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STOCK RETIREMENT AGREEMENTS RESURRECTED OR THE "TAX COLLECTOR'S BARK IS OFTEN WORSE THAN HIS BITE"

Melvin C. Teske and Louis Maier

Although it is believed there is much material in this article which will interest and benefit the tax specialist and estate planner, its primary purpose is to furnish guide-posts for the general practitioner who may occasionally be called upon to draft a stock retirement agreement.

I. INTRODUCTION

The year 1957 brought sputniks I and II, and with them a national anxiety and a nervous revaluation of our defense policies. The field of business insurance and corporate planning also had its sputniks in the area of insured stock retirement agreements for close corporations. These were the Tax Court decision in Prunier,1 a Federal District Court decision in Sanders v. Fox,2 and another Tax Court decision in a case involving a related area of an insurance-funded deferred compensation agreement, Oreste Casale.3 That these judicial sputniks too have resulted in a revaluation is evidenced by the prolific flow of articles by attorneys and insurance planners discussing and criticizing them, and appraising their effect on insured stock retirement agreements.4 Discussions have ranged from "Prunier Offers No Threat to a

1 Henry E. Prunier et al., 28 T.C. 19 (April 12, 1957); vacated and remanded, 248 F.2d 818 (1st Cir. 1957).
2 149 F. Supp. 492 (D. Utah 1957); rev'd, 253 F.2d 855 (10th Cir. 1958).
3 26 T.C. 1020 (1956); rev'd., 247 F.2d 440 (2nd Cir. 1957).
4 For example, see: Mannheimer and Friedman, Stock Retirement Agreements—The Prunier and Sanders Cases, 35 Taxes 567 (1957); Taylor & Maier, Sanders Case Again Emphasizes Care Needed in Agreements Funded With Life Insurance, 7 J. Taxation 68 (1957); Jones and Gleason, Casale Reversed; Corporate Insurance Not Dividend to Controlling Stockholder, 7 J. Taxation 258 (1957); Lawthers, Prunier reversed, 8 J. Taxation 12 (1958); and The Fragile Bark of the Small Corporation, J. Am. Soc'y C.L.U 4 (Winter 1957); The Use of Life Insurance to Fund Agreements Providing for Disposition of a Business Interest at Death, 71 Harv. L. Rev. 687 (1958).
Sound Insured Buyout Plan"\textsuperscript{5} to "Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement."\textsuperscript{6}

The purpose of this article is to: (1) define the closely held corporation and its particular problems which may be solved through the use of insured stock retirement agreements, (2) describe the public policy favoring them, (3) set forth some general principles to be followed in drafting such agreements, (4) review the cases cited above and evaluate them in the light of the prior discussion and, finally, (5) set forth a typical form of stock retirement agreement including appropriate comments on its general features.

II. SOME PROBLEMS

Recognition and appreciation of the corporate area in which the insured stock retirement agreement can most effectively be applied requires an initial review of some of the vital distinctions between a publicly owned corporation and a close corporation. The typical publicly owned corporation has a substantial number of stockholders most of whom take no part in the active management of the business. Its shares are readily marketable either through the stock exchanges or in over-the-counter transactions. The death of a stockholder in such a corporation normally has little or no effect on the overall operation and continuation of the corporate business.

Contrasted with this is the close corporation owned by a small group of stockholders most of whom are actively engaged in the management and operation of the business. Its stock is not readily marketable. Certainly the bulk of such corporations fall within the category of "small business," particularly as compared with some of the publicly owned "big business" giants, and in practical operation have in some respects been characterized as "incorporated partnerships."\textsuperscript{7} Finally, and most important, the death of a stockholder in the typical close corporation creates a number of problems not ordinarily arising in the publicly owned corporation. We now focus our attention on these problems.

A. Introduction of Adverse Interests: Reference has already been made to the active participation in the business of the original stockholders of a close corporation. Fortunate indeed is the close corporation in which the son of a deceased stockholder stands ready to replace his father's special ability in the direction or operation of the business—a son who has worked cohesively with the other stockholder-officers, who is in accord with the current management policies of the firm, and who succeeds to his father's ownership interest in the corporation!

But what of the future of the close corporation not so fortunate

\textsuperscript{5} J. TAXATION 2 (1957).
\textsuperscript{6} 26 FORDHAM L. REV. 189 (1957).
\textsuperscript{7} See WHITE, BUSINESS INSURANCE p. 291 (2d ed. 1956).
upon the death of an active stockholder? Will it find as its new co-owner a window and perhaps minor children unable to replace the ability and contributions of the deceased stockholder in running the business? Will the stock be retained by the heirs, or will its sale be necessary to pay probate expenses, debts and estate and inheritance taxes? If the former, will the heirs become active stockholders seeking advice of outsiders, disrupting corporation policies established and carried out in a spirit of harmony while the active "partner" lived, seeking dividends and still larger dividends to replace the loss of income previously paid as salary to the decedent, or even taking control with possibly disastrous results to the corporate enterprise?

If the stock must be sold to meet estate obligations, or if the heirs prefer to sell for other reasons, what then of the corporate future? Will outside interests and perhaps even competitors become co-owners? Or will the stock be offered to the corporation or to the surviving stockholders, and if so, will there be funds to carry out the purchase? This leads us to the next problem:

B. Effect on Corporate Credit: More often than not, particularly in its early years, the credit of the close corporation is primarily the credit of its individual stockholders. Lenders and suppliers frequently will require the personal guarantee of such stockholders before extending credit to the corporation, particularly in tight money markets. What will the firm's credit picture be on the death of a stockholder, and what of its future credit position, if the disruptive influences discussed in the preceding paragraph are present?

C. What About Key Employees: Will the death of a stockholder in the close corporation cause the loss of a key employee or employees who are uncertain of the future of the business, or even faced with loss of their jobs if the succeeding owners acquire a majority interest in the business?

D. Liquidation of Investment and Forced Mergers: The heirs of a deceased stockholder in a publicly owned corporation can easily liquidate his investment with no adverse tax consequences. Because the stock acquires a new basis upon the decedent's death, there may not even be any capital gains tax on a sale of such stock by the estate or the heirs.

When a few men own a small but successful corporation, their investment is good as long as they live and continue to manage and operate the business. Upon the death of a shareholder whose knowledge and ability was an important factor in the success of the business, his family may often be left with an extremely speculative investment. The subsequent deaths of the surviving manager-shareholders may result in the investment becoming worth even less, perhaps even reduced to what can be realized upon a forced sale.
Unless some method is available for liquidating his investment and providing an assured life income for his widow or other heirs without adverse tax results, the investor in a close corporation is placed at a disadvantage as compared with the investor in a publicly owned corporation. Too often the only safe alternative for the close corporation shareholders has been to sell out to a publicly owned "big business" corporation through the device of a tax-free exchange of stock. Recent business history discloses many such mergers. (In Part III, we consider the public policy aspects of this alternative.)

While the foregoing summarizes some of the problems upon the death of a close corporation stockholder, it is by no means exhaustive nor is it intended to be. It is, however, intended to point out that, while organization of a business in the corporate form has the advantages of limited creditor liability and continued existence of the corporate entity regardless of a stockholder's death, such a death in the case of a close corporation almost inevitably creates problems not present when stock in a large publicly held corporation passes to heirs at the owner's death. For more detailed discussion of these problems the reader is referred to other sources. The problems are relevant here only because we propose to discuss insurance-funded stock retirement plans as an established solution for such problems, and the recent cases which have threatened to disturb that solution.

III. SUPPORT IN PUBLIC POLICY

Encouragement of the formation, growth and continuance of small business has long been a part of the American economic philosophy. Individual initiative and imagination combined with business acumen and efficient production methods have resulted in a flourishing free enterprise system which has provided the people of this country with a standard of living which is unique.

On the preventive side of the business picture, anti-trust laws to prevent monopolies and general restraints on competition have long been a part of the federal law. Active enforcement of anti-merger laws in recent years is evidenced by a recent announcement of the Federal Trade Commission that the number of its enforcement actions against mergers reached a postwar high in 1957. A report of the F.T.C. action states further:

"The commission this year expects to crack down even more in all fields. And a special target will be corporate marriages. . . . Just in the past six months the F.T.C. has moved to bar or break up five mergers. . . . Since 1950, when the anti-merger laws were last tightened up, the Commission has intervened to

8 See, for example, id. at Ch. 7, beginning p. 292; also, 2 The R & R Advanced Underwriting and Estate Planning Service, §15, (The Insurance Research and Review Service, Inc.), Close Corporations, A-What Happens When a Stockholder Dies.
halt no less than 23 business marriages, almost twice the Justice Department's score. . . . And there's more to come . . . some 18 merger cases are making their way through the F.T.C. mill as a result of initial complaints already issued."9

On the more positive side, general concern with stimulating the formation, growth and prosperity of small business is evidenced by the creation of the Small Business Administration in 1953 (and its recommended continuance in the President's 1958 budget message), the establishment and activities of the Congressional and Cabinet Committees on Small Business (including the recent Milwaukee hearing of the Senate Select Committee on Small Business),10 and legislation, both actual and proposed.

In amendments to the Internal Revenue Code particularly, Congress has come to the assistance of small business in the form of the close corporation. The Revenue Act of 195011 added sec. 115(g)(3) to the 1939 Code to provide relief from taxation as a dividend of amounts received in redemption of stock to the extent of estate, inheritance, legacy and succession taxes where a substantial portion of the decedent's estate consists of stock in a corporation. Further expansion of this provision, including its application to the amount of funeral and administration expenses, followed in sec. 303 of the Internal Revenue Code of 1954.

Further Congressional relief for the small corporate business is found in sec. 535(c) of the 1954 Code. In order to assist small corporations in the accumulation of funds needed for expansion, this section created an accumulated earnings credit of $60,000 which permits retention of earnings and profits to that extent without imposition of the penalty tax which might otherwise be assessed under sec. 531 of the 1954 Code (sec. 102 of the 1939 Code).

In addition to existing legislative and administrative support for the creation, growth and continuance of small business, further action in this area is indicated for the future in view of current administrative recommendations and proposed legislation already introduced in the present session of Congress. Among such proposals are:

1. That original investors in a small business be given an ordinary loss, up to a specified maximum, on any losses realized on their stock investments. At present the deduction for stock losses is limited to $1,000 a year against ordinary income.

2. That corporations with 10 or fewer stockholders be given the option of being taxed as partnerships.

3. That taxpayers be given the option of paying estate taxes by installments over a period up to 10 years in cases where the estate con-

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11 §209 (a).
sists largely of investments in closely held business concerns. (The objective: to free small business firms tied up in non-liquid business investment from the threat of liquidation or merger because of the present law requiring payment of all estate taxes within fifteen months after death of the decedent.)

4. That businesses be given the right to utilize accelerated tax depreciation on used as well as new property up to a purchase cost of $50,000.

5. That the "minimum accumulated earnings credit" be increased from $60,000 to $100,000 (under Code sec. 535(c)).

Perhaps even more important for our discussion than the general public policy in support of small business is the specific Administrative and Congressional recognition and acceptance of the insured stock retirement agreement as an effective means of assuring the growth and continuance of the close corporations. In the federal administrative area it is of special interest that the Small Business Administration and the Department of Commerce recommend stock redemption agreements, funded by life insurance, to meet the hazards which face the close corporation upon the death of a stockholder.

Enactment of sec. 101(a)(2)(B) of the 1954 Code was a specific recognition by Congress of the use of life insurance in partnership and corporate buy and sell agreements, including the corporate stock retirement agreements under discussion. Prior to this development, in cases where it was necessary to use existing insurance on the life of a stock-

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13 Business Service Bulletin No. 34, June 1954 and Business Service Bulletin 35, Revised December 1956, issued by The Office of Distribution, Business and Defense Services Administration, U.S. Department of Commerce. Reemphasizing material presented earlier in the body of this paper, note these significant statements in the latter Bulletin:

"The death of a stockholder of a close corporation may cause serious repercussions in the business... may lead to management or personnel clashes which might seriously effect the business; credit impairments resulting from the death, or direct loss of business or damage to employee morale..."

"Many Questions Raised... Will management deteriorate if the heirs stay in?... Can a buyer be found for the stock? Will the firm's credit stand up under such a strain? How long will the whole matter be held up in controversy? Will the firm's sales hold up? Will the employees become restive? These are just a few of the problems that may arise. Failure to take proper steps to meet them might readily cause serious financial loss and possibly bring the business to an end.

"These questions can be met in several ways, one of which is an adequately financed stock sale and purchase agreement... (funding) can be done effectively through life insurance, which makes funds immediately available for accomplishing the objectives of the plan.

"Benefits... Continuity of management without interruption is guaranteed... The common causes of friction between heirs and surviving stockholders are removed... Not only is the credit position of the firm saved from damage, but it is actually enhanced by the plan. The morale of employees is assured for the period of adjustment."
holder to fund the corporate stock retirement agreement, the insurance proceeds received by the corporation upon the death of the insured stockholder were subject to income tax under the "transfer for value" rule. Although, in general, life insurance proceeds payable by reason of the insured's death are excludible from income tax, under that rule anyone (other than the insured) who purchased an existing policy on the life of the insured and later received the proceeds on his death could exclude from gross income only the purchase price plus any premiums subsequently paid. Any excess over this sum constituted taxable income. Sec. 101(a)(2)(B) renders the "transfer for value" rule inapplicable if the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer."

Additional legislation to support insured stock retirement agreements may be forthcoming as changes have also been recommended to remove certain restrictions on the use of stock retirement agreements (and other buy and sell agreements) resulting from application of the attribution of ownership of stock rules in sec. 318 of the 1954 Code as those rules affect stock redemptions and their taxation under sec. 302 of the 1954 Code.

14 For example, a currently uninsurable stockholder (particularly an older stockholder with reduced family insurance needs) might want to sell an existing personally owned policy to the corporation for use in funding its obligation under the agreement.

15 Pointing out, among other things, that "The desirability of stock purchase agreements and the principle of protecting small business are well settled," the American Life Convention and the Life Insurance Association of America (life insurance company organizations with a combined membership of 267 life companies having in force 96% of the legal reserve life insurance in the U.S. and Canada) in recent proposals (January 7, 1958) addressed to the members of the Committee on Ways and Means, have recommended a further liberalization of §101(a)(2)(B) in the following proposed amendment of that section:

"(B) If such transfer is to the insured, to a spouse, former spouse, parent, or lineal descendant, or adopted child of the insured, to a partner of the insured, to a partnership in which the insured is a partner, to a corporation in which the insured is a shareholder or officer, or to a shareholder of a corporation for the purpose of funding, in whole or in part, a buy and sell agreement relating to stock of the corporation in which the transferee and the insured are shareholders, or to a trust established to effectuate such a buy and sell agreement."

16 See Report and Proposed Amendments of Advisory Group on Sub-chapter C of the Internal Revenue Code of 1954, dated December 24, 1957, received by the Subcommittee on Internal Revenue Taxation and transmitted to The Committee on Ways and Means, U.S. House of Representatives; also ALC-LIAA Internal Revenue Code Revision Recommendations (January 7, 1958) pp. 4-7, Attribution of Ownership of Stock: Subchapter C, Sections 302 and 318 which states in the concluding paragraph:

"Thus, although we agree in principle with the Advisory Group's recommendation on this subject, we feel that it leaves unanswered an important need in an area in which administrative relief is quite doubtful. For this reason, we recommend that the attribution rules of Section 318 be made specifically inapplicable to a complete redemp-
IV. General Principles for Drafting Stock Retirement Agreements

In the light of public policy supporting the establishment, growth and continuance of small business corporations and the specific Administrative and Congressional recognition of the insured stock retirement agreement as a means of carrying out this policy, we turn now to a discussion of the basic principles of a conventional agreement.

The exhibit appending this article sets out in full the complete form of a stock retirement agreement funded by life insurance. The form illustrated has appeared substantially unchanged in all editions of the Collateral Agreements Forms booklet published by The Northwestern Mutual Life Insurance Company since 1928. Although thousands of copies of the booklet have been distributed to attorneys and, we presume, used by them in drafting agreements, we know of no situation where adverse tax consequences have resulted from the use of this form. Even though we are aware that there are other forms used by competent and learned attorneys, this form has stood the test of use and time. It is an illustration of what we call a conventional agreement.

In explanation of the form illustrated, an outline of essential points and procedure in considering and drafting a conventional stock retirement agreement is set forth below:

A. The corporation enters into an agreement with a shareholder under which it agrees to buy his stock and the shareholder, for himself and his estate, agrees to sell his stock to the corporation upon his death.17

B. The agreement either sets the price for the stock or provides a formula under which the price can be determined. Where a fixed price is set, the agreement usually provides for revision of the price at frequent intervals, usually annually. Upon failure to revise the price at the stated time, the agreement can provide for an alternative price

17 This differs from the cross-purchase type of agreement under which the shareholders agree among themselves that the survivors will buy the stock of the shareholders first to die. See Doran v. Commissioner, 246 F.2d 934 (9th Cir. 1957) for a case in which both the parties and the Tax Court apparently failed to recognize the difference between corporate purchase pursuant to a stock retirement agreement and a cross-purchase agreement between the shareholders.
based on book value, book value plus a fixed amount, or a percentage amount of book.\textsuperscript{18}

C. The shareholder agrees not to dispose of any of his stock during his lifetime without first offering it to the corporation at a price not in excess of the amount provided in the agreement for the sale at the time of his death. If the price is arrived at between parties who are "strangers" as a result of arms-length bargaining, the price set (unless clearly unreasonable) will be accepted by the Internal Revenue Service as the value of the stock for estate tax purposes.\textsuperscript{19}

D. The certificates representing stock subject to the stock retirement agreement should be stamped or endorsed with a summary of the restrictions on the transferability of the stock. If no such statement is placed on the certificates, sec. 183.14 of Wisconsin Statutes (Uniform Stock Transfer Act) provides there shall be no lien in favor of the corporation or restriction on the transfer of the stock.

E. The right of a Wisconsin corporation to acquire its own shares is set forth in sec. 180.385 of the Statutes. Generally a corporation can purchase its own stock if: the corporation shall not be rendered insolvent; there are sufficient assets remaining to take care of the rights of holders of preferential stock; and the acquisition is authorized by the articles of incorporation or the holders of two-thirds of the stock. Many attorneys believe that the articles of incorporation should contain specific authority to make acquisitions pursuant to stock retirement agreements. It would be preferable to provide for such authority at the time the agreement is executed rather than to count on getting approval of two-thirds of each class of shareholders at the time of a shareholder's death.

F. To assure the corporation the liquid funds with which to carry out its obligation under the agreement, the corporation agrees to purchase insurance on the life of the shareholder in an amount sufficient to cover the purchase price.

1. If a new purchase price is established pursuant to the terms of the agreement, additional life insurance should be purchased to cover any increase.

2. In order to avoid having the premiums taxed to the shareholders as dividends, the corporation should retain all of the incidents of ownership in respect to the insurance. These are usually considered to include the following:\textsuperscript{20}


\textsuperscript{20} See Proposed Estate Tax Regulations under 1954 Code, §20.2042-1(c) (2), 21 FED. REG. 7885 (1956).
a. Right to name and change the beneficiary.
b. Right to surrender the policy for its cash value or to borrow on the cash value.
c. Right to assign the contract to anyone or revoke an assignment.
d. Right to use the dividends.

3. The beneficiary of the policy should be the corporation or a trustee to act in its behalf. However, the agreement can provide for an additional or substituted direct beneficiary who will receive the insurance proceeds upon receipt by the corporation of the stock being purchased under the agreement. This will give the shareholder's heirs an opportunity to use the valuable option settlement rights provided in the insurance policy.\textsuperscript{21}

4. Inasmuch as the corporation will be the beneficiary under the policy, any insurance in excess of the purchase price will be available to the corporation for general corporate purposes.

5. The question often arises as to whether the insurance proceeds should be included in valuing the stock or in establishing the purchase price. Where the premiums for one shareholder are much greater than those for another, sometimes the parties desire that the entire proceeds of insurance on the decedent's life be included in the stock valuation or added to it in determining the purchase price of his stock. Usually, however, the proceeds in excess of the cash values are excluded. When a formula is used that bears some relationship to book value, this is done by making the valuation date some day prior to the shareholder's death, such as the day prior to death or the month end prior to his death.

The Proposed Regulations sec. 20.2042-1(c)(6) under the 1954 Internal Revenue Code appears contrary to current law including prior court decisions. Correction and clarification of these provisions to con-\textsuperscript{21} The question has been raised whether the designation of an additional or substituted direct beneficiary would be troublesome taxwise in view of the lower court decisions in the Prunier and Sanders cases. (See the alternative provisions to §7 of the Form No. V at the end of this article under which the policy would be endorsed during the insured's lifetime so that the proceeds could be paid to the widow or other personal beneficiary of the deceased stockholder upon proper release by the corporation.) We doubt that there is any appreciable danger here because the corporation as direct beneficiary has constructive receipt of the proceeds and can withdraw all or any part thereof without the consent of any other party. However, current policies issued by The Northwestern Mutual Life Insurance Company include a provision under which the corporate owner, during a period of sixty days following the Insured's death, may designate a beneficiary other than itself to receive the proceeds. This so-called sixty-day ownership extension period may also, upon proper request, be added to earlier series policies by endorsement during the Insured's lifetime. Therefore, as a matter of caution to reduce the possibility of unfavorable tax consequences, the additional direct beneficiary endorsement, if needed, may easily be added during the sixty-day period following the death of the Insured where the sixty-day ownership extension provision is a part of the policy. Available arrangements along this line where policies of other companies are used should be discussed by the attorney with the life underwriter involved.
form to existing law has been recommended by the insurance industry.\textsuperscript{22}

6. If the insurance proceeds are less than the purchase price, the difference must be paid by the corporation from other sources.

G. Although the form used in our illustration does not provide for the use of a trustee, many parties prefer the use of a trustee to provide for automatic and impartial execution of the terms of the agreement upon the death of a shareholder. Where a trustee is used, the attorney drafting the agreement should make sure that the cash values and proceeds of the life insurance intended to fund the agreement are available to satisfy claims of corporate creditors and for general corporate purposes.

H. The premiums paid by the corporation for the insurance are not deductible for tax purposes.\textsuperscript{23} On the other hand, the proceeds of the insurance are not subject to income tax at the insured-shareholder's death.\textsuperscript{24}

The recent cases referred to at the beginning of this article have caused many tax writers to advise careful handling of insured stock retirement agreements. Some commentators, out of an abundance of caution, have recommended that no mention be made in the agreement of insurance used to fund the obligations undertaken by the corporation. However, we believe that experience has demonstrated that this is unnecessary. This brings us to an appraisal of the cases.

V. \textbf{Effect of Recent Tax Cases on Stock Retirement Agreements} \textsuperscript{24a}

In the February 13, 1958 issue of the "Milwaukee Sentinel," syndicated columnist Sylvia Porter, in an article entitled "Small Business Gets Two Setbacks," wrote:

"The normal and often essential use of business life insurance received two staggering blows last year—in the form of two unfavorable court decisions which could not only mean more taxes for countless thousands of owners of corporations already having this type of insurance but could also discourage the future use of the insurance.

"...

"Until all the courts agree on what the tax results should be or until the Treasury comes out with a clear, unqualified rule

\textsuperscript{22} Letter dated November 30, 1956 from American Life Convention and Life Insurance Association of America to Commissioner of Internal Revenue \textit{Re: Proposed Estate Tax Regulations, Published in Federal Register on October 16, 1956}.

\textsuperscript{23} INT. REV. CODE of 1954, §264.

\textsuperscript{24} INT. REV. CODE of 1954, §101 (a).

\textsuperscript{24a} Subsequent to the submission of this article for publication, the authors received a copy of the 10th Circuit Court of Appeals decision reversing the judgment of the District Court in \textit{Sanders v. Fox}. For the sake of expediency and because the reversal, in general, confirms our analysis of the lower court decision and our prediction of its reversal, we have chosen not to revise the material which follows. However, see footnote 36.
about the agreements, thousands upon thousands of small business men must face this uncertainty and possible tax threat."

This article is an example of how some writers have warned of adverse tax consequences which are not justified by the facts of the cases upon which their warnings are based. Part of the answer to the warning issued by Miss Porter is given in the article itself. Of the two so-called setbacks, one, the Prunier case, was reversed upon appeal, and the other, the Sanders case, has been appealed and the argument was heard on January 6, 1958. The authors consider that reversal is likely.

Has usefulness of the conventional insured stock retirement agreement, supported in public policy, really been substantially curtailed as a result of these recent judicial sputniks? Is there really a new uncertainty, a new threat of adverse tax consequences, under such agreements? We believe that examination of the pertinent cases in some detail permits a negative answer to these questions.

The crescendo of anxiety concerning possible adverse tax consequences resulting from use of insurance to fund stock retirement agreements reached its peak in 1957. However, such anxiety really dates back to the Tax Court decision in the case of Casale v. Comm. decided on September 12, 1956, in a related field of tax law. In this case Mr. Casale entered into a deferred compensation agreement with a corporation of which he owned 98 of the 100 shares. The other two shares were owned, one by his daughter and one by an employee. The agreement provided him with retirement income subject to the usual provisions designed to avoid constructive receipt of the amounts to be paid until the payments were actually received by him. The corporation purchased an endowment type policy on Mr. Casale's life to fund its obligation under the deferred pay agreement. The Tax Court, in holding that the premium payments by the corporation were dividends to Casale, stated that the corporation was Casale's alter ego and a mere conduit for the purchase of personal life insurance. The implication of this decision posed a real threat to the conventional insured stock retirement agreement. Its extension to this area might well have resulted in taxation to the individual stockholder of premiums paid on corporate insurance purchased to fund such an agreement.

Upon appeal, the Second Circuit Court in an opinion handed down on September 5, 1957 reversed the Tax Court and pointed out that

25 See also article entitled "Business Life Insurance: Officers Probe Beyond Face of the Policies." Page one Column "Tax Report" in the May 8, 1957 issue of the WALL STREET JOURNAL.
26 See note 1 supra.
27 See note 2 supra.
28 See note 3 supra.
29 Ibid.
the individuals controlling the corporation were not the corporation. This was no sham organization conceived to avoid taxes since it had been actively engaged in the business of manufacturing coats for at least two years. The Court pointed out that, "... the Corporation paid the premiums and possessed the right to assign the policy; the right to change its beneficiary; the right to receive dividends as declared by the insurer; and the right to borrow on the policy in an amount not exceeding its loan value. In the event of insolvency, corporate creditors would be able to reach the policy as they might any other asset."

Now let us turn to the Prunier case\(^3\) decided by the Tax Court on April 12, 1957, which is one of the cases referred to in the Sylvia Porter article. In the tax years under consideration by the Court, each of the Prunier brothers, who were the principal stockholders of a corporation, had owned insurance on his own life payable to the other as beneficiary. Later the brothers agreed between themselves by notations made on the corporate minute book that these and any future policies (which in fact they later acquired) should go to the corporation to buy out the interest of the party who died. There was no transfer of the policies themselves to the corporation—merely a statement that the proceeds were to be used by the corporation to buy the deceased shareholder's stock. Each brother had the exclusive right to change the beneficiary on some of the policies owned by the other and on other policies the rights were exercised and could be exercised only jointly. The corporation paid the premiums.

The Court held that premiums were taxable to the brothers as corporate distributions under the general language of sec. 22(a) of the Internal Revenue Code of 1939.

On the basis of the facts alone, there was little to be concerned about in the Tax Court's decision. There was reason to hold that the insurance contracts were in fact and in form owned by the brothers rather than the corporation. The corporation could be construed to have the incidents of ownership in the policies only because of some rather unusual and vague notes concerning the use of the proceeds, entered into the minutes of the Board of Directors meeting.

The concern about the case arose from some of the language of the Tax Court giving reasons for its decision. The Court said, "In this situation, and since the record does not otherwise indicate any benefit which might go to the corporation from the purchase of the deceased insured's stock interest, we conclude that during the taxable year the corporation was neither the beneficial owner or the beneficiary of the insurance policies on the lives of Henry or Joseph and Henry involved here."

\(^3\) See note 1 supra.
The opinion of the dissenting judges in the *Prunier* case suggested that the majority of the Court might have reached the same result even if the corporation had been named beneficiary and presumably been the owner of the insurance.

Upon appeal, the First Circuit Court, in an opinion dated November 8, 195731 reversed the Tax Court, saying, "Despite the informality of the transactions, it seems to us that, in view of the facts in the record and of the findings by the Tax Court, the corporation would have been held to be the beneficial owner of the eight insurance policies under controlling Massachusetts Law, and thus could have obtained the help of a court of equity to recover the proceeds of the insurance policies if one of the brothers had died in 1950, (citations omitted). We suspect also that in that event the corporation, on some theory of 'ratification' or of 'adoption,' would have been held contractually bound to apply the proceeds of the policies to buy out the stock interest of the deceased stockholder, and that the deceased stockholder's legal representative would have been contractually bound to sell."

The Court of Appeals was critical of the Tax Court's attempt at "disregarding the corporate fiction" and pointed out that this attitude was consistent with the scheme of the Internal Revenue Code to tax corporate earnings to a separate legal entity.

Just why did we have a *Prunier* case in the first place? The answer was given by the Court of Appeals when it said, "As not infrequently happens in these closely held family corporations, the corporate books and records were kept in so sketchy and messy a fashion as to make it difficult to determine what was corporate action and what was the individual action of the two dominant stockholders."

The Prunier brothers were lucky; Massachusetts law helped them out. The Court of Appeals went a long way in looking through form to substance. The decision is no blanket endorsement of poor technique and sloppy draftsmanship. To avoid unnecessary litigation, attorneys should exercise great care and observe the technical requirements of conventional procedure. In what respects could *Prunier* 's facts have been improved upon?

A. The policies should have been specifically transferred to the corporation by endorsement on the insurance contracts. 

B. The corporation alone should have had the right to change the beneficiaries.

C. There should have been a written agreement between the corporation and the stockholders rather than an agreement among the shareholders written on the corporate minute book.

D. The corporate records and agreements should have been drafted by attorneys familiar with such matters.

31 Ibid.
A case of more serious concern to users of insured stock retirement agreements is that of Sanders v. Fox. The corporation and its four shareholders had entered into an agreement providing that the corporation would purchase the stock of each of the shareholders upon his or her death. The agreement was funded by life insurance on the life of each shareholder. The premiums for the life insurance were paid by the corporation. The opinion stated: "The insured stockholder was to designate the beneficiary."

Although it is not clear from the facts recited in the District Court's opinion, the record on appeal indicates that under the terms of the agreement and by the terms of the policies the corporation alone had the right to change the beneficiaries. It specifically retained all the incidents of ownership. If a shareholder wished to designate a new beneficiary to receive the price to be paid by the corporation for his stock, he had to request the corporation to make the necessary change in the insurance policy. To be entitled to the proceeds, the shareholder's designated beneficiary was bound to surrender decedent's stock to the corporation.

The agreement provided that the "value" of the stock was to be agreed upon by the unanimous vote of the shareholders voting at a shareholders' meeting. Such valuation was not to include the cash surrender value or any other value of the insurance policies subject to it. The "price" of an individual's stock was to be his proportionate share of the "value" so arrived at plus his proportionate share of the cash surrender value of the insurance. The lower court made an obvious error in construing these provisions.

The agreement further provided that all premiums should be paid out of the current corporate earnings or surplus which, but for the payment of such premiums, would be available for distribution as dividends. The language so providing was given emphasis by the court in its quotation of it. However, it was followed by the following language which received no emphasis: ". . . so that rights of corporate creditors will not be prejudiced by use of corporate funds for payment of such premiums." If the corporation had no earnings or surplus available for the payment of the premiums, the agreement would terminate and the beneficiary of the insurance policy would be changed to the corporation. In that event the corporation would hold said policies as ordinary assets to be retained or disposed of as the corporation might decide.

The court held that the insurance premiums paid by the corporation were taxable to the shareholders as dividends constructively received under sec. 115 of the 1939 Code. In its opinion, the court adopted the

32 See note 2 supra.
thesis advanced in the government brief that the shareholders received more benefits than the corporation from the purchase of the insurance. The court gave the impression of unfamiliarity with the actual effect of buy and sell agreements and of corporate ownership of life insurance. This is indicated by the fact that the court erroneously cited some cases listed in the government's brief in support of a point not even referred to in the cases and different from the point for which they were cited by the government.

The court rested its decision principally on two cases. One, the Tax Court decision in the *Casale* case, has since been reversed and can no longer be relied upon by the Commissioner as precedent on the appeal. 33 The other was *Paramount-Richards Theatres v. Comm.* 34 This latter case involved several corporations going through the old 77-B reorganization procedure. It is a difficult opinion to follow. However, in essence the situation is that a parent corporation and an individual (Richards) owned a subsidiary. The subsidiary paid premiums on life insurance on Richard's life. The parent corporation and Richards had the right to name the beneficiaries of the insurance contract and the parent was to use its share of the proceeds to purchase Richards' stock in the subsidiary in the event of his death. On these facts the Court of Appeals for the 5th Circuit upheld the Tax Court in taxing the premium payments to the owners of the insurance contract as a distribution by the subsidiary to them. We agree with this decision, but believe that its facts are easily distinguishable from the facts in the *Sanders* case. As said by the Court of Appeals in the *Casale* case, "... in Paramount-Richards the policy belonged to the individuals and could not be reached by corporate creditors." 35 This is not true in the *Sanders* situation. We believe that the *Sanders* decision is wrong as a matter of law and that it will be reversed on appeal. 36

33 See note 3 supra.
34 153 F. 2d 602 (5th Cir. 1946).
35 247 F. 2d at 445; Jones and Gleason, *supra* note 4 at 260.
36 The following pertinent excerpts from the Circuit Court's opinion in *Sanders v. Fox* March Term, 1958 No. 5718, No. 5719, No. 5720, handed down 3-26-58 58-1 USTC §9415, are of interest:
"... the doctrine [of consecutive dividends] has limitations and has never been held to include simple appreciation of stock value whether caused by internal corporate-stockholder buy-out agreements or ordinary corporate prosperity.
"Because of the interlocking benefits contemplated by such an agreement between a corporation and its stockholders the test of weighing the ultimate purposes to be served and the potential benefits, as has been done by some courts and was done by the trial court in this case, is impractical. *Prunier v. Commissioner*, *supra*; *Lewis v. Commissioner*, *supra*. As was said in *Lewis v. O'Malley*, supra, 'In income taxation, no matter what form the transactions may take, the inquiry must always go to the fundamental, whether the taxpayer really had income...'."
"The immediate present benefits to the stockholder arising from the execution of the agreement, such as the assurance of a market at a guaranteed minimum return on his stock, the appreciation of the value of his stock, and the
The practitioner is entitled to ask the same question here that he asked about Prunier. If insured stock retirement agreements are safe, why did the Sanders case arise? There are two points that some writers believe may have given the Commissioner an excuse to raise the tax issue. Although we believe that the points, separately or together, do not justify the decision, they are as follows:

1. The insurance proceeds were stated to be the minimum price for the stock. If, according to the formula used, the value of the stock was less than the insurance proceeds, the price would be increased to the amount of the proceeds.

We do not believe this is a justification for holding that an immediate distribution to the shareholder occurred. At the time each premium was paid, the corporation still had valuable rights to the insurance which would not be extinguished until death of the insured. Upon his death, it may be contended that any insurance proceeds paid for the stock in excess of its fair market value represents a corporate distribution taxable as a dividend.\(^{37}\)

That is why we recommend that where the insurance proceeds exceed the stock value, the excess proceeds be retained by the corporation for general corporate purposes. It is not unusual, however, for agreements to provide that the insurance proceeds will constitute the minimum price. Where this is done, the parties should be made aware of the possible tax consequences.

2. The shareholder was permitted to name the beneficiary of the insurance. Although we are not sure just what effect this might have had on the court's decision, several writers have pointed to this factor to distinguish this case from what they regard as conventional procedure.\(^{38}\) Nevertheless, we believe that this does not justify the taxation of the premiums to the insured shareholder. After all, the beneficiary has a right to the proceeds only if the shareholder's stock is turned in to the corporation. In the Prunier case that point was found only from the deduced intentions of the parties. Here the procedure is carefully spelled out in the agreement. It was unfortunate that the District Court could not see that the naming of the beneficiary by the insured was intended as a short cut for the substituted beneficiary procedure and that it should have had no real significance taxwise.

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37 Lawthers, supra note 4 at 13-20.
38 See Mannheimer and Friedman, supra note 4 at 568.
We understand that the beneficiary arrangement used in the Sanders case is recommended by some insurance companies in order to make settlement option rights under their policies available to the person designated by the stockholder in the agreement to receive the purchase price of his stock at death. The non-taxability to the stockholder of insurance premiums paid by the corporation under such an arrangement has been recognized by the Commissioner in a special ruling of June 17, 1955. However, other beneficiary procedures to accomplish the same results (that is, extending insurance policy settlement option service to the recipient of the purchase price under the agreement), are available under policies of some companies. The attorney drafting the agreement should discuss such procedures with the life underwriters involved.

3. We have the impression in Sanders that the attorneys drafting the agreement leaned over backwards to make sure that insurance policies were available for general corporate purposes and creditors, but the court erroneously interpreted these provisions as benefits to the shareholders.

VI. Conclusions

Even though there were departures from conventional procedures in at least one of the cases discussed, in our opinion it was the failure of the Commissioner's representatives and the lower courts to understand the basic principles of an insurance funded stock retirement agreement that resulted in attempts to tax the shareholders for premiums paid by corporations. Furthermore, there has been an arbitrary and wholly unjustified disregard of the separate entity of the corporations involved. Nevertheless, we believe that these cases have served to give what we regard as long standing procedure the benefit of judicial approval and will serve as precedent to forestall abuses by over-zealous revenue agents in the future.

In a discussion of the cases, Joel Irving Friedman and the late Albert Mannheimer pointed out that even though millions of dollars have been paid out for years as premiums on life insurance used to fund conventional stock retirement arrangements, "... it appears that no court has ever held:

"(1) that the premium payments constitute constructive dividends to the stockholders;

"(2) that the distribution in the case of a complete redemption of the decedent's stock constitutes a dividend to his family or estate; or

"(3) that such distribution constitutes a dividend to the surviving stockholders."
If the recent cases are reviewed in the light of established public policy and sound legal principles; if the reversals lead to a better understanding and recognition of the sound business reasons for entering into such agreements; and if the result is a proper correlation of insurance with an understanding use of the conventional insured stock retirement agreement, then perhaps these judicial sputniks too will have served a useful purpose.

**Form No. V**

**AGREEMENT WHEREBY A CORPORATION AGREES TO PURCHASE PART OR ALL OF THE STOCK OF A STOCKHOLDER AT HIS DEATH**

[As the laws of several states do not permit a corporation to buy its own stock, and in perhaps most of them such right is restricted, this or any form should be used only when prepared or approved by counsel familiar with corporation law of the state where the corporation was organized.]

THIS AGREEMENT, Made and entered into at ................. in the State of ........................., this ............. day of ........................., 19........, between the John Doe Company, a corporation organized under the laws of the State of ............ with its principal place of business in the City of ................. in said State (hereinafter called the "Company"), party of the first part, and John Doe, of ........................., party of the second part,

WITNESSETH:

WHEREAS, the party of the second part is a stockholder and an officer, to-wit .................................. of the Company, and actively engaged in the management of its affairs;

AND WHEREAS, the Company, in order to be recompensed in part on account of the loss by death of an able and experienced official and to further the plan hereinafter stated, has caused the life of the second party to be insured for its benefit, as hereinafter provided; 

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42 See note 18 supra; Agreements for use with Business Insurance, at 50-54.

43 We believe that many attorneys will want to include at this point a more specific statement of the corporate purposes for entering into the agreement.
AND WHEREAS, the parties desire that the Company acquire by purchase, upon the terms herinafter stated, shares of stock held by the second party at his death, and that it have an option to purchase all or any of said shares that he may desire and offer to sell during his lifetime;

Comment:

This form of agreement covers only the specific stock listed above. If it is desired to cover stock hereafter acquired, including stock obtained through subscription, stock dividends, reorganization, etc., appropriate provisions must be made therefor.

NOW, THEREFORE, in consideration of the mutual promises herein contained and the sum of one dollar paid by each to the other, receipt whereof is hereby acknowledged, the parties agree as follows, to wit:

1. There shall be legibly stamped or endorsed upon each certificate of stock held by the second party and covered by this agreement, a statement in substance as follows:

This certificate is transferable only upon compliance with the provisions of a certain agreement dated the day of , 19 , between John Doe and the John Doe Company, a copy of which is now on file in the office of the Secretary of said Company. Said agreement provides, in substance, that if the holder desires to sell any of the shares represented hereby, said Company shall have the first right to purchase the same at a price determinable as provided in said agreement; that in the event of the death of the holder, said Company has agreed to purchase and the holder has obligated his estate to sell

This may include the following points:

a. Continuation of existing corporate policies which have been demonstrated to be sound.
b. Prevention of the introduction of interests adverse to present successful management.
c. Continuation of the existing harmonious relationship among shareholders.
d. Encouragement of key men and other long-time employees to remain with the corporation.
e. Elimination of any need to merge with a large concern to provide a non-speculative investment for a deceased shareholder's estate.
f. Enhancement of the corporation's credit standing.

These points are discussed at points A, B, C and D of Part II above. As stated by the Court of Appeals in *Emeloid Co., Inc. v. Comm.*, 189 F. 2d 230, at 233 (3rd Cir. 1951): "The trust was designed ... to provide for continuity of harmonious management. Harmony is the essential catalyst for achieving good management; and good management is the sine qua non of long term business success." [A deceased shareholder's] "... estate, not being bound by contract to sell the stock to petitioner [corporation], might sell it to adverse interests. The fragile bark of a small business can be wrecked on just such uncharted shoals."
to the Company, the shares of stock represented hereby at a price and upon terms ascertained as provided in said agreement.

### Purchase of Insurance

2. The Company agrees that it will procure life insurance policies on the life of the contracting stockholder who is the other party to this agreement, as follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
<th>Plan</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>The N. W. Mut. Life Ins. Co.</td>
<td>$50,000</td>
<td>Ordinary Life</td>
<td>Jan. 2, 19..</td>
</tr>
<tr>
<td>The N. W. Mut. Life Ins. Co.</td>
<td>$25,000</td>
<td>20-Yr. Endowment</td>
<td>March 15, 19..</td>
</tr>
</tbody>
</table>

Additional insurance may be acquired on such terms as may be agreed upon by the parties. Each policy of life insurance shall be made payable to the Company as direct beneficiary thereof, and all incidents of ownership in said insurance shall be vested in it.

The Company agrees that it will pay all premiums on life insurance carried by it on the life of the contracting stockholder hereunder, and will, upon demand, exhibit to the insured due proof of such payment at least ........ days before the last day allowed by the policy for the payment of the premium. If the Company fails to pay the premium and to exhibit proof as herein provided, the insured shall have the right to pay such premium, and such payment shall be considered a loan to the Company, and the insured shall be entitled to recover such loan from the Company with interest from the date of payment at the rate of ............% per annum.

The Company agrees in respect to the life insurance policies that it will not revoke or change the designation of any direct beneficiary, nor exercise the loan, surrender or other privileges in said policies, nor pledge, encumber or otherwise dispose of said policies.

Comment:

*It is important to note that this agreement makes no provision for termination of the agreement at the election*

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44 A minority shareholder, as party to the agreement, may consider this paragraph necessary to prevent dissipation of the insurance for other purposes by voluntary corporate action. Where a party to the agreement is a dominant shareholder, the paragraph is probably unnecessary. However, we believe as a matter of sound legal principle that the agreement may restrict the corporation's exercise of its rights as long as the ownership of the policy is vested solely in the corporation and the policy and its proceeds are corporate assets available to general creditors. Note that the agreement specifically states that all incidents of ownership under the policies are vested in the corporation.
of the insured upon failure of the Company to pay premiums or otherwise comply with the terms of the contract. Moreover, the agreement does not provide for termination of the contract at the election of the Company, nor permit the Company to surrender the contract or take any other action which would be contrary to the main purpose of the agreement. The agreement may of course be modified by mutual consent.

If the parties wish to provide for termination of the contract by election of either party, or upon the happening of certain contingencies, appropriate provisions for that purpose should be included. Also, if the parties desire to make the loan or other policy privileges available to the Company, a provision to that effect should be included. However, it should be remembered that the exercise of such policy privileges may result in loss of the insurance.

Generally speaking and subject to underwriting practices, the amount of insurance carried should approximate or exceed the value of insured’s stock. Section 6 of this agreement and the Section entitled “Valuation” should be referred to in this regard.

3. In case the contracting stockholder shall desire to sell all or part of his stock in the Company which is subject to this agreement, he shall give written notice thereof to the President or Secretary of the Company, and the Company shall have and is hereby given option to purchase said stock at the price hereinafter specified. The purchase price of all stock purchased pursuant to the option is hereby fixed at $............. per share. The parties may from time to time change said price by mutual agreement endorsed hereon or attached to this contract.

Comment:

In connection with fixing sale price of stock pursuant to option, see comment following Section 6 hereof, the Section entitled “Valuation.”

4. If the Company fails to purchase the stock so offered within ................. days after receipt of said notice, the party offering to sell may, within ................. days thereafter, surrender to the Company the certificates representing the shares so offered, and receive in lieu thereof new certificates for an equal number of shares without the stamp or endorsement thereon set forth in Section 1 hereof; and thereupon he shall cease to be a
party hereto and this agreement shall terminate. If he does not surrender his certificates as herein required he shall remain a party and his stock shall continue to be subject to this agreement.

Comment:

The effect of the foregoing section is to give the stockholder an option to terminate the contract by withdrawal of his stock within the time specified after failure of the Company to exercise its option.

The parties may desire to give the Company an option to terminate the contract by providing for an automatic termination upon failure of the Company to exercise the option.

A third method would be to provide that neither party shall have the right to terminate the contract upon failure of the Company to buy. In such case the contract should be so drawn as to remain unaffected by the offer to sell or the failure to buy.

5. In the event the contracting stockholder shall cease to be a party to this agreement for reasons other than his death, he shall have an option to purchase the policy or policies on his own life owned by the Company. The purchase price of said policies shall be the interpolated terminal reserve as of the date the contracting stockholder ceased to be a party to this agreement, plus the proportional part of the gross premiums last paid before said date which covers the period extending beyond that date. In the event any policy transferred to the insured, as herein provided, shall not have been in force for a period sufficient to obtain a value, as stated above, then the amount to be paid by the insured in thus taking over a policy on his own life shall be an amount equal to all net premiums paid thereon. This option shall be exercised within ............... days after the contracting stockholder ceases to be a party to this agreement.

6. Upon death of the contracting stockholder, the purchase price of decedent’s stock subject to this agreement shall be $.............. per share. The parties may from time to time change said price by mutual agreement endorsed hereon or attached hereto.

Comment:

If, instead of a fixed price, there is to be an appraise-ment or computation of value by some formula, the sub-
ject should be carefully considered by the attorney entrusted with the preparation of the instrument. The Section entitled “Valuation” which appears in the beginning of this booklet should prove to be of assistance together with the Section on “Tax Considerations.”

Where premiums are paid out of corporate funds, the amounts so paid come out of corporate earnings, and dividends to the stockholders are diminished to that extent. Such circumstance may result in inequality unless the valuation of the stock includes the cash values of all policies held by the corporation on the lives of its stockholders.

If, instead of a fixed price, there is to be an appraisement of the corporate stock upon death of a stockholder, the cash value of all life insurance policies carried by the corporation on the lives of its stockholders, including policies on the life of decedent, should be included in such valuation. The cash value of insurance on the life of decedent would become merged in the insurance proceeds upon his death, but if the cash value of his insurance at the moment of death should be used, rather than the insurance proceeds, no inequality would arise.

Where an agreed price for the stock is fixed in the agreement, it is impossible to follow the method set forth in the preceding paragraph because the date of death cannot be predicted. For this reason it is suggested that the parties readjust their agreed price annually so as to include the annual increase in cash values.

Generally speaking and subject to underwriting practices, the amount of insurance carried should approximate or exceed the value of insured’s stock. In most cases it will be difficult to have the value of the stock and the insurance proceeds coincide in amount, especially where the value of the stock is based upon book value, appraisement or some formula. It would therefore seem advisable to allow for an excess of insurance over the value of said stock, thus avoiding the necessity of paying the balance from other funds of the company. The valuation of the stock, if fixed in the agreement, will generally control for estate and inheritance tax purposes. Where insured holds no incidents of ownership in the insurance on his own life, the insurance proceeds applied as purchase price will not be included in decedent’s gross estate under present laws.
If it appears that the insurance proceeds will be insufficient to pay for the stock in full, the balance must be paid from other funds; and if time is to be granted for payment of the balance, and the stock transferred before the purchase price is paid in full, the contract should state the exact agreement in this respect and provide for collateral, if any. If notes are to be used, it is suggested that they be equal in amount and mature at specified intervals.

Transfer of Stock—Payment of Purchase Price

7. Immediately upon the death of a contracting stockholder, his personal representative shall diligently proceed with the probate of decedent's estate and shall promptly convey good and sufficient title to decedent's stock to the Company.

The Company shall collect the insurance proceeds, and upon receipt or tender of good and sufficient title to decedent's stock, shall pay the insurance proceeds, or so much thereof as may be necessary, to decedent's personal representative in payment of the purchase price of decedent's stock. If the purchase price of the stock shall exceed the insurance proceeds, the Company shall forthwith pay to said personal representative any additional amount necessary to pay said purchase price in full.

Comment:

If the parties desire that all of the insurance proceeds collected on the life of decedent shall be paid to his personal representative as the minimum purchase price of the stock, the above Sections 6 and 7 should be modified accordingly.

Alternate Provisions to Section 7 Where Payment is to be Made Directly to Widow or Other Beneficiary

The insurance company is frequently asked to endorse the insurance policy to make the insurance proceeds payable directly to the widow or other personal beneficiary of the deceased stockholder, as suggested in the Section entitled "Settlement Option Arrangements." If the parties desire such arrangement, the following section should be substituted for the above Section 7:

As to each policy of life insurance acquired pursuant to Section 2 of this agreement, the applicant shall name an additional beneficiary to be designated as "additional direct beneficiary," whose rights shall be as specified in the endorsement on said policy.

The insured shall in his last will and testament be-

45 Such a provision seems inadvisable because of possible adverse tax consequences at the time of the shareholder's death. See discussion at p. 374, above.
STOCK AGREEMENTS

queath his stock, subject to all the terms and conditions of this agreement, to the same additional direct beneficiary designated in the life insurance policies on his life; and shall also provide that neither said shares of stock nor the consideration therefor shall be subject to the claims of creditors, taxes or other expenses of administration until all other assets of the estate have been exhausted.

Immediately upon the death of a contracting stockholder, his personal representative and the additional direct beneficiary shall diligently proceed with the probate of decedent's estate and shall promptly convey good and sufficient title to decedent's stock to the Company.

Upon receipt of good and sufficient title to decedent's stock within two years following decedent's death, the Company shall release and relinquish all right, title and interest in and to the proceeds of the insurance on decedent's life, or as much thereof as may be equal to the purchase price of decedent's stock, and thereupon the insurance proceeds so released shall be settled with such additional direct beneficiary as provided in the policy. Said additional beneficiary and the estate shall receive and accept settlement of the insurance proceeds as herein provided and apply the same in payment of the purchase price of said stock with the same force and effect as if the amount were paid in cash.

If for any reason a release of interest in whole or in part in and to the insurance proceeds payable on account of insured's death is not delivered to the insurance company within two years following insured's death, as above provided, any proceeds not so released shall be paid in one sum to the direct beneficiary. Any such payment by the insurance company to the direct beneficiary shall constitute a complete release and discharge of the insurance company on account of said proceeds. Thereafter, upon receipt of good and sufficient title to the decedent's stock, the Company shall pay said insurance proceeds in one sum, or as much thereof as may be necessary, upon the purchase price of decedent's stock.

If the purchase price of the stock shall exceed the insurance proceeds, the Company shall within ...... days pay such excess to the additional direct beneficiary.

Comment:

The foregoing substitute section imposes no time for ultimate completion of the transaction. The parties may
specify a time limit and penalties for breach of contract if they so desire.

This agreement is designed to create a present interest in the purchaser of the stock which will be superior to any interest which might be claimed by the widow of the deceased party. However, in some jurisdictions it may be advisable or even necessary for the wives of the respective parties to join in the agreement.

8. No insurance company shall be under any obligation in respect to the performance of the terms and conditions of this agreement, and payment by the insurance company pursuant to the terms of any policy shall be a complete discharge of the said insurance company from all claims, suits and demands of all persons whatsoever.

9. This contract shall bind the Company, its successors and assigns, and the second party, his heirs, executors, administrators and assigns.

IN WITNESS WHEREOF, the Company, pursuant to action duly taken by its stockholders or board of directors (as the law of the state may require), has caused this agreement to be executed by its President, attested by its Secretary, and its corporate seal to be hereunto affixed, and the second party has hereunto set his hand and seal, the day and year first above written.

In presence of:

                      Stockholder.

            JOHN DOE COMPANY

By ..................

      President.

Attest: .................

     Secretary.

................. (Seal)

[Add an acknowledgement legally sufficient to permit the instrument to be recorded according to the laws of the state where the contract is executed.]