[82] The result is that the attribution rules which may have been an absolute bar to capital gains treatment under (b)(2) and (3) are only a single factor, albeit a significant one,[83] among the several to be considered in

79. Ballenger v. United States, 301 F.2d 192, 196-97 (4th Cir. 1962).

80. *E.g.*, Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957). Some of the considerations involved are whether the amount received would have been the same, how much control was given up, and what right to future earnings was lost. *Id.*

81. *E.g.*, Herman v. Commissioner, 283 F.2d 227 (8th Cir. 1960); Perry S. Lewis, P-H TAX CT. REP. & MEM. DEC. ¶ 47.12 (1966); John A. Decker, 32 T.C. 326 (1959). *But see* B. BITTKER 293. Under either test there appears to be considerable weight given to how disproportionate the redemption really was. *Compare* Estate of Arthur H. Squiers, 35 T.C. 950 (1961), *with* Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

82. Treas. Reg. § 1.302-2(b) (1960) (narrow construction of applicability of § 302(b)(1) to stock redemptions).

83. *Cf.* Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

determining the status of the redemption. In *Perry S. Lewis*,[84] a shareholder qualified for capital gains treatment on the sale of his stock over a five-year period even though his sons held all the remaining stock and he retained a nominal officership in the corporation. The court applied the legitimate business purpose test, finding considerations of business purpose sufficient to dispel the taint of dividend equivalence,[85] while giving no weight to the shareholder's constructive ownership of his sons' stock.

An additional, and more certain, method of avoiding the application of section 318(a), or any other chance the operation of the agreement will be deemed to produce a dividend to the selling shareholder, is to have the stock purchased by the other shareholders or by a trust. However, this method, while eliminating the dividend problem, creates problems of its own.

If the agreement provides for purchase of the shares with payment by installments, the disabled shareholder will face further tax problems absent careful drafting. For example, the sale of the stock to the corporation or to the other shareholders is a casual sale of personal property within section 453(b)(1),[86] provided the conditions of the statute are met.[87] By meeting the requirements of this section, the shareholder is able to pay the taxes on the proceeds of the sale as he receives them. Otherwise he would have to pay the taxes on the full amount of the gain at the time of the sale. Thus in drafting an agreement which provides for an installment purchase the terms should be drawn to fit within section 453 to spare the shareholder the burden of being taxed on more than his in-hand profits. A further con-

84. P-H TAX CT. REP. & MEM. DEC. ¶ 47.12 (1966). *But see* Thomas G. Lewis, 35 T.C. 71 (1960) (applying second step attribution under § 302(b)(1)). However, the Tax Court subsequently modified the strict application of § 318 adopted in *Thomas G. Lewis* in Arthur H. Squiers, 35 T.C. 950 (1961), *acq'd*, 1961-2 CUM. BULL. 8.

85. Perry S. Lewis, P-H TAX CT. REP. & MEM. DEC. ¶ 47.12, at 97 (1966). The concurring opinion, while holding no dividend, criticized the majority for failing to give adequate consideration to the attribution rules.

86. Rev. Rul. 56-153, 1956-1 CUM. BULL. 166.

87. INT. REV. CODE § 453(b)(2). There may be a conflict between the requirements and the obtaining of capital gains treatment as a disproportionate redemption if the price per share is such that 30% of the total price will not purchase enough shares to meet the percentage requirement of § 302(b)(2).

Failure to provide for interest or attempt to hide the interest within the price to get capital gains treatment may place the sale under § 483 and the unstated total interest covered therein will not be includible in the selling price. Treas. Reg. § 1.453-1(b)(2) (1966).

sideration for a shareholder contemplating an installment payment type of agreement is the possibility of his death before the end of the payment period. At death, the fair market value of the unpaid installments will be included in his gross estate for estate tax purposes under section 2031(a).[88] This will increase the tax liability of the estate while providing no additional cash with which to pay it.[89]

III. POSSIBLE METHODS AND SUGGESTED PROVISIONS FOR ESTABLISHING A DISABILITY BUY-OUT

A. THE USE OF DISABILITY INSURANCE

Disability insurance may be used as a funding device in setting up a disability buy-out.[90] Disability insurance is designed to indemnify the policyholder against loss of income by providing him with periodic benefit payments while he is disabled. The contract is similar to indemnity insurance in that it is aleatory in nature, and resembles life insurance since it deals with human life and pays a fixed amount regardless of actual loss. This type of coverage varies with the insurance company on such factors as the insurer's right to cancel or change premium rates, the size of the benefit payment, and the length of time such payments are to run.[91]

The concept of disability is largely subjective. As such, it is difficult both to underwrite and to police.[92] Insurance companies must, therefore, confine their policies strictly, limiting the disabilities covered as to degree, duration, cause, and time of

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88. Cump v. Commissioner, 124 F.2d 540, 543-44 (9th Cir. 1941); *see* Duffield v. United States, 136 F. Supp. 944 (E.D. Pa. 1955).

89. As installment obligations under § 453, the payment will be considered income in respect of a decedent under § 691(a)(4). The installment, therefore, will be taxable as income when actually paid. However, the estate tax paid may be credited against the subsequent income tax liability under § 691(c). For the proper method and an indication of the complexity of computing and allocating this credit see Rev. Rul. 67-272, 1967 INT. REV. BULL. No. 31, at 11. On the propriety of taxing both the right to the payments and the payments themselves, see Bull v. United States, 295 U.S. 247, 256 (1935).

90. *See, e.g.*, W. HARMELIN & M. FRIEDMAN, DISABILITY INSURANCE IN THE BUSINESS BUY-OUT AGREEMENT 3-4 (1963); W. HARMELIN & R. OSLER, BUSINESS USES OF HEALTH INSURANCE 10 (1960).

91. E. FAULKNER, HEALTH INSURANCE 64-69 (1960); W. HARMELIN & R. OSLER, *supra* note 90, at 3-4, 11; Miller, *Disability Income—Individual Policies*, in LIFE AND HEALTH INSURANCE HANDBOOK 581, 588-89 (1959).

92. *See* Day, *Legal Problems in Disability Insurance*, 1957 INS. L.J. 19, 20; Siebert, *The Insured Event: Disability Insurance*, 1964 U. ILL. L.F. 382, 383-84.

inception, as well as providing certain exclusions.[93] The amount of benefit coverage available is also limited. At present, $1,000 per month is the approximate ceiling on long-term disability coverage.[94] In order to limit the risk of malingering, insurers have established the practice of not insuring for an amount in excess of eighty per cent of the insured's after-tax income.[95] Further, companies normally will not contract to pay benefits, at least for disability due to illness, beyond age sixty-five.[96]

These limitations may pose serious obstacles for the planner desiring to use disability insurance as a fund for a buy-out agreement. Initially, the narrow and inflexible definition of disability may limit the applicability of insurance in a particular business. In addition, the companies use a split definition of the term [97] which may impose a further limitation on the usefulness of insurance as a planning device. The first definition bases benefits on the insured's inability to continue in his present employment, but it covers only an initial period. The second, which is far more restrictive, bases benefits on the insured's inability to be gainfully employed, and covers the remainder of the benefit period.[98] Under such a split definition a disabled shareholder may fail to qualify after the initial period, and the benefit payments which were intended to fund the buy-out will be discontinued.

An additional problem is imposed by the benefit limitations. The higher the value of the shareholder's interest, the longer the installment payment period will be. Depending on the shareholder's age at the time he becomes disabled coupled with the nature of his disability, increasing the installment period also increases the chances either that the policy coverage will terminate or that the shareholder will recover sufficiently so that the benefit payments will be discontinued prior to completion of the repurchase. In either event the purchaser will be left to satisfy the purchase debt out of other resources. The problem is

93. Siebert, *supra* note 92, at 384.

94. W. HARMELIN & R. OSLER, *supra* note 90, at 11.

95. Faulkner, *The Role of Health Insurance*, in LIFE AND HEALTH INSURANCE HANDBOOK 523, 527 (1959).

96. W. HARMELIN & R. OSLER, *supra* note 90, at 11.

97. *See also* Miller, *supra* note 91, at 584.

98. The rigor of these definitions has been mitigated by the liberal interpretation of the courts. *See generally* Day, *supra* note 92, at 22-28. While these judicial definitions vary from jurisdiction to jurisdiction, one that has gained fairly broad acceptance holds an insured totally disabled when he is unable to carry out the duties of any work or profession for which he is fitted by education, training, and experience. Siebert, *supra* note 92, at 389-90.

compounded if the shareholder has a private disability plan in force. In order to avoid possible over insurance, applications for disability coverage inquire as to any other disability benefit to which the applicant is entitled or for which he has applied, as well as to his average income.[99] In addition, some policies will contain a pro rata clause[100] which will also restrict the amount of the benefits.[101]

A further problem with insurance funded buy-outs is the insurability of the shareholders and the cost of obtaining such insurance. It may be impossible to obtain the type of coverage necessary because of one shareholder's poor health, medical history, or age.[102] The most desirable coverage—maximum benefit, noncancellable, long-term coverage under the first definition —is also the most restrictive on the insurer and the most expensive. If the corporation is already paying life insurance premiums, the addition of the cost of disability insurance may render it insurance poor. The alternative of reducing the amount and duration of the benefits will reduce the cost, but will also negate the effectiveness of insurance as a funding device.

From a tax standpoint disability insurance may present further problems. Section 104(a)(3) of the Code provides that amounts received through accident or health insurance for personal injuries or sickness, except as deductible under the medical expense provisions, shall not be included in gross income.[103] This would apparently include the proceeds of disability income insurance since the same phrase, "health or accident insurance," is used with reference to employee wage continuation plans.[104] Therefore, it is arguable that a corporation which pays the premiums will receive the benefit tax free. However, section 104(a)(3) refers to payments for personal injury or sickness and not to the receipt of benefits by one other than the person disabled. Thus the corporation, which is taxable on the premium payments,[105] may be taxed on the benefits in excess of the premiums paid.

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99. E. FAULKNER, HEALTH INSURANCE 76-81 (1960).
100. Day, *supra* note 92, at 28; Miller, *supra* note 91, at 590.
101. If the corporation could take out a group policy on the shareholders this might not be a problem, but generally it will not be possible to get the kind of high indemnity coverage necessary with group insurance. *See* Smith, *Disability Income-Group Coverage*, in LIFE AND HEALTH INSURANCE HANDBOOK 596-601.
102. *See* Miller, *supra* note 91, at 591.
103. INT. REV. CODE § 104(a)(3).
104. Treas. Reg. § 1.105-1(d) (1964).
105. *See* Rev. Rul. 66-262, 1966 INT. REV. BULL. No. 36, at 9.

An additional tax problem when the insurance is wholly owned by the corporation is the possibility that the premiums will be treated as dividends to the shareholders. However, the attempt to treat death buy-out life insurance premiums as dividends has been disallowed by the courts[106] and the Internal Revenue Service has acquiesced in these decisions.[107] The similarity of corporate purpose indicates that the same result should follow with disability insurance,[108] but the uncertainty of whether a disability injures the corporation dictates caution in discounting the prospect of an adverse result.

B. THE CHOICE OF PURCHASER

There are three possible purchasers the planner may choose: (1) the corporation itself—the entity purchase agreement; (2) the other shareholders—the cross-purchase agreement; or (3) a buy-out trust funded with insurance or other assets.[109] Although the decision as to which of these alternatives is most effective will depend on the facts of the case, some of the advantages and disadvantages of the cross-purchase and trust type of agreements, as opposed to an entity purchase, can be generally stated.

The choice between an entity and a cross-purchase agreement[110] will depend on several factors such as cross insurance and individual cost reduction. If insurance is involved,[111] under a cross-purchase agreement, each shareholder must possess a disability policy on every other shareholder sufficient to allow him to purchase a part of that shareholder's stock. If there are five

106. *See, e.g.*, Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957).

107. Rev. Rul. 59-184, 1959-1 CUM. BULL. 65.

108. *Cf.* Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737, 744 (4th Cir. 1960).

109. *See* Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business*, 46 IOWA L. REV. 516 (1961).

110. *See generally* Cunningham, *Stock "Buy-Out" Plans: Selection and Drafting*, 18 MD. L. REV. 277, 278, 284 (1958); Polasky, *supra* note 109, at 518; Stoeber, *Stock Redemption v. Cross-Purchase Agreements in Closely-Held Corporations*, 17 J. AM. SOC'Y C.L.U. 212 (1963); Walker, *Life Insurance From the Standpoint of the Federal Corporate and Personal Income Tax, Gift Tax, and Estate Tax*, U. SO. CAL. 1966 TAX INST. 543, 564.

111. In either case the insurable interest requirement should not be a problem since the existence of the agreement will place the purchaser under a financial obligation in the event of disability. *See generally* 4 J. APPLEMAN, INSURANCE § 2123 (1941); W. VANCE, INSURANCE § 28 (3d ed. 1951).

shareholders in the corporation, twenty policies will be involved. Thus the complexity and cost may make this type of agreement impractical.

If the shareholders are paying for the insurance out of dividends, the funds available for premiums will be reduced by a second tax. Furthermore, if the share distribution is unequal, those receiving the smallest dividends must carry the greatest amount of insurance to buy out the largest holdings. The cross-purchase type of agreement also means smaller payments from several sources for the disabled shareholder rather than a large payment from one source. Should a purchasing shareholder be unable to meet his obligation at the time it falls due, he will be held to have received a dividend if the corporation meets it for him.[112]

Furthermore, the problem of the disabled shareholder's failing to qualify for continued benefits due to the restrictive second definition or a partial recovery may make a shareholder reluctant to bind himself to purchase stock on the strength of the benefit payments. Mitigating against the cost of insurance in the case of a death buy-out is the fact that a shareholder is assured his estate will recover the premiums paid, either by retaining the policies until the insured shareholders die, selling them back to those shareholders, or simply turning them in for their cash surrender value. With disability insurance there is no certainty that the policies will pay off even if retained, and their value in a sale will not equal the amount of the premiums paid.

The factors favoring the cross-purchase are that it splits up the cost of the stock among several purchasers and eliminates many of the most difficult problems encountered in establishing an entity purchase agreement. The state corporate law restrictions affecting the funds available for the purchase are not applicable to the shareholders. Therefore, a shareholder building up a fund to purchase stock does not face the possibility of an accumulated earnings tax. There is no danger the premiums he pays will be a dividend to the other shareholders, and the sale to another shareholder could not be classed as a dividend to the seller under section 302.

The use of a trust for a disability buy-out is conspicuous in its absence from the suggested methods of formulation previously encountered. This is unusual since the trust need hold only one policy per shareholder. It can thus effectively eliminate the

112. Rev. Rul. 58-614, 1958-2 CUM. BULL. 920; Wall v. United States, 164 F.2d 462 (4th Cir. 1947).

multiple policy problem found in an insurance-funded cross-purchase agreement.

However, the trust faces the same problems as the corporation or a shareholder in its obligation to purchase stock if the benefit payments cease. In the case of the trust, the problem is more severe since the policy is the trust's only source of funds for making payments. Furthermore, since this arrangement involves three separate entities connected with the policy—the trust holding policies payable to itself, the shareholder whose contingent disability is the risk, and the corporation which pays the premiums—there may be some difficulty finding an insurer. A corporate entity paying the premiums on a policy it owns, payable to the entity, arguably involves no dividend consequences to the shareholders.[113] However, if the policies are in a trust established so that the corporation and its creditors cannot reach the payments, there is some danger that the payment of premiums will be treated as a dividend on the rationale that they are primarily for the benefit of the shareholders and not the corporation.[114]

C. Suggestions for Drafting a Buy-Out Agreement

As in the drafting of any contractual agreement, there is a need for clear, precise definitions. "Disability" is the most difficult term to define and the one most requiring a clear explanation. The problems involving insurance policy definitions have been considered, but it is suggested that to go beyond a policy definition in drawing the agreement if insurance is to be

113. *See* text accompanying note 108 *supra.*

114. *See* Paramount-Richard Theatres, Inc. v. Commissioner, 153 F. 2d 602 (5th Cir. 1946). To answer this problem and to fulfill the desire of the shareholder to insulate the trust from the corporation and its creditors a planner should: 1) provide that the shareholder designate the beneficiary of the policies; 2) have them direct that the trustee turn over the shares to the corporation upon their receipt; and 3) hope that Rev. Rul. 59-184, 1959-1 CUM. BULL. 65, which stated that payment of premiums on life insurance policies held by the corporation were not dividends, will be read broadly enough to include this situation.

Further difficulty is encountered by a Subchapter S corporation which opts to use a trust for buy-out purposes. Under § 1371 only an individual or an estate may hold shares in such a corporation and § 1372(e)(3) will terminate the corporation's Subchapter S election if at any time it ceases to qualify under § 1371. Thus it may be argued that, even if immediately on receipt of the stock the trust passes it on to the corporation or the other shareholders, the trust became a stockholder at the time it purchased the shares and thereby disqualified the corporation. Smith, *Recent Developments in the Field of Corporate Business Purchase Agreements*, 14 TAX L. REV. 413, 432 (1959).

the funding device will serve only to compound these already existing difficulties. However, one contingency the parties may wish to provide for, even if the insurance policy does not, is the possibility of a disabling mental illness.

Where insurance is not used, the definition of disability found in an insurance policy remains a good basic point from which to begin; another source may be a workman's compensation statute. Before adopting a definition from any source, it is important to investigate the interpretation, if any, it has received in the courts. Furthermore, since the definition ultimately decided upon must, of necessity, be cast in broad terms, a provision for arbitration in the event of subsequent disagreement should be inserted.

A second major consideration for the draftsman is the valuation of the shares. Failure to provide adequately for this in advance invites dissension and litigation when the buy-out becomes operative. If there is a death buy-out agreement in effect which deals with the problem in a manner acceptable to the parties, it may be incorporated into the disability purchase agreement. If incorporation of a prior agreement's solution is not used, the following guidelines should be utilized: (1) adopt recognized standards for valuation;[115] (2) provide for periodic revaluation while the agreement is in force; (3) make the time for final valuation explicit in terms of the definition of disability and other phases of the buy-out procedure; (4) state in detail any special considerations desired by the parties or required by the type of business;[116] and (5) provide for arbitration of any disputes as to the method or value.[117]

Related to the question of valuation are problems of method and manner of payment. Two possible fund sources have been mentioned, the retained earnings of the corporation and disability insurance benefits. Another source is life insurance policies held by the purchaser on the seller. Such policies may be used either by turning them in and applying the cash surrender value to the purchase, transferring the policies themselves as considera-

115. These would include (1) liquidation value, (2) book value, (3) capitalization of earnings, and (4) replacement value. *See generally* 2 F. O'NEAL, CLOSE CORPORATIONS § 7.24 (1958); Block, *Book Value Pitfalls in Buy-Sell Agreements*, 95 TRUSTS & ESTATES 408 (1956).

116. An example of this would be the procedure to be invoked in arriving at a present value of inventory held for sale.

117. If arbitration is to be provided for it is advisable to specify whether the arbitrators are to use the standard provided in the agreement, or whether they will be free to adjust that standard to the prevailing conditions at the time the agreement becomes operative.

tion, or borrowing against them to raise the necessary funds.[118] Whatever source the parties agree on should be incorporated into the agreement. Also, if payment is to be by installment, the agreement should state the time and amount of the installments, the amount of interest, whether interest will be computed on the whole purchase price or the unpaid balance, and whether the purchaser is to give evidences of indebtedness. The agreement should also make provision for the possibility of default by the purchaser, including safeguards designed to protect the shareholder's interest.

The agreement should provide for a time lapse between the date a shareholder becomes disabled, within the agreement definition, and the date his stock is to be transferred to the purchaser. This period will allow time to value the shares and, more importantly, to avoid a premature termination of the shareholder's interest. Depending on the wishes of the parties and the nature of the business, a period of from ninety days to five years is possible, but one year should be an acceptable time. The salary a shareholder is to receive during this period, and whether and how long such salary is to continue after the buy-out becomes operative, are questions to be settled at the time the agreement is made and included therein.

It must be determined whether the buy-out is to be mandatory after the initial period has elapsed. If there is to be a formal agreement, the buy-out should be mandatory. In view of the many variables involved in such an agreement, however, an escape clause should be provided. The parties should look ahead and attempt to determine those factors which may change sufficiently to make the buy-out disadvantageous and include them in the escape clause.

The possibility of the shareholder's death during the buy-out period has been mentioned. If a lump sum payment of the remaining debt is not provided for, it is suggested that at least a portion of the remainder be callable by the deceased shareholder's executor to meet estate expenses and avoid the sale of other assets.

Other important problems the drafter must consider and provide for include (1) the possibility of a forced sale of any shareholder's stock while the agreement is in effect; (2) other

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118. If the policies are not to be disposed of it is suggested that a waiver of premium rider be included, thereby releasing the premium payment while the shareholder is disabled. *See* E. FAULKNER, HEALTH INSURANCE 63 (1960).

persons having an interest in the stock, *e.g.*, the wife of a shareholder in a community property state, who should be made a party to the agreement; and (3) the need for restriction on voluntary transfers of the stock prior to a disabling accident or illness.

V. CONCLUSION

Writers advocating corporate use of disability insurance make many arguments in favor of establishing a disability buy-out agreement. However, it is far from a one-sided question. In the proper situation a buy-out agreement can be of great benefit to the parties involved. In the wrong situation it may be a severe burden on both the corporation and the shareholders. Before entering such an agreement, the pros and cons should be considered carefully. In some situations, dissolution of the corporation may be the only realistic solution when a shareholder becomes disabled. Disability buy-outs are devices of limited applicability devised as an attempt to make the best of a bad situation. This fact must be kept in mind in dealing with each particular case.