Transcript of the Webinar

Buy-Sell Agreements: What Estate Planners Need to Know

Sponsored by Mercer Capital and presented April 21, 2026

INTRODUCTION

Host

[Slide 1] Hello everyone and welcome to Mercer Capital's webinar, Buy-Sell Agreements: What Estate Planners Need to Know (presented April 21, 2026). Our presenters for today's session are Tom Insalaco and Bo Trudeau.

[Slide 2] Tom Insalaco is a senior vice president with Mercer Capital and has been valuing businesses since 2008. He has experience valuing businesses in many different industries and for many different purposes.

Bo is a shareholder at Purcell, Flanagan and Hay. He is Florida Bar Board certified in taxation as well as wills, trusts, and estates. Bo's practice focuses on the legal needs of business owners and high net worth individuals. Specifically, he focuses on the areas of estate planning, estate and trust administration, asset protection, taxation, business planning, and the preparation and negotiation of marital agreements for high-net-worth individuals. You can learn more about their backgrounds and experience in the resources tab of this webinar.

Before we dive in, let's review a few housekeeping details. If you encounter any technical difficulties during the webinar, please notify us using the chat box. To ask our presenters questions, please enter them into the Q&A box. We will address questions at the end of the webinar. To record your attendance for CLE, you must respond to the survey questions that will pop up during the webinar.

Finally, don't forget to explore the resources tab where we've provided additional helpful materials.

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Thomas Insalaco

Good afternoon. I'm Tom Insalaco from the Gift Estate and Income Tax Compliance team at Mercer Capital.

And I have with me Bo Trudeau who's a shareholder at Purcell, Flanagan and Hay in Jacksonville, Florida. We're excited to have this conversation about buy-sell agreements and how they overlap with estate planning and when buy-sell agreement pricing can be used for estate planning purposes.

SECTION 1: BUY-SELL AGREEMENT FUNDAMENTALS

[Slide 3] We're going to discuss a few things today. First, we're going to start with some basics: what a buy-sell agreement is, then we'll talk about triggering events, and a few common methods to determine pricing for buy-sell agreements. And then we'll discuss if you're going to use valuation to determine pricing for buy-sell agreements, what are the elements that should be defined in the agreement to help the valuation professionals?

Then, we're going to get into the good stuff. Bo is going to cover the tax consequences of buy-sell transactions. He's then going to go over, in detail, the rules that regulate when buy-sell agreement pricing can be used for gift and estate tax values.

We're going to finish with talking about a couple of examples of when buy-sell agreement pricing failed to be used for estate and gift tax values and some Tax Court cases.

[Slide 4] So, with that, Bo, I don't know if you want to kind of get us started talking a little bit about the basics of what buy-sell agreements are.

Robert H. "Bo" Trudeau

[Slide 5] Yeah, thanks Tom. You know, in their nature, buy-sell agreements are fairly simple. They are agreements among owners of businesses and often the business itself that establish obligations to purchase and sell business interests. And these agreements get into a bit more specifics, such as establishing triggering events, what gives rise to these purchase and sale obligations, and they can establish pricing as well.

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And the benefit of a buy-sell agreement is we're establishing these agreements at a time when no one is under a compulsion to buy or sell. And doing so at that point in time takes away the economic incentive to put your finger on the scale one way or the other, whether you're the buyer or the seller.

[Slide 6] If we flip over to the next slide, we can see some common triggering events for when buy-sell agreements will often apply. As a general rule, it's when someone is often departing the business. So, we've got a business owner who quits, who's no longer going to be working for the company, or who, conversely, is fired from the company. In that case with many businesses, your role as an owner is tied significantly to your employment with that company as well.

So, quitting or firing, or even retiring are often appropriate triggering events. Then we have the uncertainties in life. And if you look down at the bottom of the slide, we talk about the "Ds" of buy-sell agreements. Someone becoming disabled, no longer able to work in the business. Someone dying, at that point you're definitely no longer able to work in the business, these are some of the more common triggering events.

Let's talk about the last two on the slide: divorce and bankruptcy. These are the types of transfers that often keep my clients up at night. This idea that they may become owners with someone's ex-spouse or someone's bankruptcy trustee, and these types of transfers are ones that will frequently be [addressed] in a buy-sell agreement to ensure that we're keeping the group of owners as just those persons that people want to be in business with. And not persons who may receive transfers of interest as a result of some very difficult event like divorce or bankruptcy.

Tom, you're going to talk about the types of buy-sell agreements.

Thomas Insalaco

One other comment, I think a lot of people think "death" first when they think about this, but what we see and, I'm sure Bo, you see the same thing, is the odds are one of these other items *(on the list of Triggering Events)* are going to happen before one of the partners passes away. So, the other ones [triggering events] are important to think about as well.

Robert H. "Bo" Trudeau

Fair point.

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Thomas Insalaco

[Slide 7] Let's talk about the types of buy-sell agreements. There are different mechanisms for getting to the price for a buy-sell agreement. The most common three that we see are: 1) Fixed Price Agreement, 2) Formula Agreements, and 3) Process Agreements which include valuations.

[Slides 8-9] In Fixed Price Agreements, the owners agree on a fixed price. Typically, when agreement is formed, there's going to be a Schedule in the agreement that documents the fixed price that the owners all agreed to. But what we commonly see here with these types of agreements is that the owners never actually agree to a price, so when we receive the organizational documents for the entity, the Schedule is blank.

The other thing is even if the owners do come to an agreement on the on a fixed price, they might never update that agreed upon price. Years might pass, it might be a decade or two later, and a triggering event happens and you're going to have a transaction at a value that was agreed upon years ago that may not make sense anymore. So, it's going to end up being unfair to one of the parties involved. Therefore, we do not recommend using fixed price agreements.

Robert H. "Bo" Trudeau

Tom, I will frequently inherit buy-sell agreements when I get a new client and I have yet to find, I call these Schedule A Agreements, where you update the price on Schedule A. I have never seen a Schedule A update. I have only seen an initial price determination and never after that have the clients updated it. And in my experience, this is probably the most common type of agreement I run into.

It's also the one that most frequently will fail. It's not a type of agreement [Fixed Price] that I would ever recommend.

Thomas Insalaco

I agree. The disadvantages far outweigh the advantages. The advantage is that it's easy to implement, which is why we probably see more of these than anything else.

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[Slides 10-11] Let's talk about Formula Agreements. In these agreements, you'll agree on a formula. These are easier to implement, as well. But the same issue applies. Typically, it might be a multiple of EBITDA or book value. The issue is the multiple selected to apply to EBITDA, if that's what you're using, over time the industry conditions and economic conditions in the company change. So, if you pick, say, a 5x multiple ten years ago, maybe that 5x multiple is not close to representative of a fair market value now. So, again, you could end up in a situation where one of the parties feels that the got the worst end of the deal [upon a triggering event].

Another thing is who is calculating the formula. If you are going to use a Formula Agreement, you want to make sure how the formula is calculated is very clearly defined but, again, you have the same issue in that these are probably not going to be good to use for fixing prices of buy-side agreements to use for gifts and estate tax purposes.

[Slides 12-17] The third [type of agreement] is a Valuation Process Agreement. Here you have really two general kinds. One is Multiple Appraiser Processes and the other is Single Appraiser Processes. I think the Multiple Appraiser Processes seem to be more common and generally you'll see a couple of appraisers, one representing each side, being bought brought in. And if their [conclusions] are within a certain percentage, then maybe [the final price] is just the average of the two. But if they're not [within a certain percentage], a third appraiser is brought in. Then some kind of arrangement, either an average of the closest two appraisals or the third appraiser just determines price, will be used to come up to the final definitive price.

The downsides to these are there's a lot of uncertainty with how long the process is going to take, is a third appraiser going to be needed, what's the price going to ultimately be, what's the valuation methodology going to be. So, there's just a lot of uncertainty here for all the owners involved when a triggering event occurs.

Robert H. "Bo" Trudeau

So, Tom I'm not a big fan of the Multiple Appraiser Process. My experience is that when we have each side hiring their own appraiser, there's always the wink-wink, nudge-nudge, you know which side of the table I'm on. And the appraisals are certainly science-based, but they're also an art form as well.

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And what ends up happening is naturally the buyer's appraisal favors the buyer and the seller's appraisal favors the seller. And that to me sort of undermines the process of what we're going for. I will always try to steer my clients into some sort of single appraiser methodology, whether it's the two of them agreeing on an appraiser, whether we get a disinterested party to appoint the appraiser, and I'll frequently name myself or another member of my law firm to appoint the appraiser. Everyone's going to agree upfront that we're going to have an independent person select the appraiser. And that takes a lot of the gamesmanship out of the appraisal process.

Thomas Insalaco

Real quick before getting into the Single Appraiser Process discussion, if there's a third appraiser, typically they can be the determiner, in which their price is definitive, or they can be the judge, or the mediator, which means that basically they're deciding between the [conclusions of] the first two appraisers. Or they can be the reconciler, which is a process where [the third appraiser] either averages of the closest two [conclusions of value] or the average of the three are taken. Oftentimes, we see the average of the closest two.

And the interesting thing about that is, if [the conclusions of value of] appraiser one and two are significantly apart, and appraiser three, depending on where their value falls, if they're right towards the middle of the midpoint of the first two appraisals, there can be, with just a small dollar change in their concluded value, there can be quite a swing in what the average of the two closest would be. So that's something to be conscious of.

[Slides 18-20] But anyway, [a Single Appraiser Process is] also what we as a firm recommend and I know a lot of appraisers also recommend a single appraiser process where you select the appraiser when the agreement is created and ideally have company valued then. The benefits to this are you get the valuation done right away so all the parties involved will see what the methodology looks like and know what the price is going to be.

Then everyone can agree on the appraiser upfront, whether it's the parties picking an appraiser themselves or them picking an attorney like yourself, Bo, and you picking an appraiser. This relieves some uncertainty about how long the process is going to take, pricing, and the methodology.

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Robert H. “Bo” Trudeau

Tom, I am certainly a proponent of using appraisals as our pricing mechanism in buy-sell agreements. To me is the appropriate fit for probably 90% plus of businesses. What I struggle with is clients are more than happy to identify the appraisal as the pricing mechanism for our triggering event, but most of them don't want to pay for the appraisal now. They would rather live with the uncertainty to avoid that immediate cost.

Thomas Insalaco

I understand. We also recommend having the company valued every year so there's always a recent appraisal. Therefore, when a triggering event happens, the parties already have a price and there's no uncertainty in that regard. But you know, I would say, obviously pragmatically for many clients, the cost to getting an appraisal upfront and recurring appraisals might be a roadblock for them. But for the attorneys listening, if you have clients who view this as a stress point, I recommend talking to the appraiser because full appraisals [might not be necessary] every year. We could [provide] calculations. That might help alleviate some of those stress points. I think it's always worth at least having a conversation with a valuation professional. Don’t just think that your clients are going to balk at the price and just kind of eliminate that as an option.

Robert H. “Bo” Trudeau

That's helpful.

SECTION 2: DEFINING ELEMENTS OF BUY-SELL AGREEMENTS

Thomas Insalaco

[Slides 21-22] So, in the next section, we're going to go through quickly the defining elements of buy-sell agreements. If there is an appraisal process involved, when the appraiser is coming in to do the valuation, they need a roadmap. [As appraisers,] we don't want to be making decisions on some of these items ourselves.

[Slide 23] There's several things that we recommend being defined. The first one is Standard of Value. The Standard of Value is typically “fair market value.” It is the based on ruling or Revenue Ruling 59-60. All appraisers are familiar with the concept of the standard hypothetical buyer, hypothetical seller, no compulsion to buy. Both parties are knowledgeable of all the relevant facts.

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There's also "fair value," but there's different meanings of "fair value" under different state laws for shareholder oppression. There's also accounting rules or accounting definitions of what "fair value" is. So, if you just say "fair value," that there could be of confusion. And then there is the "investment value" to a specific owner. Well, which specific owner? So, we recommend "fair market value" be used for Standard of Value.

Robert H. "Bo" Trudeau

Yeah, and I share that recommendation, Tom. One thing I would encourage the other attorneys in the room is define to "fair market value." Spell it out in the agreement so that it does provide a clear roadmap to the appraiser with no ambiguity about it.

Thomas Insalaco

[Slides 24-25] The second [defining element] is "Level of Value." I think this might be the most important one. When you're looking at an interest in a business, it could be at a Financial Control Value, which is just the pro rata value per share or per membership interest that everyone would get if you if you sold the business to a financial buyer. But then, you move up a level and you have Strategic Control Value, which would include synergies to a specific buyer. Then you move down from Financial Control Value to a Nonmarketable Minority level. That's typically with discounts for what we would do for an estate or gift tax valuation for a minority interest. You know, you could see a 30 or 40% premium [to move to the] Strategic Control [level] if your base Financial Control Value is $100 per share. Alternatively, you could see a 30 or 40% discount. So, the difference between Strategic Control value for an interest and a Nonmarketable Minority level value for an interest could be very significant. So, to [remove] uncertainty [from] which level appraisers should be [basing their valuation conclusions], we recommend defining it.

[If the agreement is not clear on this, the seller is going to contend] for a value at the strategic level of value. The buyer is going to say, "no," it's a minority interest, so there should be discount. Just lay it out in the agreement so there's no confusion.

Robert H. "Bo" Trudeau

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I agree with that, Tom. You know, I see often that the value will be defined as just the “fair market value of the stock.” And frequently, I'm dealing with third-party independent business owners, and they really don't want the “fair market value of the stock,” which would likely include discounts for lack of marketability, discounts for minority interest control premise, those sorts of things. Rather, what they're looking for is a percentage of the enterprise value.

So, this needs to be an absolute point of focus when the agreement is being drafted. You know, what do the owners want? Do they want just a straight percentage of the enterprise value that we're not going to factor in all these discounts? Or is it appropriate to take into account these discounts or potential premiums in the value of the interest?

Thomas Insalaco

[Slide 26] The next [defining element] is the “As-Of Date” of the valuation. Obviously, if someone passes away, the date of death is the date that's going to be used. But there could be a little bit of uncertainty with some of the other triggering events as to when they occur.

Robert H. “Bo” Trudeau

One I would recommend is when if you've got a divorce buy-sell agreement, we don't want to use the date of divorce, because frequently we want the buy-sell to be triggered well before that. Rather what I would recommend is the date either spouse files for divorce.

Thomas Insalaco

And another thing here is what is reasonably known or knowable as of the valuation date. Each side could say different things were known [or knowable at the valuation date]. If there's an acquisition or expansion of the company that's being talked about around the triggering date, there the opposite sides could argue over what was known or knowable about that on the valuation date because it could impact value. So, I think good documentation by companies providing proof of what was known or knowable when there's a triggering event is helpful, but that probably goes beyond what's going to be in a buy-sell agreement.

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[Slide 27] Defining element number four is the Qualifications of Appraisers. And again, this goes back to the two sides – [if there are no appraiser qualifications spelled out,] if the selling side wants a higher value, they might go and get an investment banker that has industry experience and the investment bankers are commonly looking more at transactions, so they might they tend to come up with a higher, more strategic level of value.

Then, alternatively, the buyer is going to want a lower price so they might hire someone like me who focuses on a gift and estate tax work and is used to putting discounts on most of our work.

So, I think spelling out which [appraisal] qualifications are [required for] the appraiser to have is important. There's the ASA credential (Accredited Senior Appraiser} from the American Society of Appraisers. That's what I have. That requires at least five years of full-time valuation experience and [requires] following the USPAP standards (*Uniform Standards of Appraisal Practice* developed by The Appraisal Foundation). I'd recommend that designation. But there's also the CVA designation (Certified Valuation Analyst) from NACVA (National Association of Certified Valuators and Analysts) and the ABV (Accredited in Business Valuation) from the AICPA. Those are the commonly held valuation credentials.

Robert H. "Bo" Trudeau

Yeah, limiting it to qualifications, I think, can help mitigate a lot of the gamesmanship that might otherwise go on. You know, someone who may just want to hire their CPA or someone they know who will push the numbers in the direction that they'd like to see it head to.

Thomas Insalaco

Or "my brother has an MBA" but he's never performed a valuation, so you want to rule out people like that that don't have appraisal experience.

[Slide 28] The fifth defining element is Appraisal Standards. I mentioned the *Uniform Standards of Professional Appraisal Practice*, or USPAP. All ASAs are bound to follow those standards [as well as the *Business Valuation Standards of the American Society of Appraisers*]. The AICPA has professional standards for valuation services and NACVA has professional standards as well. I would recommend defining [professional standards that should be followed] so everyone's using the same set of standards.

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[Slide 29] The sixth [defining element] is the Premise of Value. "Going concern" is the premise of value that's mostly used for fair market value appraisal in assessing companies that are going to be a going concern. The other Premise of Value is "liquidation value." So, you want to define this. If there's a two-appraiser valuation process, one side or the other might decide to use "liquidation value" if it benefits their side. I think you want to define the Premise of Value in the buy-sell agreement.

[Slides 30-31] The last thing are Funding Mechanisms [for the buy-sell agreement]. That's not exactly a valuation thing, but it's kind of tied to it. Bo, I don't know if you want to talk briefly about some of the major funding methods.

Robert H. "Bo" Trudeau

Yeah. Life insurance advisors are frequently the referral sources for buy-sell agreements. They do a good job of educating their clients on the risks of one owner dying and what can happen as a result of that. So, it's not uncommon that we will be looking specifically at using life insurance to fund a buy-sell agreement in the event of death.

Even in those scenarios where we know we're getting life insurance, I try not to make the assumption that life insurance will always be available. It may term out. It may be that someone may not be insurable. And so, I will always, always include some sort of structured payments to serve as a backstop and, in some cases, serve as the primary mechanism for funding.

Disability insurance is also something that we look at to fund buy-sell agreements and specifically the disability buyout. I've looked at it plenty. Admittedly, I have never had a client purchase disability insurance to fund a buy-sell agreement. So, it is a tool that's available.

I will frequently see buy-sell agreements that say we're going to use a different valuation methodology if this is a buy-sell for divorce or bankruptcy. You know, we don't want to pay the divorcing spouse the same price we would pay to the owner's family in the event of death. We don't want to pay creditors or the bankruptcy trustee the same price we might pay in other circumstances. And I'm very wary about the enforceability of these types of provisions.

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I've seen we're going to use "book value" in those circumstances. I think you run the risk that if you're going to reduce the payments for certain triggers, that a matrimonial judge or a bankruptcy judge might reject your buy-sell agreement. So, I generally steer clients away from trying to reduce the payout for certain purchasers.

You know, maybe we factor in discounts for lack of marketability or minority interest in those circumstances when we might not otherwise. So those types of things are things I talk about with clients, but I discourage clients from getting too aggressive with reducing the payments for divorcing spouses and bankruptcy buy-sells.

Thomas Insalaco

One more thing from a valuation standpoint on life insurance being used to fund a buyout in a death. There's two ways that valuation people could look at the life insurance. It could be viewed as a funding vehicle. In this scenario, let's say you have a $10 million company and two owners own 50/50, $5 million each. There's $5 million of life insurance. So, if it's used as a funding vehicle, the value would just be $5 million for the 50% owner. We would kind of disregard this because the proceeds from the insurance are going to come in and then they're going to be paid out to the estate.

The second way is looking at [the life insurance] as a corporate asset. In that case, if you have a $10 million dollar company, again, the $5 million dollar proceeds from life insurance would flow into the company and would be viewed as a corporate asset. You have a $15 million dollar value for the company. Suddenly you have a $7.5 million dollar value for each of the 50/50 owners. Then the $5 million would be used to pay out the estate and the other $2.5 million would need to be funded some other way.

The *Connelly* case, which we'll talk about that later, pointed to using corporate-owned life insurance, but the point of this is if you have a buy-sell agreement, and it's a three appraiser method, both sides are going to possibly view the life insurance proceeds differently based on which side they're on. So, if I get brought in as the third appraiser and it's not spelled out how the agreement should consider life insurance in the valuation, then I'm going to have to make the decision, should I view it as a corporate asset or a funding vehicle? I don't want to be in that position as an appraiser. So, that's something that I think should also be very clearly spelled out in the in the agreement.

Bo, you're going to talk about tax code considerations next.

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SECTION 3: TAX CODE CONSIDERATIONS

Robert H. "Bo" Trudeau

[Slides 32-40] There's kind of two general types of buy-sells. One is a Cross-Purchase. You know, this is the circumstance where Tom and I are owners of a business. I pass away and Tom gets the opportunity to buy my interest in the business.

And the second type is a Redemptive buy-sell agreement, Redemption. In that circumstance when I pass away, the company purchases my interests in the business, and Tom still ends up as the 100% shareholder. But what we see is that the Cross-Purchase and the Redemption can have very different tax consequences.

There is a third type of buy-sell agreement which is the model agreement I use in almost all scenarios, and that's the Hybrid or Wait-and-See. And that gives us basically the option to use either a Cross-Purchase or a Redemption.

And usually, the other owner is given the option first or the company is given the option first, and then if that option isn't exercised, the other party has the option. So, there's an ordering rule to it.

The next slides are going to illustrate some of the tax consequences of Cross-Purchase or buy-sell.

[Slide 34] And Tom, if we could go back to that last slide, let me just lay out the facts here. We've got business worth $10 million dollars, it's father and son, each owning 50% interest, and they have a $2 million dollar basis in their stock in the company. And well, let me just preface this with, these are oversimplified examples, but I think these examples do a good job of highlighting how Cross-Purchase and Redemption can have very disparate results from a tax perspective.

[Slide 35] On the next slide you'll see we've illustrated father passing away. And when someone dies owning a capital asset, we get a nice tax benefit that's frequently referred to as a tax loophole, but that's stepped-up basis. And, basically, that's the elimination of capital gains at death.

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So, father previously had a $2 million dollar basis in his stock. The company was worth $10 million dollars, so father's pro-rata interest is $5 million. But let's assume we're going to factor in discounts for lack of control, lack of marketability. These will be an aggregate 20% discount. So, the fair market value of father's stock is $4 million dollars.

What you see is that the basis of father's interest increased from $2 million dollars to $4 million.

[Slides 36-37] If you go to the next slide, Tom, we'll show how Cross-Purchase works. So, specifically, father's estate is going to sell the stock to son for $5 million dollars. And what you'll notice here is that this buy-sell agreement, requires the purchase price based on a pro-rata share of the enterprise value.

If we had required it to be the fair market value of the stock itself, factoring in discounts for minority interest and lack of control, we might have had a $4 million dollar value. But here the agreement establishes a $5 million dollar value. So, the stock passes to son, he's now the 100% owner, and $5 million dollars passes to father's estate.

So, what we know from a Cross-Purchase is that the transaction will be treated as a sale for tax purposes. And when we go to the Redemption example, we'll talk about scenarios where it could be treated as a dividend. So, that might be the alternative. But here we have father's estate paying a tax of $238,000. So, a $1 million dollars of gain. And we've got our maximum combined capital gains and net investment income tax rate of 23.8%.

The ultimate tax consequences of this transaction are that we've got net proceeds to father's estate of about $4,762,000. That's the sale proceeds minus the tax. Then son takes a basis in the stock he has acquired from his father of $5 million dollars. Added to his original basis of $2 million dollars, son now has $7 million dollars of basis in his stock. So, this is a pretty good example. You know, barely low tax because of stepped-up basis and son having significant basis in the stock of the company after the transaction.

[Slides 38-39] Next, we'll go to the Redemptive buy-sell agreement. In this case, father's estate transfers the stock back to the company and then father takes $5 million dollars again using the pro rata value of the enterprise value of the company to determine the pricing. At the end of the day, son still has his stock, but his stock now represents 100% interest in the company.

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[Slide 40] So, what are the tax consequences? If this is treated as a sale, the tax consequences are the same as what we saw in the Cross-Purchase. However, anytime we have a redemption, we have the transfer of money from the company to an owner, which can often be treated as a dividend. And if it's a dividend, the tax consequences are very different.

Instead of capital gains treatment, the full amount of the purchase price, or pardon me, the purchase price that's paid to father's estate, is taxable. So, we don't get the offset for basis. You'll also notice from the parenthetical that we don't get installment sale treatment. If that $5 million dollars was paid at a $1 million dollars per year over 5 years, it may not benefit from deferring the tax over that duration.

Son's basis in the stock remains $2 million dollars as well. So, son didn't buy dad's stock. Yeah, he doesn't get a percentage. That stock was turned into the company.

Thomas Insalaco
He doesn't look happy.

Robert H. "Bo" Trudeau
Yeah, so ChatGPT helped me with my little stick figures here. You'll see Son has a frowny face, because he's only got $2 million dollar basis in his stock. Also, if Son is the only beneficiary of Father's estate the net proceeds he's taking from the purchase and sale is significantly reduced. Went from $238,000 of tax to over $1 million of tax.

So, you can see that the redemption will frequently, or could potentially, result in much more onerous tax consequences to the family in this circumstance. And here we have the comparison of the two transactions. Again, these are very oversimplified examples, but I think they do highlight the ways that the different types of structures can be treated.

So, if I'm funding a buy-sell agreement and we know we're getting life insurance, I am usually looking at the Cross-Purchase, or something that we're not going to get in today [which is] partnership-owned life insurance, to serve as my mechanism because the Redemption in most circumstances will result in a worse tax result for the parties.

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[Slides 41-42] So, Tom, I'm going to zip through this because I don't know that we want to get too bogged down on Sale or Dividend treatment when we've got a redemption, but there are tests that you can meet. And in the event of death, it's usually not too difficult to meet one of these tests and to qualify for Sale treatment. So, I don't want that Redemption example to be too inflammatory. But you need to, if you are designing a Redemptive buy-sell agreement (and sometimes there's good reasons to do so – maybe that's where the cash is available), but if you are, you need to make sure that the potential purchase at death or another triggering event is going to get Sale or exchange treatment and not be treated as a Dividend that potentially gives rise to greater tax. So, not essentially equivalent to a Dividend. These are basically meaningful reductions of a shareholder's interest in the company, and I'll let our viewers review these slides at their leisure.

[Slide 43] Tom, let's go to test #2 ("Substantially Disproportionate"). These are four specific tests that you've got to meet all the requirements. One thing to note is family attribution rules apply to these, so be careful of those.

[Slide 44] Test #3, "Complete Termination of Interest." Again, we have family attribution rules. So, there is the ability to mitigate those rules with family attribution waiver.

[Slide 45] Test #4, we're doing a partial liquidation of the company eliminating one area of the business, for example.

[Slide 46] Test #5, the §303 Redemption. We are redeeming some of the business interests so that the estate can get cash to pay the estate tax. And that's frequently a very good tool to use.

Thomas Insalaco

[Slides 47-60] Bo, do we want to move along to the sections of the tax code ("Fixing Estate Tax Values with Buy-Sell Agreements)?

Robert H. "Bo" Trudeau

Yeah, so fixing estate tax values is a huge benefit that you can get with a buy-sell agreement.

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[Slides 48-49] Essentially, you can have your buy-sell agreement dictate or safe harbor the value with the IRS for estate tax purposes. But there's specific requirements that have to be met. The first of those requirements is listed under §2031 of the regs. And I'm not going to read this whole regulation to you. And in fact, I think it's summarized on the next slide, which is it's referred to as the Wilson-Lomb rule, which is two cases from the 1930s that articulated the four requirements. And just to run through them briefly:

- Number one, there's got to be an obligation to sell.
- Number two, there's got to be a fixed and determinable price.
- Number three, preclude lifetime transfers at a price in excess of the agreement.
- And [four], not a device to transfer the interest to family effectively, for inadequate consideration.

[Slide 50] §2031 was our only body of law on this until the 1990s when §2703 was enacted as part of Chapter 14. And we got some additional requirements.

And there's three requirements from Chapter 14 or §2703, but one of these overlaps and so I think of it as two additional requirements to be met:

- The first one is it's got to be a Bona Fide Business Arrangement. So that's one of the new requirements.
- Second is not a Device. So that's our requirement that overlaps.
- And then third, the Comparability Test. This, to me, is the big one. The agreement needs to be comparable to similar arrangements entered into by unrelated parties dealing at arm's length. So, in total we get six requirements. We still have the four requirements from §2031, and then §2703 adds requirements five and six.

Tom, go to the next slide.

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[Slide 51] So, you are deemed to meet the §2703 requirements if more than 50% of the company is owned by individuals who are not members of the transferee's family. Remember, this is another case in which we have broad attribution rules applied. So, when you're looking to calculate that 50% interest, or more than 50% interest, we have to be mindful of that.

[Slides 52-53] What ends up happening is we have different sets of requirements between a business that's primarily owned and controlled by unrelated parties versus a family-owned business.

Thomas Insalaco
Bo, quick question. What constitutes a family member? I mean, how closely do you have to be related for it to fit under that rule?

Robert H. "Bo" Trudeau
The attribution rules are pretty broad. I'm not sure offhand how far it goes. I've got to go look at it every time. The traditional close family members are what you would frequently think of.

Thomas Insalaco
In the quote it is defined who can who qualifies and who doesn't though. Okay.

Robert H. "Bo" Trudeau
It's fairly mechanical.

Thomas Insalaco
Got it.

Robert H. "Bo" Trudeau
So, if you have a transferor who doesn't own 50% of the business, either directly or through attribution, then the requirements are fairly straightforward: obligation to sell, fixed indeterminable price, and precluding lifetime transfers at a price in excess of the agreement price.

Conversely, if we've got a transferor who owns more than 50% of the business, either directly or with family, then we've got the three additional requirements that have to be met: not a Device; Bona Fide Business Arrangement; and the most difficult one, which is Comparability.

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[Slide 54] So, going through each of these requirements, the obligation to sell is a pretty easy one to meet. In fact, we don't have to mandate that there's a purchase and sale in the event of death. Rather, an offer, a mandatory offer, by the estate of the decedent is sufficient to establish and to meet, this first requirement.

[Slide 55] So, second requirement is a Determinable Price. And I would tell you that this is generally an easy requirement to meet. I sort of viewed this as one that you couldn't really run afoul of. You just have to establish some sort of price, or pricing mechanism, in the agreement. But, what we'll see from the *Connelly* case is this determinability test wasn't met, at least as articulated in the Eighth Circuit opinion.

[Slide 56] The third requirement is Restrictions on Lifetime Transfers. So, we can have an absolute prohibition on lifetime transfers. You know, say no one's allowed to transfer their interest. We can also have a right of first refusal and that's something I will frequently include in a buy-sell agreement. You can't transfer it to a third party without offering it to the other owners, or you know maybe to a controlling owner. You'll see the Private Letter Ruling 9133001. They had a prohibition against transfers unless it was consented to by all shareholders. And the IRS ruled that this was not a sufficient restriction on lifetime transfers. I'm not sure this was the correct result. I mean, as a practical matter, if all the other shareholders consent, you can amend any agreement anyways. So, this seems like it should have been sufficient to me, but clearly the IRS disagreed with this.

And then you've got the *Estate of Hall*, which permitted transfers to family members. The IRS argued that this arguably permitted transfers at a price in excess of the agreement price because there was no constraint on what the price would be. The Tax Court rejected this argument, basically saying there was never a transfer during lifetime in excess of the agreement price, nor was it likely to occur. That said, I don't think you want to rely on the *Hall* case. Frequently I'll include family members as permitted transferees in agreements, but they're only permitted to receive their interests through gift or with a cap, for example, on the price that can be paid – it can't be more than the agreement price.

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[Slide 57] So, fourth requirement, the Device Test. This is the "don't play games with us." You'll see we've got some indicia of a "Device": a party is in poor health and they decide at that point they're going to execute a buy-sell agreement. Also, the failure of parties to honor a buy-sell agreement in previous instances. And this is something we see frequently with the IRS. Why should we, the IRS, be bound by an agreement price if you, the taxpayer, and your other business owners aren't going to honor the agreement?

This is something we see as well in the *Connelly* case.

[Slide 58] Bona Fide Business Arrangement? The existence of unrelated parties. Tom and I are in a business together and, Tom doesn't want to be in business with my wife if I pass away. This is usually a bona fide business arrangement. Similarly, if it's all family members, preserving that family control has been interpreted as a valid business arrangement. So, this isn't too difficult of a test as well.

[Slide 59] The real test I think that we get from §2703 is Comparability. It's got to be comparable to a similar arrangement by parties in an arm's length transaction. And to me, this is probably the biggest reason I use the requirement of a business appraisal in my buy-sell agreements, particularly if I'm trying to fix estate tax values. As a practical matter, it strikes me as nearly impossible to otherwise get there. And so fixing values is important.

[Slide 60] I think the appraisal methodology is really the only path. On the next slide, we go through some of the cases that have interpreted Comparability.

First, we have the *Lauder* case and, this is Estee Lauder, the cosmetic company. They had a buy-sell agreement that used book value to determine the value of the shares. And the Tax Court rejected that as a sufficient methodology. One, there was no relationship whatsoever to fair market value. Two, there was evidence of cosmetic companies being traded at much higher prices.

We have the *Blount* case. Here they had a formula-based methodology. 4x earnings. The Tax Court held that there was no evidence of similar arrangements entered into by parties at arm's length.

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So, two negative cases, but last, we have the *Amlie* case. And the *Amlie* case is a favorable one. Here the Comparability requirement was met because a valuation expert was used to determine the stock price. They determined that price based on an analysis of other similar businesses in that region. The price was negotiated and the price was approved by the conservator for the decedent. So, we see that we've got a negotiated agreement and we've got a valuation methodology being used to establish the price.

Thomas Insalaco

The Comparability requirement, that's specifically for businesses that are more than 50% owned by family members, right? So, if you're a bunch of non-related parties that own a business, you don't have to meet that requirement?

Robert H. "Bo" Trudeau

Yeah. I mean, so Tom, if it's you, me, and my brother in business together, and we're all one-third owners of a business. You pass away, the Comparability requirement doesn't have to be met, because you would be the transferor and you own less than 50%. I pass away, the Comparability requirement has to be met, because I'm an owner of the business and through attribution, I own more than 50% of the stock.

SECTION 4: TAX COURT CASES/EXAMPLES

Thomas Insalaco

[Slides 61-62] Alright, let's move on. We have we have about ten minutes left, so we're going to go through two recent cases, *Connelly*, which everyone's familiar with probably already, and then the *Huffman* case. Bo, do you want to talk about the *Connelly* case?

Robert H. "Bo" Trudeau

Yes.

[Slides 63-66] You know, it's rare that we get tax decisions from the United States Supreme Court, but this is this is one of those. And, the *Connelly* case is an important one. So, here we had the Crown C Corporation owned by two brothers, Michael and Thomas. Michael was the 77% owner, Thomas was the 23% owner, and they entered into a buy-sell agreement, giving each other the right to buy the shares and if the surviving brother declined, the company had the right to redeem the shares.

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This was a hybrid buy-sell agreement. And they had two mechanisms to determine the purchase price. One, they had the certificate of agreed value or our notorious Schedule A to the agreement that would be updated every year. Or if they failed to do that, there was the requirement of two or more appraisals. They also funded the buy-sell agreement. The company purchased $3.5 million dollars of life insurance on each brother.

Michael died in 2013.

And there was an agreement between Thomas, the surviving brother, and Michael's estate on a redemption price for the stock of $3 million dollars. I think it's important to note that the executor or personal representative of Michael's estate was also Thomas. So, the arm’s-length nature of the transaction is certainly something that can be questioned in this scenario.

The estate reported the agreed upon $3 million dollar purchase price as the value of Michael's stock for estate tax purposes. The IRS came in, audited Michael's estate tax return, and determined the value was not $3 million, but it was actually $5.3 million.

Michael's estate paid the tax deficiency and filed suit for refund. The District Court awarded summary judgment for the IRS:

1) They determined that the agreement did not fix the value for estate tax purposes.
2) They determined that the value, or pardon me, the proceeds of the life insurance, the $3.5 million that was paid to Crown C Corporation, had to be included in determining the value of the company.

The estate appealed and the Eighth Circuit followed suit and upheld the decision of the District Court. They held that the agreement did not establish a fixed and determinable price. So again, we talked about that determinability test. Here they failed the determinability test.

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So even though they had multiple mechanisms in the agreement to figure out a purchase price, because Thomas, on both sides of the transaction did not have a Schedule A, did not use the appraisal process, whatever agreement he came up with, it didn't really have any sort of tie to the actual document itself. So, the Eighth Circuit affirmed that there was no fixed and determinable price. They also affirmed the decision that the $3.5 million dollars of life insurance should be included in determining the value of Crown C.

When the Eighth Circuit ruled, they created a split in the Circuit. So, previously we had the *Blount* decision, which was also referenced earlier, for fixing value, as one of the cases that said you don't have to include the value of life insurance in the value of a company in determining the value for estate tax purposes. And the logic of the *Blount* case was basically, yes, we've got this life insurance that's coming into the company, but it should be offset by the obligation that the company has to use that life insurance to purchase the stock.

So, the split in the Circuit is what caused this issue to be brought before the United States Supreme Court. And Clarence Thomas was the author of the opinion for, what seems to be an unlikely event these days, which is a unanimous opinion of the United States Supreme Court.

You know, the opinion did not go into fixing values for estate tax purposes. Rather, it focused solely on the issue of: is life insurance included in the value of a company for estate tax purposes if it's used to fund a redemptive buy-sell agreement? And the answer was Yes. And Thomas provided a simple redemption example that illustrated how the value of the company has increased when it receives life insurance. Thomas also noted that these guys could have just done a cross-purchase if they didn't want this result. So there's there are a few takeaways from the *Connelly* case:

- The most important one is respect the agreement. If you want the IRS to respect your agreement, you're going to have to do so as well. You know, so that's just kind of a basic tax principle.
- Two, don't do a Schedule A. It's simple on the front end, but it doesn't really accomplish the objective that you're trying to accomplish.

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- And three, if planning for estate tax purposes is important to you, the Redemptive buy-sell agreement is probably not going to be the best option. Rather you should be thinking about a Cross-Purchase, or if you've got a situation where you've got a lot of different owners and buying multiple life insurance policies on every owner is unwieldy, then consider partnership-owned life insurance. And we're not going into detail on partnership-owned life insurance today, but you know, that's something that needs to be carefully drafted as well. And if anyone has any questions on it, I'm happy to answer those.

Thomas Insalaco

[Slides 67-69] So, the second case (*Huffman*) we're going to go over gets right into that Comparability test, that Bo was talking about, which applies to businesses that are more than 50% owned by family members. This was also shortly after the *Connelly* case, so I think it might have gotten overshadowed. I think people are not as familiar with this case, but it revolved around a company called Infinity Aerospace, which was formerly known as Dukes (so we'll refer to it as Dukes). Founded back in the 1950s in California. Lloyd Huffman and his wife Patricia both worked for the company as Engineer and Bookkeeper, respectively.

In 1970, Lloyd was named president of the company and acquired 113,000 shares. Then he and his wife formed the Huffman Family Trust in 1979 and moved the shares over to the Trust and then also purchased another 5,000 shares for the Trust. There are more facts to this case, but I'm going through this at high level because we're running out of time. I'd recommend reading the case.

In 1987, this is when Lloyd and Patricia's son Chet became involved. Lloyd was into car racing, and he had a nearly fatal accident. His son, Chet, took over as the CEO and was issued 5,000 shares, which 5,000 shares at the time was just a little bit under 1% of the shares total outstanding. Chet's two older brothers were also working for the business, but they're not that important to this story. In 1990, Lloyd and the biggest shareholder of the company, Robert Barneson, entered into a Right to Purchase Agreement (RPT) where Lloyd had the right to purchase Robert's shares at his death or for a price not to exceed $2 per share. He also had a right of first refusal.

So, then in 1993, Lloyd assigned his rights to the Barneson Right to Purchase Agreement to Chet and Chet purchased Barneson's shares for $150,000 and that made Chet a 43.7% owner. That purchase price of $150,000 for the 322 shares amounted to, I think, 40 something cents per share, so it was well below the $2 per share [price].

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In 1993, Chet entered into two new RPT agreements: one with the Huffman Family Trust with his parents, and then the other with an entity called Duke's Research Manufacturing, Inc. (DRM), which was wholly owned by his mother Patricia. So we had the two agreements with those two entities to purchase all their shares in Duke's for a sum of $2 and "other good and valuable consideration." The "other good and valuable consideration" is going to be important.

So, the other facts. Chet took compensation of between $65 - $85 thousand dollars per year from 1987, when he took over CEO, until 2006. There was only one other executive at the company, and they were being paid about $250 thousand dollars annually, so Chet was clearly taking a below-market rate for his services. The company grew significantly under Chet's leadership. The case, if you read the Opinion, it goes into all the details of everything Chet did, but he played a significant role in growing the company from $5 million in revenues in the early 1990s to $28 million in 2006.

Also, during this time, Chet's brothers and other family members formed various other business entities to lease employees and manufacturing equipment back to the company so there were related entities. But in the early 2000s, Chet and the company received several offers to buy the company from outsiders, but the company wasn't for sale, so they turned them all down.

But then in 2007, the company received an offer from a Korean company, Hanwha, for between $85 - $105 million. They received a Memorandum of Understanding, pending diligence findings. Part of that Memorandum of Understanding was that Chet was going to consolidate all the related entities and consolidate ownership. In 2007, Chet made those moves and he exercised his option to purchase the shares from the Trust in DRM for $5 million dollars. But then in 2008, Hanwha backed out of the deal, but at that point Chet wanted to sell. So, they continued marketing the business and they sold to Transdigm for $95 million plus a potential $60 million earnout in 2009.

So, Chet exercising the option to purchase the shares from the Trust in DRM in 2007 was one of the things that the IRS took issue with. They said that the $5 million was obviously below the fair market value of the shares at the time of the purchase. And the estate tried to use the pricing from the buy-sell agreement to fix the pricing for the estate tax.

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So, the Tax Court opined that the Comparability test is where those RPT agreements with the Family Trust and DRM failed. They said it was a bona fide business arrangement. The court opined that the agreement was meant to keep management control of the business within the family. They said it did meet the second requirement of §2703 which was it was not a device to transfer property for less than full adequate disclosure. Because even though it was only $2 a share, which was in 2007 well below what any fair market value estimate of the company would have been, all "other good and valuable consideration" was considered and that was Chet taking a significantly under-market compensation for his leadership at the business. So, that they passed that test but, then the Comparability, they did not submit that Barneson agreement into evidence and they tried to claim that the Barneson agreement was comparable.

The Court opinion said that 1) they couldn't consider the Barneson agreement because it was not entered into evidence, and then 2) the DRM and the Huffman Family Trust Agreements were amended to allow Chet to purchase the shares from those two entities at any time, for any purpose; whereas the Barneson agreement only gave Lloyd the right to purchase at the time of Barneson's death or, under right of first refusal. So, because of that difference and Chet had more flexibility in when he could exercise the agreement, the court opined that even if they did submit that agreement into evidence, it would not have been considered comparable enough to pass this test.

So, basically that's the big takeaway here: this case just shows how hard it is to pass the Comparability test like Bo was saying. So, Bo, I don't know if you have anything to add?

Robert H. "Bo" Trudeau

I just echo that comment, Tom, as a practical matter, it's the Comparability test that is always going to be the big hurdle. And that to me pushes towards valuation-based methodology for buy-sell agreements.

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CLOSING

Thomas Insalaco

With that, we'll take questions. I know we’re pretty short on time. I think we're right at about an hour and fifteen minutes, so let's take a look to see if we have any questions. And while we're waiting for questions, I just want to mention we will send the slides around, and we'll send a replay of this webinar to everyone who registered.

[Slide 70] Also, our founder at Mercer Capital, Chris Mercer, has written several books on buy-sell agreements. We'll send his 2010 e-book that has more detail [about some of the topics we discussed today such as] the different pricing mechanisms and [the defining elements of a buy-sell agreement]. And then there's also his 2024 book which you can purchase from ABA, that has additional commentary on the *Connelly* case and suggested language that you can use for the valuation sections of buy-sell agreements. With that, let me see, questions.

Robert H. “Bo” Trudeau

And Tom, I think our slides that we're going to share, they're we've got a more robust version than [what we’ve used on the webinar].

Thomas Insalaco

We cut [the original powerpoint deck] down to make it fit [our time constraints]. So, we have a more robust version with more details. We will send the more robust version around.

Oh, Bo, I got one question I have here: Recommendations for funding buy-outs when there is no life insurance and there's other triggering events. Do you have any additional thoughts there that we haven't covered?

Robert H. “Bo” Trudeau

Yeah. I mean It's not uncommon that life insurance is not practical economically for some business owners or some business owners are uninsurable. And I think it always makes sense to include some sort of structured mechanism to fund the buy-sell agreement whether that's allowing seller financing over five years or seven years, something like that, to create the flexibility and make the agreement work.

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Thomas Insalaco

One more question that I see here and I'm going to rephrase a little bit because this is something I'm curious about too … so the I was talking before about the examples of life insurance as a funding vehicle if it's corporate owned or as a corporate asset. So obviously *Connelly* ruled that it was a corporate asset and you add the proceeds back, but I guess if there's an agreement that's being followed, unlike the *Connelly* case, the agreement is actually being followed and the agreement for buy-sell pricing calls for it being viewed as a funding vehicle, so you don't add the proceeds from the life insurance in.

If a case with that fact pattern came up, do you think the IRS would point to the *Connelly* case and say, no, you have to for estate tax purposes count the proceeds in the corporate value, or would they say, well, you followed your agreement in this case and so it's okay?

Robert H. “Bo” Trudeau

Yeah, I think I'll give you the ideal attorney answer which is “it depends” and if the agreement uses some sort of liquidation value-based methodology, I think if you've got life insurance coming into the company, it's probably going to be factored in exactly the way the courts did it in *Connelly*, which it just adds to the value.

Conversely, if it's a going concern-based value, and, Tom, this is probably more your area of expertise, but then it becomes a question of should an asset like life insurance really move the needle on the value? Or is it going to be dictated more based on earnings, things like that? So, if we've got an established methodology we're using for valuation, yes, it may factor in that life insurance policy to some extent. But I don't know that it'll just be a dollar-for-dollar increase if we meet the Comparability Test.

Thomas Insalaco

There's probably a lot more we could talk about on that, but we're out of time. So, to everyone listening, if you have any questions, you can you can definitely feel free to reach out to Bo or myself. And then also look for that follow-up communication with the slides, the replay, and the e-book that I mentioned. Thanks everyone for attending. And thank you, Bo.

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Robert H. “Bo” Trudeau

My pleasure. Thanks for having me, Tom.

Host

Thank you so much for joining us today. If were not able to address your question during our session, we will follow up with you individually.

The recording of today's webinar will be available shortly, usually within the hour. You'll receive an email with a direct link, so keep an eye on your inbox. If you'd like to reach out with additional questions for Tom or Bo, please scan one of the QR codes on your screen to access their contact information or email them using the email addresses listed. CLE certificates will be emailed no later than Monday, April 27th. We appreciate your participation and hope you found today's discussion insightful and valuable. Keep an eye on your inbox for future webinars.

Thanks again and have a wonderful rest of your day.

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