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Establishing the Purchase Price for Buy-Sell Agreements

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The lack of an effective buy-sell agreement is a problem, which currently impacts a large number of closely held business owners. Many such owners remain unaware of the problem until a triggering event such as the death of a co-owner exposes the inadequacies of a poorly planned or nonexistent buy-sell arrangement. Such inadequacies often result in unexpected taxes and/ or difficult negotiations among the remaining owner(s) and the estate of the deceased owner. A properly structured buy-sell agreement can facilitate the transfer of ownership interests at a price and terms, which are equitable to all parties involved, allow for necessary tax planning, and provide reasonable assurance that the business will survive the triggering event.

Perhaps the most crucial aspect of a well-structured buy-sell agreement is the provision for the purchase price. Beyond the obvious fairness consideration that transfers of ownership interests be based on a price, which reasonably considers the fair market value of the interest transferred, there are specific tax issues, which must be addressed in the determination of the appropriate purchase price.

A particular concern in many estate planning situations is that the buy-sell price meet specific parameters as set forth in Internal Revenue Code Section 2703. If Section 2703 is not property addressed, a buy-sell purchase price that is less than fair market value may not establish the value of a decedent's interest for estate tax purposes upon his/her death. As a result, the estate may be contractually obligated to sell the interest at a price, which does not leave sufficient proceeds to pay the estate taxes due.

According to Section 2703 (which applies to all buy-sell agreements entered into or substantially modified after October 8, 1990 in which the transferor and his/her family own at least 50 percent of the stock subject to the buy-sell agreement), the purchase price under the buy-sell agreement will be disregarded in establishing the value for estate tax purposes unless the buy-sell agreement:

- is a bonafide business arrangement,
- is not a device to transfer the interest to the natural objects of the transferor's bounty for less than full and adequate consideration, and
- has terms comparable to similar arrangements entered into by persons in arm's length transactions.

Considerable uncertainty exists regarding the interpretation of these items, in particular the last item, the so-called "comparability test". Is there a requirement to show examples of buy-sell agreements among unrelated third parties in similar businesses with comparable terms? While by no means clearing up all of the uncertainty, the Regulations subsequently adopted by the IRS seem to suggest an alternative means of conforming. The Regulations suggest that the comparability test is not met by demonstrating isolated comparable buy-sell provisions, but rather by consideration of such factors as:

- the term of the agreement,
- the current fair market value of the interest (at the time the agreement was entered into),
- anticipated changes in value during the term of the agreement, and
- the adequacy of any consideration given in exchange for the rights granted.

Based on the above, the objective should be to establish a buy-sell price that is based on fair market value at the time the agreement is entered into and also provides a mechanism designed to track changes in value over time. Periodic independent appraisals are one way of addressing this issue, but they are expensive and time consuming. Conversely, waiting until a future triggering event to perform an appraisal makes it difficult to plan today for funding of the buy-out and payment of taxes, with no current knowledge of the company's fair market value. Finally, "formula" prices designed without the input of independent appraisers or financial experts familiar with valuation issues generally bear little relation to fair market value.

Cogent Valuation's approach is to complete an independent appraisal of the subject company as an initial basis for the buy/sell price. The initial appraisal involves a detailed analysis of the specific factors which are most influential in determining the company's value. These factors vary significantly not only between industries, but between companies in a given industry. Based on knowledge of the company's "value drivers" obtained in the initial appraisal, we assist the company (and its professional advisors) in structuring a customized buy-sell pricing mechanism designed to track future changes in value without the necessity of annual independent appraisals (although, if desired, the agreement could call for a periodic cursory review by the appraiser for a nominal fee to make certain that the valuation approach

adopted continues to properly track changes in the value of the business). A well drafted pricing mechanism will consider future changes in the company's financial position, including earnings and cash flow generating capability, as well as changes in the external marketplace.

The following factors must also be addressed:

- treatment of owners' compensation,
- when and how to factor fractional interest discounts,
- treatment of "key-person" risk, particularly when the triggering event involves the termination of the key-person's active involvement in the business, and
- changes in accounting practices which affect the buy-sell price.

Other than constantly updated independent appraisals, which are generally cost-prohibitive, no buy-sell purchase price provision can assure absolute consistency with fair market value. Nonetheless, if the proper pricing mechanism is employed, the price should in the external still be: i) valid for estate tax purposes because Section 2703 was specifically addressed at the time the agreement was entered into, and ii) reasonably consistent with fair market value so that the purchase price is not grossly unfair to either party. However, given the complexity of issues, the structuring of a proper buy-sell provision should not be taken lightly and should involve a coordinated effort involving the client, the attorney, the accountant and the valuation advisor.