**8814. How are interests subject to a buy-sell agreement valued?**

One of the most difficult areas in negotiating a buy-sell agreement is determining the purchase price for the interests that are the subject of the agreement.Advance agreement upon the purchase price, or the method for determining the purchase price,is important, because failure to include pricing terms may make enforcement of the agreement problematic. There are three common methods used in determining the purchase price.The parties may either (1) set a fixed price; (2) use a formula to determine price; or (3) obtain an independent an appraisal.

The valuation method provided under the buy-sell agreement is not always determinative of the parties’ final tax liabilities, however, especially in the case of a closely-held company where the IRS could argue that the interests were undervalued and attempt to impose penalties under Section 6662.[[1]](#footnote-1) Use of an independent appraiser can help to alleviate this concern for some companies.

However, if the valuation in the buy-sell agreement complies with the “price term control test,” the purchase price in the buy-sell agreement will generally control the value of the asset for *estate* tax purposes.[[2]](#footnote-2)For the terms of the buy-sell agreement to control for estate tax purposes, therefore, it is important that the agreement prohibit the decedent from transferring shares outside of the buy-sell agreement for any other price than that which is specified in the agreement.Further, the parties must be able to demonstrate that, based on the specific circumstances of the case, the buy-sell agreement represents a legitimate business arrangement, rather than a disguised scheme to pass the shares at an artificially low value to the deceased owner’s children or other natural beneficiaries.[[3]](#footnote-3)

It is also necessary to address the requirements of IRC Section 2703.Under Section 2703, the IRS will disregard the price established in the buy-sell agreement for establishing the fair market value of the interest being sold unless certain requirements are met.Specifically, (i) the agreement must be a bona fide business arrangement, (ii) the agreement must not be a device to transfer property to members of the decedent’s family for less than full and adequate consideration, and (iii) the terms must be comparable to similar arrangements entered into by persons in an arms’ length transaction.[[4]](#footnote-4)

**Planning Point:** While using a fixed price may be the simplest method for the parties, it is important that the agreement is reviewed at regular intervals to ensure that the price still accurately reflects the value of the business to avoid IRS intervention.On a practical level, clients frequently fail to update these stipulated values.

If the parties develop a formula to determine the pricing under a buy-sell agreement[[5]](#footnote-5) it is important that they clearly define all terms necessary to determine the price under that formula. Further, they should be aware that the courts may set aside the formula in certain cases, including cases where the formula was not determined in an arm’s length negotiation or is found to be against public policy.[[6]](#footnote-6)

**Planning Point:** When deciding upon a particular formula, it is useful to determine if there are “rules of thumb” for valuing a particular type of business. If there are industry yardsticks to valuing the business, the formula can be applied in setting a formula.

**Planning Point:** Some agreements provide for a stipulated value; however, if the stipulated value is not updated with a specified period of time (i.e., 2 years), then a formula is used to determine the value.

See Q 8815 for a discussion of the use of so-called “showdown clauses” in pricing under a buy-sell agreement. Another type of provision would have the sales price under the buy sell agreement be redetermined if the business were sold within a specified time frame.

1. . See also *True v. Comm.*, 2001 TCM LEXIS 199 (2001) for an illustration of understatement penalties that may apply. [↑](#footnote-ref-1)
2. . See Treas. Reg. §20.2031-2(h); *True v. Comm.,* above. [↑](#footnote-ref-2)
3. . Treas. Reg. §20.2031-2(h). [↑](#footnote-ref-3)
4. . IRC Sec. 2703(b). [↑](#footnote-ref-4)
5. . See e.g., *Anderson v.* *Comm.*, 1970 TCM LEXIS 10 (1970). [↑](#footnote-ref-5)
6. . See e.g., *Hendrix v. Comm.,* TC Memo 2011-133 (in this case the pricing was upheld, but the court discussed the circumstances that might cause it to be set aside). [↑](#footnote-ref-6)