

Davis & Company, CPA's, CVA's

Estate of True, Jr. v. Commissioner, No. 02-9010 (10th Cir. 12/02/04)

Buy-Sell Agreement Did Not Establish Value for Estate and Gift Purposes

Dave True was a successful entrepreneur and established a number of companies involved in oil and gas exploration, marketing, and transportation. These companies often worked in concert, providing services to one another and assisting in one another's efforts. Companies which generated a substantial amount of revenue often provided the funds to support companies which were not as profitable. Dave also established ranching operations.

Due to an unsatisfactory work experience early in his career, Dave developed a business philosophy which was guided by four basic principles. He did not want to own a business with anyone but his own family members, every business owner or partner should be actively engaged in the business, buy-sell agreements were necessary to avoid conflicts among owners and to establish clear exit strategies, and outside debt would be incurred only as a last resort.

Each True company was governed by buy-sell agreements which embodied these business principles. The agreements dictated that an owner or partner could not transfer or encumber his or her interests in the business, and each owner or his or her spouse had to work in the business. Failure to work in the business, any attempt to transfer an interest in the business, death, and disability were each treated as if the holder of the interest had notified the other owners of his or her intent to withdraw from ownership. Upon the occurrence of such an event, the other owners were required to purchase the departing owner's interests at a formula price listed in the buy-sell agreement.

The formula prices in the buy-sell agreements were derived from a calculation of the tax book value for the various True companies. The companies characteristically kept their business records according to tax book values rather than following generally accepted accounting principles.

On June 4, 1994, Dave died unexpectedly. In accordance with the buy-sell agreements, Dave's remaining interests in the True family companies were transferred to his wife and sons at tax book value. The estate subsequently filed an estate tax return reporting the date-of-death value of Dave's interest in the True family companies as equal to the proceeds the estate received under the buy-sell agreements. In January 1998, the I.R.S. issued a notice of deficiency against the estate, asserting that the values of the True companies listed in the return were higher than the tax book values at which they were sold.

As developed in case law, and embodied in Treasury Regulation § 20.2031-2(h), the stated price in a buy-sell agreement will control for estate tax purposes where (1) the price is determinable from the agreement, (2) the terms of the agreement are binding throughout life and death, (3) the agreement is legally binding and enforceable, and (4) the agreement was entered into for bona fide business reasons and is not a testamentary substitute intended to pass on the decedent's interests for less than full and adequate consideration.

The Tenth Circuit agreed with both parties that the first three prongs of the test are not at issue. The fourth prong of the price term control test asks whether a buy-sell agreement is entered into for bona fide business purposes and does not represent a testamentary substitute intended to pass a decedent's interests on to the natural objects of his bounty for less than full and adequate consideration. This prong of the price term control test is conjunctive in nature. The buy-sell agreement must be entered into for a legitimate business purpose, and it cannot be a testamentary device.

The tax court reached its conclusion that the True company buy-sell agreements were substitutes for testamentary dispositions by first examining a variety of factors permitting an inference that the agreements served a testamentary purpose. The court then determined taxpayers failed to prove the price terms in the agreements represented adequate consideration at the time the parties entered into the agreements. Consequently, the court found the price terms were not binding for estate tax valuation purposes.

The Tenth Circuit Affirmed the Tax Court's Decision and concluded the following:

1. Where the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute.
2. The buy-sell agreements did not contain within their provisions a mechanism by which to reevaluate the price terms listed therein.
3. Unrelated parties negotiating at arm's length would likely have required a periodic reevaluation of the use of tax book accounting to value the interests in the buy-sell agreements.