

## CHAPTER 18

### Drafting Shareholder Agreements for Closely-Held C and S Corporations

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**§ 18.01 GENERAL CONSIDERATIONS****[1] Introduction**

One of the most frequent matters encountered by the tax practitioner is the preparation of Shareholder Agreements for closely-held C and S corporations. Although such agreements may seem “routine,” the various options selected by the practitioner in drafting a Shareholder Agreement can have a significant impact on the shareholders, both from a tax and non-tax standpoint. Because of the number of options available in drafting Shareholder Agreements and the complex tax (and non-tax issues) presented in the law, this article will highlight the primary tax issues that should be considered by the practitioner in drafting Shareholder Agreements for closely-held corporations, including, in particular, special provisions that should be considered when drafting a Shareholder Agreement for an S corporation and its shareholders. Appendix A to this article is a form letter that may be sent to clients in anticipation of meeting with them to discuss the drafting of a Shareholder Agreement, and Appendix B to this article sets forth a form Shareholder Agreement.

**[2] Definition of a Shareholder Agreement**

A Shareholder Agreement is a contract under which each shareholder agrees to offer his or her stock for sale to the corporation, the other shareholders, or both, on the occurrence of certain events, such as the shareholder's retirement, termination of employment, receipt of an outside offer to buy, death or disability. A Shareholder Agreement may also address a variety of issues relating to the operation and management of a corporation. A Shareholder Agreement is also commonly referred to as a "Buy-Sell Agreement" or a "Stock Restriction Agreement."

**[3] Reasons for Shareholder Agreements**

A Shareholder Agreement can create a market for what is otherwise an unmarketable interest in a closely-held corporation.

- A Shareholder Agreement provides a means of determining a fair price for the shares of stock of a closely-held corporation in light of the goals sought to be achieved by the shareholders of the closely-held corporation.
- A Shareholder Agreement may be used to establish a control mechanism for the transfer of stock and to exclude or remove inactive or potentially dissident shareholders depending upon the circumstances and desires of the shareholders.
- A Shareholder Agreement may provide a means of transferring control of a closely-held corporation upon the death, disability or termination of employment (through retirement or otherwise) of a shareholder to other shareholders.
- A Shareholder Agreement may be used to reduce the financial pressure on a decedent's heirs to pay estate taxes and other expenses by providing for a mandatory purchase of a deceased shareholder's shares or by giving the estate (or the decedent's heirs) the option to sell such shares to the closely-held corporation.
- A detailed and well-drafted Shareholder Agreement will greatly reduce the potential for shareholder disputes resulting in litigation which would be both time consuming and costly to a corporation and its shareholders.

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- A properly drafted Shareholder Agreement may prevent an S corporation from losing its eligibility to be an S corporation by restricting the shareholders from transferring their shares to an entity or other person that would be ineligible to hold shares of an S corporation.
- A Shareholder Agreement may set forth the mechanics for making certain elections which an S corporation and/or its shareholders can make with respect to allocations of income and loss when a shareholder terminates his or her entire interest in the S corporation or the corporation ceases to be an S corporation.
- A Shareholder Agreement may provide for the amount and timing of operating distributions.
- A Shareholder Agreement can assist in providing evidence of valuation for estate and gift tax purposes.

**[4] Documenting a Shareholder Agreement**

A Shareholder Agreement should, of course, be contained in a written document in the nature of a contract. The Shareholder Agreement's restrictions on stock transfer may also be documented in the corporate bylaws, charter, and on the stock certificates. U.C.C. § 8-204 provides that restrictions on the transfer of stock must be evidenced on the security itself or they are not effective against subsequent transferees without actual notice.

**[5] Basic Forms of Shareholder Agreement**

There are three forms of corporate Shareholder Agreements: Redemption (or entity) Agreements, Cross-Purchase Agreements, and Hybrid Agreements.

**[a] *Redemption Agreements***

A Redemption Agreement is a contract between each shareholder and the corporation, by which the corporation agrees to buy the offered stock.

**[b] *Cross Purchase Agreements***

A Cross-Purchase Agreement is a contract between or among the shareholders, to which the corporation is not necessarily a party,

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by which each shareholder agrees to buy all or part of the offered stock.

[c] *Hybrid Agreements*

A Hybrid Agreement is a contract among the corporation and the shareholders. In a Hybrid Agreement, a shareholder may offer his or her stock first to the corporation, and then to the other shareholders, or the shareholder may sell part of his or her stock to the corporation and part to the other shareholders. The corporation may be able to buy all or only part of the offered stock, with the shareholders buying the remaining portion of the offered stock.<sup>1</sup>

§ 18.02 INCOME TAX PLANNING FOR CROSS-  
PURCHASE SHAREHOLDER AGREEMENTS

Cross-Purchase Agreements are often considered the simplest form of Shareholder Agreements because they raise the fewest income tax planning problems. A shareholder or his or her estate merely sells the shares to the other shareholders at the price and terms set by the agreement.

**[1] Impact on Selling Shareholder**

Corporate stock is typically a capital asset, so unless the shareholder is a dealer in stock, any gain on the sale is generally capital gain, regardless of the character of the corporation's underlying assets. Thus, a Cross-Purchase Agreement will be more advisable than a Redemption Agreement where a redemption may not qualify for sale or exchange treatment under section 302(a).<sup>2</sup> In addition to the tax rate preference applicable to net capital gains,<sup>3</sup> it is important that the gain under a cross purchase (or non-dividend equivalent redemption) be characterized as a sale or exchange, rather than as a dividend, since the seller will be allowed to recover

<sup>1</sup> Hybrid Agreements obviously provide the most flexibility, and as such, are the most common type of Shareholder Agreement. The form Stock Restriction Agreement set forth in Appendix B is a Hybrid Agreement.

<sup>2</sup> See § 18.03[1], *infra*, for a discussion of the § 302 redemption rules.

<sup>3</sup> I.R.C. § 1(h) generally sets forth a maximum capital gains rate of 20% as compared to the highest marginal income tax rate applicable to ordinary income under § 1(i) of 39.1% for tax year 2001, 38.6% for tax years 2002 and 2003, 37.6% for tax years 2004 and 2005, and 35% for tax years 2006 and thereafter.

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basis without tax and if payments are to be made over a period of years, the seller will be allowed to use the installment sales method under section 453.

An exception to capital gains treatment will apply if the corporation is a collapsible corporation within the meaning of section 341.<sup>4</sup> In such instance, the gain (but not loss) would be converted into ordinary income.

Generally, a selling shareholder's basis in his or her stock will equal the amount paid for the shares plus the amount of cash and adjusted basis of property contributed to the corporation in exchange for stock or as a capital contribution.<sup>5</sup> In the case of the death of a shareholder, the shareholder's estate generally will receive a basis under section 1014 equal to the fair market value of the stock as of the date of the shareholder's death.<sup>6</sup> However,

<sup>4</sup> I.R.C. § 341(b) provides that the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the purchase of property which (in the hands of the corporation) is property described in § 341(b)(3) (generally, inventory, property held primarily for sale to customers in the ordinary course of trade or business or unrealized receivables), or for the holding of stock in a corporation so formed or availed of, with a view to: (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, *before* the realization by the corporation manufacturing, constructing, producing, or purchasing the property of two-thirds of the taxable income to be derived from such property; and (2) the realization by such shareholders of the gain attributable to such property.

<sup>5</sup> See I.R.C. §§ 1012, 351, 358 and 118.

<sup>6</sup> Pursuant to applicable provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("TRA 2001"), over the next 9 years, Federal Estate Tax Rates will be reduced and the applicable Exclusion Amount will be increased, until the year 2010, when both the Estate and Generation Skipping Transfer Taxes are repealed. Also in 2010, current rules under § 1014, providing for a fair market value basis for property acquired from a decedent, also will be repealed and replaced with a significantly more complicated set of basis adjustment rules. Under these new rules, a receipt of property received upon a decedent's death will no longer be entitled to an automatic step-up in basis. Instead, recipients of a decedent's property at death will be entitled to an adjusted basis in such property equal to the lesser of (i) the decedent's adjusted basis in the property received or (ii) the fair market value of such property. In addition, recipients of property "owned by the decedent" at his or her death will be entitled to an aggregate basis increase of \$1,300,000 (increased by certain carryovers and losses), plus an additional aggregate basis increase of \$3,000,000 for qualified spousal property owned by the decedent at his or her death. To ensure compliance with the

the estate of a deceased S shareholder will *not* receive a step-up in stock basis to date of death value to the extent of the shareholder's interest in unrealized receivables of the corporation.<sup>7</sup> This may have a dramatic impact on the tax cost of Shareholder Agreements to decedent's estates, especially in service based S corporations.

[a] *Adjustments to S Corporation Shareholder Basis*

For shareholders owning stock in an S corporation, adjustments to basis are made for the pass through of tax items in accordance with section 1367. If a shareholder disposes of stock during the taxable year, the basis adjustments with respect to such stock are effective immediately prior to the disposition.<sup>8</sup> Such adjustments will affect the computation of gain or loss on the sale of such shareholder's stock.

The daily allocation rule of section 1377(a)(1) results in the selling shareholder of an S corporation being allocated an amount of the corporation's tax items even after the stock is sold. Absent an election under section 1377(a)(2) or under Regulations section 1.1368-1(g)(2), the selling shareholder will be allocated his or her share of the S corporation's items of income, loss, deduction and credit for the tax year based on a per share, per day allocation.

Under section 1377(a)(2), however, where a shareholder in an S corporation completely terminates his or her stock interest in the corporation, the corporation and all of the "affected shareholders" may elect hypothetically to close the taxable year of the corporation as of the date of sale in allocating tax items. The "affected shareholders" are the shareholders whose interest ends and all shareholders to whom such shareholder transferred shares during the taxable year.<sup>9</sup> If a shareholder's interest in an S corporation

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Congressional Budget Act of 1974, all these changes are inapplicable for taxable years beginning after December 31, 2010. Whether such new rules will actually go into effect in 2010 is not certain and how practitioners will plan for such uncertain changes is also problematic.

<sup>7</sup> I.R.C. § 1367(b)(4) provides that § 691 (relating to income in respect of a decedent) will be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

<sup>8</sup> Treas. Reg. § 1.1367-1(d)(1).

<sup>9</sup> I.R.C. § 1377(a)(2)(B) and Treas. Reg. § 1.1377-1(b)(2).

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is redeemed by the S corporation, all the shareholders during the taxable year of the redemption are “affected shareholders.” If section 1377(a)(2) applies, the pro rata shares of the affected shareholders are determined as if the corporation’s taxable year consisted of two taxable years, the first of which ends on the date as of the termination of the shareholder’s interest.<sup>10</sup>

If a shareholder disposes of 20% or more of the corporation’s stock during a 30-day period, however, the corporation may elect to close the books hypothetically as of the date of disposition, for purposes of allocating items of income and loss.<sup>11</sup> Moreover, the regulations provide that a redemption treated as an exchange under section 302(a) or section 303(a) of 20% or more of the outstanding stock of the corporation from a shareholder in one or more transactions over a 30-day period during the S year will constitute a “qualifying disposition” for which the hypothetical closing of the books election may be made.<sup>12</sup>

Because both the corporation and the “affected shareholders” must consent to a section 1377(a)(2) terminating election, and both the corporation and all shareholders must consent to a Regulations section 1.1368-1(g) qualifying disposition election, the practitioner should carefully consider who has the power to act on behalf of the corporation (a majority of its board of directors, unless otherwise provided), and whether the determination by the corporation to make such an election should bind *all* shareholders to consent to such election. Depending upon the party represented, the election to close the books could be automatic, require all shareholders to consent upon the approval of the board of directors to make the election, or require all shareholders to consent upon the determination to make the election by a majority (or supermajority) of the

<sup>10</sup> See § 18.06[4], *infra*, for a discussion of the planning opportunities and pitfalls associated with making or not making the § 1377(a)(2) election.

<sup>11</sup> Treas. Reg. § 1.1368-1(g)(2)(i)(A).

<sup>12</sup> Treas. Reg. § 1.1368-1(g)(2)(i)(B). Additionally, Treas. Reg. § 1.1368-1(g)(2)(i)(C) provides that the issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30-day period constitutes a qualifying disposition for which an election to close the books may be made. In order to make the election to close the books upon a “qualifying disposition,” Treas. Reg. § 1.1368-1(g)(2)(iii) provides that all shareholders who held stock in the S corporation during the tax year must consent to the election.

shareholders. It is critical in situations where the agreement requires all shareholders to consent to an election if the board of directors, shareholders owning a majority of the outstanding stock or shareholders owning a supermajority of the outstanding stock determine that an election be made, that there be a power of attorney in the Shareholder Agreement appointing one or more persons to act on behalf of the shareholders to consent to such election.<sup>13</sup>

[b] *Transfers that Terminate Corporation's S Election*

If a sale of S corporation stock results in the termination of the corporation's S status, the taxable year of the termination is considered an "S termination year" as defined in section 1362(e)(4) and Regulations section 1.1362-3(a). The S termination year is divided into two short taxable years, with Subchapter S governing the first short year (which ends on the day *before* the effective date of termination and is known as the "S short year") and with Subchapter C governing the balance of the year (the "C short year"). The corporation generally allocates its items of income, loss, deduction and credit between the two short years based on the number of days in each year, on a per share, per day basis. Section 1362(e)(3), however, allows the corporation to elect to close its books on the day before the termination date, provided that all persons who own stock during the S short year and on the first day of the C short year consent to such election. Section 1362(e)(3)(B) and Regulations section 1.1362-3(b)(1). Additionally, under section 1362(e)(6)(D), the books will close automatically if there is a sale or exchange of 50% or more of an S corporation's stock in an S termination year.

[c] *Passive Activity Loss Limitation Rules*

For dispositions of stock in an S corporation, Temporary Regulations section 1.469-2T(e)(3) requires that the resulting gain or loss be allocated among the various activities of the S corporation as if the entity had sold all of its interests (assets) in such activities, including activities conducted by ownership of a pass-through entity such as a partnership, as of a prescribed valuation date, for purposes of applying the passive activity loss limitation rules.

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<sup>13</sup> Paragraph 34 of the Form Stock Restriction Agreement in Appendix B sets forth an example of such a power of attorney.

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## [2] Impact On Cross-Purchase Buyers

The buying shareholders will receive a cost basis in the shares of stock purchased, even if the purchase is funded with tax-free life insurance proceeds. To the extent that life insurance cannot be used to fully fund the purchase price, a disadvantage of the Cross-Purchase Agreement is that the purchasing shareholders will be acquiring the stock with after-tax dollars.

### [a] *C Corporations*

This basis increase may actually be of only modest utility for shareholders in a C corporation, especially one which has significant earnings and profits. This is due to the fact that post-purchase distributions will frequently represent dividend income (instead of a tax-free return of capital) and their shares, including the newly purchased stock, will frequently be retained until their death, at which time the stock will receive a basis equal to date of death fair market value.<sup>14</sup> A debt financed acquisition of stock in a C corporation will generally generate investment interest expense subject to limitations on deductibility under section 163(d).

### [b] *S Corporations*

A cross-purchase may be more desirable to the purchasing shareholders in an S corporation with a prior (and profitable) C corporation history since the cost basis for the acquired stock will not only reduce gain (or increase a loss) in the event of a subsequent sale, but will facilitate the tax-free receipt from the corporation's accumulated adjustment account (AAA) under section 1368(c)(1) or recovery of basis under section 1368(c)(3) for distributions made by the corporation. This is primarily attributable to the fact that a cross purchase will not result in a reduction in the S corporation's AAA.

Having the purchasing shareholders obtain a cost basis in the acquired shares may also be important to absorb losses for those who are faced with a basis limitation problem under section 1366(d)(1)(A) or have already accumulated suspended losses from prior years due to insufficient stock (and debt) basis.

<sup>14</sup> See Note 6, *supra*.

Consideration must also be given to the possible application of the passive activity loss rules in section 469, as well as the at-risk limitations in section 465, in determining whether a cross-purchase is more favorable. Where the S corporation does not have earnings and profits from prior C years, the cross purchase arrangement will generally be more favorable since the shareholders will get an immediate basis increase in their stock and achieve only a single level of taxation on the use of corporate level profits to pay for the shares.

Just like the selling shareholder, the purchasing shareholder will also be allocated a pro rata share of the S corporation's items of income, loss, deduction and credit for the tax year of the purchase. Absent an election under section 1377(a)(2) or Regulations section 1.1368-1(g) to close the books of the S corporation, the allocation will be made on a per share, per day basis.<sup>15</sup>

The use of a promissory note to acquire stock in an S corporation will be treated under Notice 89-35,<sup>16</sup> as a debt financed purchase. Consequently, the debt and related interest expense incurred in connection with the stock purchase can be allocated among all the assets of the corporation using any reasonable method (i.e., average monthly book value of company's assets). Accordingly, assuming the S corporation is engaged in a trade or business activity (as opposed to a rental activity) and the purchasing shareholder materially participates therein, the deductibility of the interest expense incurred by the shareholder on the debt financed stock purchase will not be subject to limitation under section 163(d) or 469.

### [3] Impact on Corporation

There are few real tax effects on the corporation when a Cross-Purchase Agreement is executed.

- The shift in stock ownership does not affect earnings and profits or, as to an S corporation, either its earnings and profits or accumulated adjustments account.
- Unlike the rules governing purchases and redemptions of partnership interests, there is no mechanism for the buying shareholder to adjust his or her allocable portion of the

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<sup>15</sup> See § 18.02[1][a], *supra*.

<sup>16</sup> 1989-1 C.B. 675.

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corporation's inside basis in its assets to correspond to such shareholder's outside basis in the corporation's stock.<sup>17</sup> Furthermore, unlike section 708 which provides for the termination of the partnership's taxable year in the event there is a sale or exchange of more than 50% of the interests (capital and profits) during a 12-month period, no similar rule applies to accelerate income (or the reporting of loss) by a C corporation or an S corporation.

- A Cross-Purchase Agreement also removes from direct consideration whether the corporation has adequate surplus with which to redeem the shares of the withdrawing shareholder under state law.

## § 18.03 REDEMPTION AGREEMENTS

Income tax planning for a Redemption Agreement is more complicated than that required for a Cross-Purchase Agreement. This is because the corporation is a necessary party to the agreement and often is the party who in fact purchases (redeems) the stock of the withdrawing shareholder. The rules of sections 302(b) and 303, by which "sale or exchange" treatment may be obtained, are complicated, and any Redemption Agreement must be carefully designed to assure that the redemption of a shareholder's stock will qualify for sale or exchange treatment. The practitioner must consider the probable situations under which a redemption is likely to occur, and whether sale or exchange treatment is likely to be available. If it is clear to the practitioner that sale or exchange treatment will not be available, a Cross-Purchase Agreement should be used.

**[1] Impact on Selling (Redeemed) Shareholder***[a] Importance of Sale or Exchange Treatment*

In order for a selling shareholder to qualify for "sale or exchange" treatment, the redemption must meet the requirements of section 302(b). Qualifying for sale or exchange treatment in a redemption agreement is critical not only because of the ability to benefit from

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<sup>17</sup> See I.R.C. §§ 754, 755, 743(b) and 1060(d).

a shareholder's basis in his or her shares, but also because of the disparity in tax rates for net capital gains versus ordinary income.<sup>18</sup>

1. The primary reason for avoiding dividend treatment is the ability to receive basis tax-free in a redemption treated as an exchange, in contrast to a dividend equivalent redemption whereby basis is not recovered until (and unless) the corporation has distributed all of its earnings and profits. Any residual unrecovered basis constitutes long-term capital loss, which by virtue of the limitation contained in section 1211(b), may be of limited utility.
2. If the purchase price is to be paid over a period of years, sale or exchange treatment will also qualify the sale for installment reporting under section 453 provided the stock is not publicly traded.

[b] *Dividend Treatment*

Dividend treatment can be disastrous especially with respect to post-mortem redemptions, since the estate of a deceased shareholder would normally recognize no taxable gain on a sale or exchange of stock due to the step-up basis received by an estate under section 1014.

**Example:** Adam is a shareholder of the ABC Corporation, a C corporation. Pursuant to a Redemption Agreement, Adam's stock is to be redeemed after his death for \$500,000 (\$500 per share for his 1,000 shares). The corporation has substantial accumulated earnings and profits. If the redemption is taxed as a sale or exchange of the stock in accordance with section 302(a) or 303, the estate recognizes no gain because its income tax basis is \$500 per share (the same as the sales price). If the redemption is taxed as a dividend under section 302(d), the estate has \$500,000 of ordinary income, without regard to its basis and a corresponding \$500,000 long-term capital loss.<sup>19</sup>

[c] *Sale or Exchange Treatment*

A redemption is treated as a sale or exchange of a shareholder's stock under section 302(b) if it: (1) is not essentially equivalent

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<sup>18</sup> See Note 3, *supra*.

<sup>19</sup> See I.R.C. § 1244(d)(4) (estate not eligible for § 1244 loss treatment).

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to a dividend;<sup>20</sup> (2) is substantially disproportionate;<sup>21</sup> (3) completely terminates the shareholder's interest in the corporation;<sup>22</sup> or (4) is of stock of a noncorporate shareholder in partial liquidation of the redeeming corporation.<sup>23</sup> Furthermore, the redemption cannot result in exchange treatment at the shareholder level if the corporation is collapsible.<sup>24</sup>

Of these four categories, the substantially disproportionate and complete termination exceptions are the most useful for planning purposes, since they operate with mathematical precision. However, in proper circumstances, a redemption under a Shareholder Agreement might not be essentially equivalent to a dividend. Regulations section 1.302-2(b) provides that this determination is made on a case-by-case basis, looking at all of the relevant facts and circumstances. Thus, it is less useful for planning purposes than the substantially disproportionate redemption or the complete termination of interest categories.

A redemption is substantially disproportionate for purposes of section 302(b)(2) if the shareholder's interest in outstanding common stock (both voting and non-voting) after the redemption is less than 80% of his or her interest before the redemption, and if, after the redemption, the shareholder owns less than 50% of the total combined voting power of all shares.

Under section 302(b)(3), sale or exchange treatment applies if a shareholder terminates his or her entire proprietary interest in the corporation as a result of the redemption. The simplest example of a complete termination redemption is where a corporation is owned by two unrelated shareholders and the corporation redeems all of the stock of one shareholder for cash. Although many section 302(b)(3) redemptions will also qualify under section 302(b)(2), the potential scope of section 302(b)(3) is broader and could qualify a non-substantially disproportionate redemption of nonvoting stock or section 306 stock.

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<sup>20</sup> I.R.C. § 302(b)(1).

<sup>21</sup> I.R.C. § 302(b)(2).

<sup>22</sup> I.R.C. § 302(b)(3).

<sup>23</sup> I.R.C. §§ 302(b)(4) and 302(e).

<sup>24</sup> See Note 4, *supra*.

[d] *Attribution Rules*

Qualifying a redemption under either section 302(b)(2) or 302(b)(3), especially in the context of a family corporation, may be difficult because of the application of the constructive ownership rules of section 318.

Stock is owned constructively if it is owned by certain family members, or entities in which the shareholder has an interest. Specifically, section 318(a)(1) provides that an individual be considered as owning the stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents. Section 318(a)(3) provides that stock owned, directly or indirectly, by partners, beneficiaries, or shareholders is attributed to their partnerships, estates, trusts or corporations, respectively.<sup>25</sup> Section 318(a)(2) generally provides that stock owned, directly or indirectly, by partnerships, estates, trusts and corporations is attributed to their owners, beneficiaries and stockholders, respectively.<sup>26</sup> Section 318(a)(4) provides that a person who has an option to acquire stock is deemed to own such stock.

Section 318(a)(5)(B) provides that stock constructively owned by an individual by reason of the application of the family attribution rules will not be considered as owned by him for purposes of again applying the family attribution rules in order to make another

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<sup>25</sup> I.R.C. § 318(a)(3)(A) provides that stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate. Section 318(a)(3)(B) provides that stock owned, directly or indirectly, by or for a beneficiary of a trust will be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. Section 318(a)(3)(C) provides that if 50% or more in value of the stock of the corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

<sup>26</sup> I.R.C. § 318(a)(2)(A) provides that stock owned, directly or indirectly, by or for a partnership or a estate will be considered as owned *proportionately* by its partners or beneficiaries. Section 318(a)(2)(B) provides that stock owned, directly or indirectly, by or for a trust will be considered as owned by its beneficiaries *in proportion* to the actuarial interest of such beneficiaries in such trust. Section 318(a)(2)(C) provides that if 50% or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, *in that proportion* which the value of the stock which said person so owns bears to the value of all of the stock in such corporation.

the constructive owner of such stock. Thus, so-called “double family attribution” is prohibited under the operating rules of section 318. Likewise, section 318(a)(5)(C) provides that stock constructively owned by a partnership, estate, trust or corporation by reason of section 318(a)(3) (attribution to the entity), will *not* be considered as owned by it for purposes of applying section 318(a)(2) (attribution from the entity), in order to make another the constructive owner of such stock.

Thus, in the typical family corporation, in which all stock is held by parents and their children, the redemption of all of the stock owned directly by any shareholder will be neither substantially disproportionate nor a complete termination of the shareholder’s interest.

**Example:** Father and Mother each own 1,000 shares of ABC Corporation stock; Son and Daughter each own 1,000 shares. Under a binding Redemption Agreement, the shares of any deceased shareholder must be redeemed by the corporation for \$500 per share. Father dies in 1990, leaving all of his stock to Mother. His estate submits the stock to the corporation, which redeems it for \$500,000 in cash. The \$500,000 is treated as a non-exchange distribution under section 302(d), rather than a sale or exchange, because the estate is deemed to own 100% of the corporation’s shares both before and after the redemption. Under the attribution rules, Mother is deemed to own the stock of her two children, as well as her own 1,000 shares. The estate is deemed to own the stock owned by its beneficiary, Mother, so before the redemption the estate is deemed to own 4,000 of the 4,000 outstanding shares, and after the redemption it is deemed to own 3,000 of the 3,000 outstanding shares.

[e] *Statutory Waiver of Family Attribution*

The distributee in a redemption can waive the family attribution rules under section 318(a)(1) in order to have a complete termination of interest under section 302(b)(3) if three requirements are met.<sup>27</sup>

1. “*The Look Back.*” During the past 10 years, the distributee must not have transferred any stock to, or received any

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<sup>27</sup> I.R.C. § 302(c)(2).

stock from, someone from whom it would have been attributed to the distributee (other than stock received by bequest or inheritance), unless the distributee satisfies the IRS that the transfer did not have as one of its principal purposes the avoidance of federal income taxes.<sup>28</sup> The IRS will not issue an advance ruling on a complete termination if there were transfers within the past 10 years and the facts are not materially identical to one of these rulings.<sup>29</sup>

2. *“The Look Forward.”* Immediately after the redemption, the distributee must have no interest in the corporation (other than as a creditor), including interests as an employee, officer, or director, and the distributee must not acquire such an interest for a period of 10 years following the date of the redemption.<sup>30</sup>
3. *Notification.* The distributee must agree to notify the IRS of the acquisition of any prohibited interest in the corporation and to retain records of the transaction.<sup>31</sup>
4. *Retained Interest.* The IRS takes an expansive view on whether a shareholder-distributee has retained any interest in the corporation. Clearly, any retained stock interest as well as payments for services rendered as a director, officer or employee is not permitted. Furthermore, rendering services as an unpaid consultant is also prohibited.<sup>32</sup> Moreover, the IRS ruled in Revenue Ruling 59-119,<sup>33</sup> that a former shareholder’s right to have his counsel serve as a paid director of the corporation to protect his creditor interest on an installment redemption is not permitted despite the fact that the lawyer would be a minority director.

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<sup>28</sup> I.R.C. § 302(c)(2)(B). For examples of transfers without a tax avoidance purpose, see Rev. Rul. 56-556, 1956-2 C.B. 177; Rev. Rul. 56-584, 1956-2 C.B. 179; Rev. Rul. 77-455, 1977-2 C.B. 93; Rev. Rul. 77-293, 1977-2 C.B. 91; Rev. Rul. 79-67, 1979-1 C.B. 128; and Rev. Rul. 85-19, 1985-1 CB 94.

<sup>29</sup> Rev. Proc. 2001-3, 2001-1 I.R.B. 111, § 3.01(19).

<sup>30</sup> I.R.C. § 302(c)(2)(A)(i).

<sup>31</sup> I.R.C. § 302(c)(2)(A)(iii). See Rev. Rul. 81-233, 1981-2 C.B. 83 (prohibited interest acquired when shareholder was named custodian under the Uniform Transfer to Minors Act to hold stock for minor child).

<sup>32</sup> Rev. Rul. 70-104, 1970-1 C.B. 66; Rev. Rul. 56-556, 1956-2 C.B. 177.

<sup>33</sup> 1959-1 C.B. 68.

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Similarly, in Revenue Ruling 71-426,<sup>34</sup> the right to serve as a voting trustee to vote stock of the corporation was a prohibited retained interest where the beneficiaries of the trust were family members for purposes of section 318(a)(1).<sup>35</sup>

5. *Retained Services.* In *Lynch v. Commissioner*,<sup>36</sup> the Ninth Circuit held that post-redemption services either as an employee or independent contractor constituted a prohibited retained interest in the corporation within the meaning of section 302(c)(2)(A)(i). The Court held that the Tax Court's position of looking at all relevant facts and circumstances to determine if a taxpayer has retained managerial control or a financial stake in the corporation after the redemption is inconsistent with congressional intent to bring certainty into the area.<sup>37</sup> As an illustration of how narrow the court's focus in this area can be, in *Seda v. Commissioner*,<sup>38</sup> a father who had all of his stock redeemed terminated an employment relationship after being informed that his \$1000 per month payments violated section 302(c)(2)(A)(i). The Tax Court held that such employment converted the redemption payments from capital gain into ordinary income.<sup>39</sup>

[f] *Entity Waiver of Family Attribution Rules*

Entities can waive family attribution, if both the entity and the related individual join in the waiver and agree not to acquire a prohibited interest, and if both agree to be jointly liable for any deficiency caused by the subsequent acquisition of a prohibited interest. Section 302(c)(2)(C).

<sup>34</sup> Rev. Rul. 71-426, 1971-2 C.B. 173.

<sup>35</sup> See Rev. Rul. 77-467, 1977-2 C.B. 92 (a retained debt instrument may actually be a prohibited equity interest unless it is not subordinated to the other corporate debts and its payments do not depend on earnings).

<sup>36</sup> 801 F.2d 1176 (9th Cir 1986), *rev'g* 83 T.C. 597.

<sup>37</sup> See also Michael N. Cerone, 87 T.C. 1 (1986); Jack O. Chertkof, 649 F.2d 264 (4th Cir. 1981) (management contract with controlled affiliate disqualified family waiver).

<sup>38</sup> 82 T.C. 484 (1984).

<sup>39</sup> But see *Estate of Lennard v. Commissioner*, 61 T.C. 554 (1974), *acq.* in result only, 1974-2 C.B. 3, *nonacq.* 1978-2 C.B.3.

The entity waiver rule can be useful when an estate or trust beneficiary owns none of the redeeming corporation's stock personally, but is related to other shareholders. The entity waiver rule will not, however, be helpful if a beneficiary directly owns stock which he or she does not also have redeemed in the transaction.

**Example:** Mother bequeathed her 1,000 shares of ABC Corporation stock to Father. Their children, Son and Daughter, each already own 1,000 shares of ABC Corporation stock and plan to run the business after Mother's death. Father owns none of the stock himself. After Mother's death, the corporation redeems her estate's 1,000 shares for \$500,000. The estate can waive the attribution of Son's and Daughter's stock to Father under section 318(a)(1), from whom it would be attributed to the estate under section 318(a)(3), in order to have a complete termination of interest.

**Example:** Assume the same facts as above, except that Father owns 1,000 shares of ABC Corporation stock and plans to continue to own these shares. Mother's estate cannot file a valid waiver of attribution, since the waiver will only sever family attribution and not entity attribution. Thus, while such a waiver could prevent the estate from being deemed to own the shares of Son and Daughter, it could not prevent the estate from being deemed to own Father's 1,000 shares.

[g] *Special Considerations for S Corporation Selling Shareholders*

The same rules governing shareholders in C corporations under section 302 (and 303) also apply to distributions in redemption of stock of an S corporation, including the stock attribution rules in section 318.<sup>40</sup>

Characterization of a distribution as a redemption under section 302(a) or as a distribution under section 1368(a) may make little difference to the redeeming shareholder because of the distribution rules governing S corporations having no earnings and profits. Under section 1368(b)(1), distributions of cash or property made

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<sup>40</sup> I.R.C. §§ 1371(a) (except as otherwise provided, Subchapter C rules applicable to Subchapter S except to extent inconsistent with Subchapter S) and 318(a)(5)(E) (S corporation treated as a partnership for entity attribution rules).

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by an S corporation having no accumulated Subchapter C earnings and profits are received tax-free by shareholders to the extent of their basis in the S corporation stock. Under section 1368(b)(2), to the extent distributions exceed basis, the excess is treated as gain from the sale or exchange of property.

Thus, unless the purchase price is to be paid over a period of years (where the shareholder will need exchange treatment to qualify for the installment sales rules), it essentially makes no difference to the redeeming shareholder whether the transaction is a redemption under section 302(a) or a distribution under section 1368. A separate block rule will apply to non-sale or exchange redemptions in mirroring the results under distributions to shareholders in C corporations.<sup>41</sup>

This indifference as to whether a distribution is characterized as a section 302 redemption or a section 1368 distribution *may* also apply to S corporations having Subchapter C earnings and profits. Distributions made by S corporations having accumulated Subchapter C earnings and profits are subject to a 5-tier system of taxation. This system utilizes the corporation's accumulated adjustment account (AAA) in determining the taxability of distributions. AAA generally consists of the accumulated gross income of the S corporation less deductible expenses and prior distributions. The AAA is essentially a running total of the S corporation's income, losses, deductions and distributions. The 5-tier system of taxation may be summarized as follows:

1. That portion of the distribution that does not exceed AAA is tax-free to the extent of the shareholder's stock basis.<sup>42</sup>
2. That portion of the distribution that does not exceed AAA, but that does exceed the shareholder's stock basis, is capital gain.<sup>43</sup>
3. That portion of the distribution that exceeds AAA is a dividend to the extent of the S corporation's accumulated Subchapter C earnings and profits.<sup>44</sup>

<sup>41</sup> Treas. Reg. §§ 1.1367-1(c)(3) and (f).

<sup>42</sup> I.R.C. §§ 1368(c)(1) and 1368(b)(1).

<sup>43</sup> I.R.C. §§ 1368(c)(1) and 1368(b)(2).

<sup>44</sup> I.R.C. §§ 1368(c)(2) and 301.

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4. That portion of the distribution that exceeds AAA and the accumulated Subchapter C earnings and profits of the S corporation is tax-free to the extent of the shareholder's residual stock basis (the shareholder's adjusted basis in his or her S corporation stock less any reductions made in his or her stock basis for any first-tier distributions).<sup>45</sup>
5. That portion of the distribution that exceeds AAA, the accumulated Subchapter C earnings and profits of the S corporation, and the shareholder's residual stock basis, is capital gain.<sup>46</sup>

Thus, even if the redemption is not treated as an exchange, the same result will apply (return of capital, gain from the sale of stock), if the amount received by the shareholder is not in excess of the corporation's accumulated adjustments account (AAA) as of the close of the taxable year and is allocated among all dividend distributions made during the same period. Where the distribution exceeds AAA as of the close of the taxable year, however, such excess will be a distribution of earnings and profits and taxed as a dividend. The dividend distribution will be allocated pro-rata to all distributions made during the year.

Just like a selling shareholder in a cross-purchase arrangement, under sections 1366 and 1377(a)(1), the redeemed shareholder will be allocated his or her share of the S corporation's items of income, deduction, loss or credit for the year of the redemption on a per share, per day basis, unless an election to close the books is made under section 1377(a)(2) or Regulations section 1.1368-1(g).<sup>47</sup>

Where the selling shareholder has low basis stock, deliberately avoiding section 302(a) or 303 may be an effective tax planning technique, especially where the selling shareholder may have an incentive to help out the remaining shareholder group by significantly reducing the corporation's earnings and profits account.

<sup>45</sup> I.R.C. §§ 1368(c)(3) and 1368(b)(1).

<sup>46</sup> I.R.C. §§ 1368(c)(3) and 1368(b)(2).

<sup>47</sup> See § 18.02[1][a], *supra*.

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## [2] Impact on the Corporation

### [a] C Corporations

Earnings and profits of the corporation are reduced dollar for dollar from current earnings and profits, and then from the most recently acquired accumulated earnings and profits in a non-exchange redemption. For an exchange redemption, earnings and profits are reduced under section 312(n)(7) in direct proportion with the percentage of shares redeemed.

In general, the distribution of appreciated property by a corporation to a shareholder in an exchange or non-exchange redemption will result in gain to the corporation under section 311(b). The distribution of depreciated property (resulting in a loss) will not be recognized by the corporation and also results in disappearing basis at the shareholder level.<sup>48</sup>

If a buy-out is funded by corporate-owned life insurance, the proceeds of the life insurance received by the corporation may be subject to the alternative minimum tax to which C corporations are subject.

### [b] S Corporations

Non-exchange redemptions will reduce the corporation's AAA account first and then the corporation's earnings and profits account unless the corporation and its shareholders file a AAA bypass election for the same year, in which case distributions are deemed to be made first from accumulated earnings and profits and then from AAA.<sup>49</sup> Exchange redemptions are charged to both the AAA and accumulated earnings and profits account in direct proportion to the percentage of stock redeemed.<sup>50</sup>

<sup>48</sup> I.R.C. §§ 311(a) and 301(d).

<sup>49</sup> I.R.C. § 1368(e)(3).

<sup>50</sup> I.R.C. § 1368(e)(1)(B); Treas. Reg. § 1.1368-2(d)(1); I.R.C. § 312(n)(7); Treas. Reg. § 1.1368-2(d)(1)(iii). See Rev. Rul. 95-14, 1995-1 CB 169 (when an S corporation shareholder receives proceeds in a redemption that does not qualify as a sale or exchange under either § 302(a) or § 303(a), the corporation's AAA must be reduced by the full amount of the distribution to the extent the distribution is not included in the shareholder's income under the distribution rules of § 1368). Thus, although there may be no tax difference between an exchange and non-exchange redemption to the redeemed S corporation shareholder, the remaining

In general, the distribution of appreciated property by an S corporation to a shareholder in an exchange or non-exchange redemption will result in gain to the corporation under section 311. Moreover, gain from a distribution of appreciated property has the potential for triggering the corporate level built-in gains tax imposed under section 1374, or, if the property distributed constitutes stocks or securities, a possible tax on passive investment income under section 1375. The distribution of depreciated property (resulting in a loss) will not be recognized by the corporation and also results in disappearing basis.<sup>51</sup>

In Private Letter Ruling 9116008 (Jan. 10, 1991), the IRS applied the interest allocation rules of Temporary Regulations section 1.163-8T and Notice 89-35,<sup>52</sup> to a redemption by an S corporation of its stock from some of its shareholders. The corporation issued promissory notes to the shareholders in payment for their stock. The IRS found that since the redemptions would qualify under section 302(a) for sale or exchange treatment rather than being treated as distributions under section 302(d), the interest allocation rules for debt financed distributions set forth in Notice 89-35 would be inapplicable. The IRS additionally found that since the remaining shareholders' ownership interests in the S corporation would be increased as a result of the corporate redemptions, such redemptions should be characterized under Notice 89-35 as debt financed purchases. Consequently, the IRS ruled that the debt and related interest expense incurred in connection with the redemptions could be allocated among all the assets of the corporation using any reasonable method. The IRS concluded that allocating the debt and related interest expense incurred in connection with the redemptions among the assets on the basis of the book value of the company's assets, averaged monthly, constituted a reasonable method of interest allocation for purposes of Notice 89-35.

shareholders have an interest in the redemption qualifying as an exchange so that the AAA is only reduced proportionately and not by the full amount of the distribution. On the other hand, an S corporation can use these rules to make a non-pro rata tax-free operating distribution to one of its shareholders.

<sup>51</sup> I.R.C. §§ 311(a) and 301(d).

<sup>52</sup> See Note 16, *supra*.

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## § 18.04 DISTRIBUTIONS UNDER SECTION 303

Section 303 grants sale or exchange treatment on the redemption of closely-held stock, to the extent of the estate’s death taxes, administrative expenses, and generation-skipping transfer taxes.

### [1] General Rules

An estate qualifies under section 303 if the stock, either owned by the estate or otherwise required to be included in the decedent’s gross estate, represents at least 35% of the decedent’s adjusted gross estate (gross estate less deductible losses and expenses).<sup>53</sup> The stock of two or more corporations can be aggregated in order to satisfy this 35% test, if the estate includes 20% or more of the stock of each corporation, including the full value of stock owned jointly with the surviving spouse.<sup>54</sup>

### [2] Applicability

In practice, section 303 is of limited use. The unlimited estate tax marital deduction and the larger unified credit reduce both the estate tax liability and the amount of stock which can be redeemed. Furthermore, since section 303 applies only to the extent that the redeemed shareholder’s interest is reduced “directly (or through a binding obligation to contribute) by any payment” of estate taxes or expenses, stock passing to a marital or charitable trust of the estate is rarely going to be eligible for redemption under section 303.

## § 18.05 APPLICATION OF SECTION 83 TO SHAREHOLDER AGREEMENTS

### [1] General Considerations

If a Shareholder Agreement contains employment-related restrictions, such as a required offering to sell stock upon termination of employment or disability, the initial receipt of the stock, the lapse of these restrictions, or its subsequent sale may result in ordinary income under section 83.

<sup>53</sup> I.R.C. § 303(b)(2)(A).

<sup>54</sup> I.R.C. § 303(b)(2)(B).

**[2] General Rule**

Section 83(a) provides that if, in connection with the performance of services, property is transferred to a person, the excess of the fair market value of such property over the amount paid, if any, by the person for the property must be included in the person's gross income in the first taxable year the property is transferable or not subject to a substantial risk of forfeiture. Property that is transferable or not subject to a substantial risk of forfeiture is referred to as "substantially vested" property. Thus, an employee who receives substantially vested stock "in connection with the performance of services," must recognize as ordinary income in the year of receipt of such stock the difference, if any, between the value of the stock and the amount paid for such stock.

If stock is received subject to a substantial risk of forfeiture and if it is nontransferable, the recognition of income is deferred until the stock becomes transferable or the risk of forfeiture ceases. In this case, the amount that is recognized as ordinary income is the difference between the fair market value of the stock *at the time it becomes transferable or the restriction lapses* and the amount paid by the shareholder for such stock.

If a Shareholder Agreement requires an employee to resell his or her shares on disability or otherwise when employment ends, the stock is "property received in connection with the performance of services."

**[3] Employment Provisions in Shareholder Agreements**

Employment-related buy-sell clauses can trigger ordinary income under section 83 when the stock is acquired. Unless the stock is substantially non-vested, the shareholder must report the difference between the stock's fair market value and any consideration paid for it in the year it is received. Since most family stock transfers (including those attempting to adopt a fair market value price) rarely are accompanied by a careful appraisal, the IRS can almost always argue that the employee bought the stock at some discount.

**[4] Non-Vested Stock**

Stock is substantially non-vested under section 83 if it is subject to a substantial risk of forfeiture. Stock subject to an agreement

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that requires the shareholder to sell it at its fair market value (price set by appraisal, for example), is not normally viewed as subject to a substantial risk of forfeiture, since the shareholder suffers no loss on the resale.<sup>55</sup> A Shareholder Agreement may still create a substantial risk of forfeiture, however, if:

1. The agreement provides for sale under a formula price, which is likely to result in a price differing from fair market value. Such formula prices are presumptively the fair market value, but if the formula is inaccurate or if it can be easily manipulated (as by a change in corporate net earnings through creating reserves), it may be disregarded.<sup>56</sup>
2. The agreement sets a fixed dollar purchase price which, though accurate when signed, is later inaccurate.<sup>57</sup>

#### **[5] Forfeiture of Stock**

A Shareholder Agreement causing a stock forfeiture only upon discharge for cause or the commission of a crime is not subject to a substantial risk of forfeiture because of the character of the conditions. This must be distinguished from a provision requiring return of the stock when the shareholder (other than a controlling shareholder) quits or is fired for any reason (with or without cause), which is treated as subject to a substantial risk of forfeiture.<sup>58</sup>

#### **[6] Imputed Capital Contribution**

Section 83 applies whether the stock is issued by the corporation or transferred to the employee by another shareholder. Under Regulations section 1.83-6(d), a shareholder's transfer of stock to a corporate employee in consideration of the performance of services for the corporation is treated as a contribution to the corporation's capital by the shareholder, followed by a corporate transfer of the property to the employee.

<sup>55</sup> Treas. Reg. § 1.83-3(c).

<sup>56</sup> Treas. Reg. § 1.83-5.

<sup>57</sup> Treas. Reg. § 1.83-5(a).

<sup>58</sup> Treas. Reg. §§ 1.83-3(c)(2) and 1.83-3(c)(4) (Examples 1, 3, and 4).

### [7] Buy-Back in the Event of Death

Section 83 could even apply if the employee-shareholder held the shares until his or her death. If the shareholder's estate sells the stock back to the corporation or to the other shareholders, the fact that the shareholder's estate's basis may be equal to the shares' fair market value is not dispositive, since section 83 requires recognition of the difference between the stock's fair market value and the "amount paid," which presumably would not be adjusted on account of death.

### [8] Drafting With Section 83 in Mind

The best solution in almost every case is for the shareholder who acquires shares subject to a Shareholder Agreement requiring retransfer in case of disability or termination of employment, to file an election under section 83(b) within 30 days from the date the stock is acquired, agreeing to recognize as ordinary income the difference, if any, between the value of the stock on the date acquired (ignoring the restrictions) and the amount paid for the shares. This election must be filed even if the shareholder pays the full fair market value for his or her shares, though no gain is recognized in this situation.<sup>59</sup> Absent an undervaluation of the stock on initial purchase, the section 83(b) election eliminates future ordinary income under section 83.<sup>60</sup>

### [9] Application of Section 83 to S Corporations

Regulations section 1.83-1(a)(1) provides that until stock is substantially vested, the employer is regarded as the owner of the stock and income (i.e., distributions) received by the employee which is attributable to the stock is treated as additional compensation income and included in gross income of the employee in the year the compensation is received.<sup>61</sup>

<sup>59</sup> *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984), *aff'g* 79 T.C. 865 (1983).

<sup>60</sup> It is critical that the § 83(b) election be made within 30 days after the shareholders' receipt of the stock, because *no* extensions to the 30-day period are available. The only potential detriment to a shareholder making a § 83(b) election is that if the shareholder subsequently forfeits the stock, the shareholder will not be permitted to deduct the amount previously included in such shareholder's gross income as a result of the § 83(b) election. Treas. Reg. § 1.83-2(a).

<sup>61</sup> See Rev. Proc. 80-11, 1980-1 C.B. 616 (dividends from a C corporation paid with respect to restricted stock constitute compensation).

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For purposes of Subchapter S, stock that is issued in connection with the performance of services and that is substantially nonvested (within the meaning of section 1.83-3(b)), is not treated as outstanding stock of the corporation and the holder of such stock is not treated as a shareholder, unless the holder makes an election with respect to the stock under section 83(b). In the event such an election is made, the stock is treated as outstanding stock of the corporation and the holder is treated as a shareholder for purposes of Subchapter S.<sup>62</sup> Items of income, loss, deduction and credit of the S corporation are not allocated to an employee with non-vested stock. This further results in denying the non-vested shareholder the right to make basis adjustments under section 1367. Regulations section 1.1361-1(b)(3) acknowledges, however, that there may be many instances in which restricted stock has been treated by the parties as outstanding, despite the absence of a section 83(b) election. If issued on or before May 28, 1992, such stock will continue to be treated as outstanding, and will not be treated as a second class of stock.

For purposes of the one class of stock requirement of section 1361(b)(1)(D), Regulations section 1.1361-1(b)(3) provides that substantially nonvested stock (for which no section 83(b) election has been made) that is transferred in connection with the performance of services is *not* treated as a second class of stock. In instances in which the recipient of restricted stock makes a section 83(b) election, such stock would be treated as outstanding. Such stock would be treated as a second class of stock only if it confers rights to distribution or liquidation proceeds that are different from those rights conferred by the other outstanding shares of stock.

#### § 18.06 SPECIAL CONSIDERATIONS IN DRAFTING S CORPORATION SHAREHOLDER AGREEMENTS

S corporations raise special problems and require special provisions in a Shareholder Agreement.

#### [1] Buy-Sell Provisions Affecting S Corporation Status

One of the requirements to which S corporations are subject is the requirement under section 1361(b)(1)(D) that an S corporation

<sup>62</sup> Treas. Reg. § 1.1361-1(b)(3).

not have more than a single class of stock. Regulations section 1.1361-1(l)(1) provides that shares do not create a second class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Regulations section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock of a corporation confer identical rights to distribution and liquidation proceeds is made by looking at certain “governing provisions,” namely the corporate charter, articles, bylaws, applicable state law and “binding agreements relating to distribution and liquidation proceeds.” Accordingly, the tax practitioner should be careful not to draft a shareholder agreement in such a manner that the outstanding shares of stock of the corporation do not confer identical rights to distribution and liquidation proceeds. In this regard, the regulations set forth rules for when shareholder agreements will be disregarded in determining whether the outstanding shares of stock confer identical rights to distribution and liquidation proceeds.

Regulations Section 1.1361-1(2)(iii)(B) provides that bona fide agreements by an S corporation to redeem or purchase stock upon death, divorce, disability or termination of employment are disregarded in determining whether a corporation’s shares of stock confer identical rights. Forfeiture restrictions as to non-vested stock under section 83 which is treated as outstanding are also disregarded.

Regulations section 1.1361-1(l)(2)(iii) provides that other agreements among shareholders, agreements restricting the transferability of stock and redemption agreements are disregarded for this purpose, unless:

1. a principal purpose of the agreement is to circumvent the one class of stock requirement; and
2. the agreement establishes a redemption or purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

A purchase or redemption price set at book value or at a price somewhere between book value and fair market value will be acceptable. Moreover, a “good faith determination” of fair market value will be respected unless it can be shown that the value was

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substantially in error and that the determination of value was not performed with “reasonable diligence.”<sup>63</sup>

**Example:** A and B are shareholders of S corporation. A is also an employee of S. By agreement, S shall redeem A’s shares upon termination of A’s employment at a price equal to the book value of the shares. On these facts, the agreement is disregarded for purposes of the one class of stock requirement.<sup>64</sup>

Although a Shareholder Agreement may be disregarded for purposes of determining whether the corporation has more than one class of stock outstanding, Regulations section 1.1361-1(l)(iii) provides that payments pursuant to the agreement may have other income or transfer tax consequences.

Despite the general reassurance found in the regulations for Shareholder Agreements, such agreements should be carefully prepared in order to avoid restricting the right of shareholders to share equally in distribution and liquidation proceeds.

## [2] Pricing Considerations

In addition to the other methods and considerations used in determining the value of stock in a corporation, some special pricing considerations may be necessary in valuing stock in an S corporation for buy-sell purposes.

A shareholder having his or her stock purchased may want credit for his or her allocable share of the corporation’s AAA, especially where a cross purchase is the selected buy-sell method. On the other hand, it could be argued that since AAA is a corporate level account and is already reflected in the selling shareholder’s stock basis, a selling shareholder’s imputed share of AAA should not be treated as a positive adjustment to the purchase price. Still, it may be an issue which the selling shareholder can use as a negotiating point.

Where an S corporation has accumulated earnings and profits (from C years) and the selling shareholder is receiving capital gain and/or a full basis recovery by structuring the transaction as a sale or exchange, the remaining shareholders may wish to reduce the price paid to account for the subsequent income tax burden they

<sup>63</sup> Treas. Reg. § 1.1361-1(l)(2)(iii).

<sup>64</sup> Treas. Reg. § 1.1361-1(l)(2)(v), Example 8.

will recognize on the receipt of ordinary income dividends from the corporation's accumulated earnings and profits.

Projected corporate-level taxes on an S corporation should also be considered. For example, if the corporation is subject to the built-in gains tax under section 1374,<sup>65</sup> a shareholder selling out before the end of the 10-year recognition period will be avoiding his or her share of the double tax to which the corporation would be subject if it sold its assets or liquidated. Thus, it may be contended that a downward price adjustment should be made with respect to such shareholder's pro rata share of the potential corporate level tax. A similar adjustment could arise for anticipated corporate level taxes under the passive investment income rules of section 1375. As to the passive investment income tax, a ceiling could be placed on the required adjustment based on the amount of accumulated earnings and profits from C years that must be distributed to avoid application of section 1375.

As an alternative to resolving the complex issues concerning adjustments for corporate level taxes, it may be preferable to use a formula price based on pretax earnings and not include any adjustment for corporate level taxes. Moreover, federal income taxes generally are not relevant in determining net asset values if asset values are the primary method of valuation.

### [3] Redemptions Funded With Life Insurance Proceeds

S corporations are not subject to the corporate alternative minimum tax, and as such, may receive life insurance proceeds tax-free. Where a redemption buy-sell method is used, a group policy may be purchased by the corporation. However, the proceeds will increase the stock basis of *all* shareholders, including a deceased shareholder whose stock is being redeemed. Since section 1014 applies to increase basis at death,<sup>66</sup> the added pass through of the insurance proceeds (assuming such adjustment is nontaxable under section 101(a)), will largely be wasted or will result in a capital loss to the redeeming shareholder. To avoid this problem, the shares of a deceased S shareholder should be purchased prior to the time that the insurance proceeds are received and the agreement must

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<sup>65</sup> See Looney, "Built-In Gains Tax Revisited," 3 Business Entities 12 (March/April 2001), for a general discussion of the built-in gains tax.

<sup>66</sup> See Note 6, *supra*.

require that all shareholders and the corporation file an election under section 1377(a)(2) to close the books for purposes of allocating items of the S corporation to the deceased shareholder (and his or her estate) only up to the date of closing.<sup>67</sup>

It has been suggested that insurance proceeds may fall within the meaning of “annuities” for passive investment income purposes. For the S corporation with prior C years earnings and profits, funding redemption payments with life insurance could subject the corporation to a tax on otherwise non-taxable insurance proceeds under section 1375.<sup>68</sup>

#### [4] Planning Opportunities and Pitfalls in Connection with Terminating Elections

Because of the elective nature of section 1377(a)(2), it can be a useful planning tool for the practitioner. Depending upon the facts and circumstances of a particular situation, and the party being represented (the selling shareholder, the buying shareholder or the other shareholders), the failure to make a terminating election under section 1377(a)(2) can either be advantageous from a tax standpoint or a major blunder resulting in disastrous tax consequences to the taxpayer. In particular, a terminating election can have a dramatic effect on the *time* when income will be recognized by the shareholders as well as on the *character* of the income recognized by the shareholders. The following examples illustrate some of the planning opportunities and pitfalls associated with the section 1377(a)(2) terminating election.

**Example:** X incorporates, elects S corporation status, and issues 100 shares of stock to A and 100 shares of stock to B on January 2, 2001. Exactly half way through the taxable year, B sells all of his stock to C. During its 2001 taxable year, X has a profit

<sup>67</sup> While this technique should operate so that all of the basis increase resulting from a corporation’s receipt of corporate-owned life insurance proceeds is allocated to the remaining shareholders and not to the deceased shareholder’s estate *if* the S corporation is on the cash basis of accounting, it is not clear whether such a technique would be successful with respect to an S corporation utilizing the accrual method of accounting.

<sup>68</sup> See (former) Treas. Reg. § 1.1372-4(b)(5)(ix). Treas. Reg. § 1.1362-3(d)(5)(ii)(E) (“amount(s) received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includable in gross income under § 72”).

of \$100,000 through the date of B's sale of his X stock to C, and a loss of \$200,000 for the period after the date of such sale. If no terminating election under section 1377(a)(2) is made, X's non-separately computed loss of \$100,000 (\$100,000 profit through the date of the sale less \$200,000 loss following the date of the sale) will be allocated on a per-share, per-day basis. As such, \$50,000 of loss will be allocated to A since he owned 50% of the stock of X for the entire taxable year ( $\$100,000 \text{ loss} \div 364 \text{ days} \times 50\% \times 364 \text{ days}$ ), \$25,000 of loss will be allocated to B since he owned 50% of the stock of X for one-half of the taxable year ( $\$100,000 \text{ loss} \div 364 \text{ days} \times 50\% \times 182 \text{ days}$ ), and the remaining \$25,000 of loss will be allocated to C since he owned 50% of the stock of X for the last half of the taxable year ( $\$100,000 \text{ loss} \div 364 \text{ days} \times 50\% \times 182 \text{ days}$ ).

If, however, a terminating election is made under section 1377(a)(2), X will close its books on the date of B's sale of his stock to C for purposes of allocating all of X's items of income, loss, deduction and credit for the taxable year. As such, \$50,000 of loss will be allocated to A (50% of the \$100,000 income of X through the date of the sale of B's stock to C, less 50% of the \$200,000 loss of X following the date of the sale of B's stock to C). B will be allocated \$50,000 of income (50% of the \$100,000 income of X through the date of the sale), and C will be allocated \$100,000 of loss (50% of the \$200,000 loss of X following the date of B's sale of his stock to C). Although the section 1377(a)(2) terminating election has no effect on the net amount allocated to A, the effect of the terminating election on B and C is significant. B's ordinary income is *increased* by \$75,000 as a result of the terminating election (allocation of \$50,000 of income if terminating election is made as compared to an allocation of \$25,000 of loss if no terminating election is made). Likewise, C's ordinary income is *decreased* by \$75,000 as a result of the terminating election (allocation of \$100,000 of loss if terminating election is made as compared to an allocation of \$25,000 of loss if no terminating election is made).

**Example:** Assume the same facts as above, except that instead of B selling his shares to C, B sells all of his stock to A exactly half way through the 2001 taxable year for a sales price of \$200,000 to be received over a period of five years. B's basis

## 18-35 DRAFTING SHAREHOLDER AGREEMENTS § 18.06[4]

in his stock is \$100,000, and B intends to report the \$100,000 gain realized by him on the sale of his stock to A on the installment sales method under section 453. Through the date of B's sale of his stock to A, X has no income or loss, but following the sale of B's stock to A, X sells substantially all of its assets to a third party resulting in a gain to X of \$1,000,000. If no terminating election under section 1377(a)(2) is made, \$750,000 of gain will be allocated to A since he owned 50% of the stock of X for one-half of the taxable year and 100% of the stock of X for the remaining one-half of the taxable year. B will be allocated \$250,000 of gain since he owned one-half of the shares of X for one-half of the taxable year. Even if the entire gain on the sale of X's assets is capital gain (so that there is no rate differential between the gain allocated to B attributable to the sale of X's assets and the gain realized by B on the sale of his stock to A), B will nevertheless have to report the \$250,000 gain on his 2001 income tax return. In turn, the \$250,000 of gain allocated to B will increase B's basis in his X stock under section 1367 to \$350,000 (\$100,000 original basis plus \$250,000 gain), which will cause B to recognize a capital loss on the sale of his stock to A of \$150,000 (\$350,000 basis less \$200,000 sales price). This \$150,000 capital loss can be used by B to offset the \$250,000 of capital gain allocated to him, so that the net amount of gain that must be recognized by B on his 2001 income tax return will be \$100,000.

If, on the other hand, a terminating election under section 1377(a)(2) was made in connection with the sale of B's stock to A, *none* of the gain on X's sale of its assets would be allocated to B, and B would be permitted to recognize the \$100,000 of gain realized by him on the sale of his stock to A under the installment sales method over a period of five years, rather than recognizing the entire \$100,000 gain in 2001. Additionally, A would be allocated the entire \$1,000,000 of gain recognized by X on the sale of its assets.

**Example:** Alternatively, assume the same facts as in above, except that instead of X selling its assets for a gain of \$1,000,000, A contributes assets to X following the date of the sale of B's stock to A and those contributed assets produce \$1,000,000 of ordinary income. Assuming no terminating election is made

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under section 1377(a)(2), \$750,000 of ordinary income will be allocated to A since he owned 50% of the stock of X for one-half of the taxable year, and 100% of the stock of X for the remaining one-half of the taxable year. B will be allocated \$250,000 of ordinary income since he owned 50% of the stock of X for one-half of the taxable year. B will be required to include the \$250,000 of ordinary income on his 2001 income tax return, which will also result in an increase in the basis of his X stock to \$350,000 (\$100,000 original basis plus \$250,000 income). Again, this will result in a capital loss of \$150,000 (\$350,000 basis less \$200,000 sales price) on the sale of B's stock to A, but because the \$250,000 allocated to B is *ordinary income* rather than capital gain, B will *not* be permitted to offset the \$150,000 capital loss against the \$250,000 of ordinary income allocated to him except to the extent of \$3,000 per year. Additionally, B will be subject to the substantially higher tax rates imposed on ordinary income with respect to the \$250,000 of ordinary income allocated to him.

If, however, a terminating election under section 1377(a)(2) is made with respect to B's sale of all of his stock to A, B will be allocated no portion of the \$1,000,000 of ordinary income of X following the date of B's sale of his X stock to A, and will therefore receive capital gain treatment on the entire \$100,000 of gain realized by him on the sale of his stock to A. A, on the other hand, will be allocated the full \$1,000,000 of ordinary income of X following the date of B's sale of his stock to A.

Quite clearly, the section 1377(a)(2) terminating election can have a significant impact both on the timing and characterization of income to both the seller and the buyer of S corporation stock. The seller can avoid having his or her tax consequences affected by the actions of the buyer after the date of the sale only by having the S corporation make a terminating election under section 1377(a)(2).

Because of the varying tax consequences that can result from making, or failing to make, a section 1377(a)(2) terminating election to the seller and buyer of S corporation stock, as well as to the other shareholders of the S corporation, the tax practitioner must be fully informed of the income or loss of the S corporation through the date of a sale of stock which terminates a shareholder's entire

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interest in the S corporation, the estimated income or loss of the S corporation following the date of such sale, the amount of any distributions made by the S corporation to its shareholders prior to the date of the sale, and the likelihood that the S corporation will sell its assets following the date of the sale.

At a minimum, the stock purchase agreement between the selling shareholder and the purchasing shareholder should address whether a section 1377(a)(2) terminating election will be made, and if so, the S corporation should join in the execution of the stock purchase agreement for purposes of agreeing to consent to the terminating election. The most equitable solution may be to provide in a Shareholder Agreement between the corporation and all of its shareholders that a section 1377(a)(2) terminating election *must* be made in the event a shareholder terminates his or her entire interest in the corporation (without knowing whether such an election will be favorable or detrimental to the respective shareholders).<sup>69</sup> Although this may be the most equitable solution, such a provision eliminates the planning opportunities available to the knowledgeable practitioner under section 1377.

#### [5] Other Special Provisions For S Corporation Shareholder Agreements

In addition to the provisions discussed above that should be taken into consideration when drafting a Shareholder Agreement for an S corporation, consideration should also be given to the following provisions:

1. To ensure that the issuance of stock will not jeopardize either the effectiveness of the corporation's initial election or the status of its previously filed election, each shareholder should identify the beneficial owner of shares issued in his or her name and warrant that his or her receipt of stock will not prevent the corporation from filing/maintaining its S election.

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<sup>69</sup> Even if the shareholders have agreed to make a § 1377(a)(2) terminating election in a Shareholder Agreement, such provision will *not* meet the election requirements of Treas. Reg. § 1.1377-1(b)(4) unless an election statement is timely filed with the IRS or if the IRS finds that there has been substantial compliance with the election rules. See § 18.02[1][a] for a discussion of how to address this concern.

2. The agreement should restrict the transfer of any shares of stock to an ineligible shareholder unless prior written consent is received from a majority, a supermajority or all other shareholders.<sup>70</sup> The shares also must be legended and make specific reference to the agreement.
3. Consideration should be given to whether the Shareholder Agreement will bind all shareholders to make or revoke an S election upon the decision of a majority, supermajority or unanimous consent of the shareholders.<sup>71</sup>
4. In order to ensure the status of the corporation as a small business corporation under section 1361(b), it may be desirable to place a specific provision in the agreement or by-laws of the corporation imposing personal liability on any director, officer, or person acting on behalf of the corporation who knowingly or negligently causes the corporation's S election to terminate.
5. Depending on the party being represented, the practitioner may want to include a minimum dividend distribution requirement in order to protect minority or non-voting shareholders.<sup>72</sup> Similar issues concerning the payment of dividends from accumulated earnings and profits to avoid a termination or tax on passive investment income should also be considered.
6. Consideration should be given to including a provision on liquidated damages in the event a shareholder transfers stock to an ineligible shareholder in violation of the terms of the agreement. If such a provision is otherwise desirable, the elements comprising the basis for computing damages should be clearly identified in the agreement.

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<sup>70</sup> See Paragraph 18(a) of the form Stock Restriction Agreement set forth in Appendix B for a provision restricting transfers to ineligible S corporation shareholders. It is essential to include a statement that any transfer to an ineligible shareholder will be *void ab initio*, because such a provision should prevent the S corporation from losing its status as an S corporation and having to either reelect S status or seek inadvertent termination relief under § 1362(f).

<sup>71</sup> See Paragraph 18(a) of the form Stock Restriction Agreement set forth in Appendix B for provisions regarding the election and revocation of a corporation's S election.

<sup>72</sup> See Paragraph 18(c) of the form Stock Restriction Agreement set forth in appendix B for an example of a minimum dividend distribution requirement.

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- 7. The parties should agree as to the making of shareholder elections and consents regarding income allocations for the termination of a shareholder’s interest in the corporation, or for the termination of the corporation’s S election.<sup>73</sup>
- 8. A majority shareholder of an S corporation may wish to require all shareholders to consent to an election under section 338(h)(10). Such an election would permit shareholders that sell the stock of an S corporation to treat the acquired S corporation as having sold its assets. As a result, the gain or loss recognized in such deemed asset sale will be included in the corporation’s income for the year of the sale and will flow through to the shareholders.<sup>74</sup> Such an election can only be made with the consent of all the selling shareholders and the acquiring corporation.<sup>75</sup>

§ 18.07 Form of Preliminary Letter

\_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

Re: Stock Restriction Agreement

Dear \_\_\_\_\_:

Pursuant to our prior discussions, this letter sets forth general reasons and objectives (both non-tax and tax) for having a Stock Restriction Agreement (also referred to as a “Shareholders’ Agreement” or “Buy-Sell Agreement”). This should help you and your partners focus on your own objectives for the Stock Restriction Agreement. Additionally, I have summarized some of the important provisions and issues that need to be addressed in a Stock Restriction Agreement, which you should consider in your discussions.

<sup>73</sup> See Paragraphs 18(d) and 18(e) of the Form Stock Restriction Agreement set forth in Appendix B for provisions on making the § 1377(a)(2) and Treas. Reg. § 1.1368-1(g) elections to close the books for purposes of allocating S corporation items.

<sup>74</sup> Treas. Reg. § 1.338(b)(10)-1(e)(1).

<sup>75</sup> Treas. Reg. § 1.338(h)(100-1(D)(2) and Form 8023.

### GENERAL REASONS FOR A STOCK RESTRICTION AGREEMENT

Set forth below are a number of reasons and objectives (both non-tax and tax) for having a stock restriction agreement:

1. A stock restriction agreement can create a market for what is otherwise an unmarketable interest in a closely-held corporation.
2. A stock restriction agreement provides a means for determining a fair price of the shares of stock of a closely-held corporation in light of the goals sought to be achieved by the shareholders of the closely-held corporation.
3. A stock restriction agreement may be used to establish a control mechanism for the transfer of stock and to exclude or remove inactive or potentially dissident shareholders depending upon the circumstances and desires of the shareholders.
4. A stock restriction agreement may provide a means of transferring control of a closely-held corporation upon the death, disability or termination of employment (through retirement or otherwise) of a shareholder to other shareholders.
5. A stock restriction agreement may be used to reduce the financial pressure on a decedent's heirs to pay estate taxes and other expenses by providing for a mandatory purchase of a deceased shareholder's shares or by giving the estate (or the decedent's heirs) the option to sell such shares to the closely-held corporation.
6. A detailed and well-drafted stock restriction agreement *will greatly reduce the potential for shareholder disputes* resulting in litigation which would be both time consuming and costly to a corporation and its shareholders.
7. A properly drafted stock restriction agreement may prevent an S corporation from losing its eligibility to be an S corporation by restricting the shareholders from transferring their shares to an entity or other person that would be ineligible to hold shares of an S corporation.
8. A stock restriction agreement may make or set forth the mechanics for making certain elections which an S

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corporation and/or its shareholders can make with respect to allocations of income and loss when a shareholder terminates his or her entire interest in the S corporation or the corporation ceases to be an S corporation.

9. A stock restriction agreement may provide for the amount and timing of operating distributions.
10. A stock restriction agreement can assist in providing evidence of valuation for estate and gift tax purposes.

Because of both the non-tax and tax reasons for having a stock restriction agreement, it is essential that a closely-held corporation have a complete and well-drafted stock restriction agreement implementing the objectives of the shareholders.

#### IMPORTANT PROVISIONS OF STOCK RESTRICTION AGREEMENT

Set forth below are some of the more important provisions and issues that you should consider in connection with your Stock Restriction Agreement:

1. ***Restriction on Transfer.*** The Stock Restriction Agreement will prohibit the shareholders from selling, assigning, encumbering, pledging, transferring, gifting or otherwise disposing of any of their shares of stock in the corporation, except as expressly provided and permitted in the Stock Restriction Agreement.

2. ***Transfers to Revocable Trust.*** This provision will permit each of the shareholders to transfer ownership of his or her shares of stock to a revocable trust, which would be subject to all the terms and conditions of the Stock Restriction Agreement. This will permit the shareholders more flexibility for estate planning purposes.

3. ***Sales of Shares to Third Parties.*** This provision addresses a situation where one of the shareholders receives an offer from a third party to purchase his or her shares of stock. In this event, the shareholder receiving the offer (the “Offering shareholder”) would be required to first offer his or her shares for sale to the corporation and/or to the other shareholders, either for the price and the terms set forth in the bona fide offer or, at the option of the other shareholders, for the price and terms set forth in the Stock Restriction Agreement (as discussed below). In the event

that the other shareholders do not exercise their option to purchase the Offering shareholder's shares, then the Offering shareholder would be permitted to sell his or her shares to the third party, provided that the third party purchases such shares for the price and terms set forth in the bona fide offer and agrees to be bound by all of the terms and conditions of the Stock Restriction Agreement.

4. **Termination of Employment of a Shareholder.** In the event of the termination (voluntary or involuntary) of a shareholder's employment for any reason other than death or disability with the corporation, the corporation and/or the remaining shareholders may either be *required* to purchase all of the shares of stock of the corporation owned by the terminated shareholder for the price and in accordance with the terms set forth in the Stock Restriction Agreement (as discussed below), or have the *option* to purchase all of the shares of stock of the corporation owned by the terminated shareholder for such price and terms.

5. **Death of a Shareholder.** In the event of the death of a shareholder, the Stock Restriction Agreement could provide for any of the following four alternatives:

(a) the corporation and/or the remaining shareholders could be *required* to purchase all of the shares of stock of the corporation owned by the deceased shareholder;

(b) the corporation and/or the remaining shareholders could have the *option* to purchase all of the shares of stock of the corporation owned by the deceased shareholder;

(c) the corporation and the remaining shareholders could neither have the right nor the option to purchase the shares of stock of the corporation owned by the deceased shareholder;  
or

(d) the deceased shareholder's estate could have the option to sell the shares of stock owned by the deceased shareholder to the corporation and/or the remaining shareholder.

This is a matter which you should discuss at length.

6. **Disability of a Shareholder.** In the event of the disability of a shareholder, you again must consider whether there will be a *mandatory* purchase of a disabled shareholder's shares, an *optional* purchase of a disabled shareholder's shares (and whether

the option will be the option of the corporation and the remaining shareholders or the option of the disabled shareholder), or whether the disability of a shareholder will *not* trigger the purchase and sale of the disabled shareholder's shares pursuant to the terms of the Stock Restriction Agreement.

**7. *Voluntary and Involuntary Transfers in Violation of the Stock Restriction Agreement.*** In the case of any attempted transfer (whether voluntary or involuntary) of shares of stock of the corporation in violation of the terms of the Stock Restriction Agreement, the corporation and/or the other shareholders will be given the option to purchase such shares for the price and in accordance with the terms for which the shares were sold, or, at the option of the remaining shareholders, for the price and in accordance with the terms set forth in the Stock Restriction Agreement (as discussed below).

**8. *Purchase Price.*** The determination of the purchase price for any shares of stock to be purchased pursuant to the Stock Restriction Agreement is one of the most important decisions you must make. The purchase price set forth in the Stock Restriction Agreement will govern the purchase price to be paid for any shares that are purchased by the corporation or the remaining shareholders pursuant to the Stock Restriction Agreement. The purchase price set forth in the Stock Restriction Agreement may be determined in a number of ways. I have set forth below some approaches which may be used to determine the purchase price for the corporation's shares based on fair market value:

(a) *Formula Price.* The purchase price may be based upon a predetermined formula set forth in the Stock Restriction Agreement. This formula could, for example, be based upon some type of multiplier of the revenues (gross or net) of the corporation.

(b) *Appraised Value.* The purchase price may be based upon an appraisal of the value of the corporation at the time of purchase. Under this method, the selling shareholder and the corporation would select an appraiser to determine the value of the corporation. If the selling shareholder and the corporation could not agree on a single appraiser, the selling shareholder would select an appraiser, and the corporation would select an appraiser, and the two appraisers would then select a third

appraiser, and the average of the three appraisals would determine the value of the corporation.

(c) *Agreed-Upon Value*. Another mechanism which may be used to establish the purchase price is to have the shareholders agree at each annual shareholders' meeting on the value of the corporation, and to attach a Certificate of Value evidencing such value to the Stock Restriction Agreement. Under this method, the most recent valuation of the corporation attached to the Stock Restriction Agreement would determine the purchase price. A major shortcoming of this method is that the shareholders may fail to establish a value each year, and in such case, the valuation may not accurately reflect the current market value of the corporation.

(d) *Agreed-Upon Value with Back-Up Value*. Under this method of determining the purchase price, the shareholders would agree to determine a value for the corporation at each annual shareholders' meeting. If, however, the shareholders fail to meet and agree on a value for any given year, a back-up value would be used which could either be based upon a formula purchase price or a purchase price based upon an appraisal of the corporation. In this manner, if the shareholders fail to meet each year to establish a value for the corporation, the shareholders will not be forced to use an old valuation, but rather, will be able to use the back-up formula valuation or the back-up appraisal valuation, as the case may be.

9. *Terms of Purchase*. In the event of the death of a shareholder, the purchase price for the deceased shareholder's shares would be payable in cash at closing to the extent of any life insurance proceeds that are payable to the corporation and/or the remaining shareholders on account of the death of the deceased shareholder. The balance of the purchase price (or the entire purchase price where no life insurance is maintained on the deceased shareholder or the purchase is triggered by the disability of the shareholder or the termination of the shareholder's employment with the corporation), would be payable in equal monthly installments over some period of time (5 or 6 years for example) at an agreed-upon interest rate, such as the prime rate as established by a national banking institution. The deferred portion of the purchase price would be evidenced by a promissory note and

secured by a pledge of the stock of the corporation purchased in the transaction.

You should consider funding the purchase of a deceased shareholder's shares with life insurance maintained on your lives. This will allow the remaining shareholders to continue operation of the business without imposing a cash flow burden on the remaining shareholders, and additionally, permit the deceased shareholder's estate to receive cash for the deceased shareholder's interest in the corporation (thus easing liquidity problems which may be faced by the deceased shareholder's estate).

In the event of an attempted voluntary transfer of any shares of stock of the corporation in violation of the terms of the Stock Restriction Agreement, the purchase price would be payable in 10 equal annual installments, with no interest payable on the deferred portion of the purchase price.

In all cases, the corporation or the purchasing shareholder should be given the right to offset any amounts owed by the selling shareholder to the corporation and/or to the remaining shareholders against any amounts payable by the corporation and/or the remaining shareholders to the selling shareholder for the selling shareholder's shares.

**10. Issuance of Additional Stock.** The Stock Restriction Agreement will provide that the corporation may not issue additional shares of its stock to any individual or entity, or revise its capital structure (other than the borrowing of funds), without the unanimous consent of the shareholders.

**11. S corporation Provisions.** If the corporation is an S corporation, a number of special provisions concerning the S corporation status of the corporation should be addressed in the Stock Restriction Agreement. At a minimum, the following provisions should be considered for inclusion in the Stock Restriction Agreement:

(a) *Actions Revoking S Status.* The Stock Restriction Agreement should prohibit the shareholders from taking any action which would cause the corporation to lose its status as an S corporation, unless the shareholders (by a majority, supermajority or unanimous consent) agree to such action. Additionally, this provision should specifically provide that any transfer of

shares by a shareholder that would cause the corporation to lose its status as an S corporation will be void and of no effect.

(b) *Mandatory Dividends.* The Stock Restriction Agreement may contain a provision which will require the corporation to make minimum distributions in the amount necessary to cover the shareholders' tax liability for their pro rata shares of the corporation's income to be reported on their individual income tax returns.

(c) *Termination of Taxable Year in the Event of Sale and Purchase of All of a Shareholder's Shares of Stock.* The Stock Restriction Agreement may require all of the shareholders of the corporation to make a special election under the Internal Revenue Code which would have the effect of closing the books of the corporation on the date a shareholder sells all of his or her stock in the corporation. This will result in an equitable allocation of the income and losses of the corporation up to the date of the sale, so that the selling shareholder will not share in any income or losses of the corporation after the date of the sale.

(d) *Effective Date of Purchase of a Deceased Shareholder's Shares.* The Stock Restriction Agreement may provide that the closing with respect to the purchase of a deceased shareholder's shares will be effective as of the date of the deceased shareholder's death. In this manner, any increase in the basis of the shareholder's stock resulting from the receipt by the corporation of any insurance proceeds maintained on the life of the deceased shareholder will benefit the remaining shareholders (and not the deceased shareholder). This is important because an increased basis for the remaining shareholders will allow greater tax-free distributions to be made to him or her as well as decrease the amount of gain which he or she will ultimately recognize in the event of the sale of the business to a third party. The estate of a deceased shareholder should not be permitted to benefit from this basis increase since the deceased shareholder's estate already will have received an increased basis equal to the fair market value of the shares as of the date of the shareholder's death.

After you have had an opportunity to review and discuss this letter, please contact me with any questions or comments.

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DRAFTING SHAREHOLDER AGREEMENTS

§ 18.08

Sincerely,

\_\_\_\_\_

§ 18.08 Form of Shareholder Agreement

**STOCK RESTRICTION AGREEMENT  
FOR**

\_\_\_\_\_

**THIS STOCK RESTRICTION AGREEMENT FOR**  
\_\_\_\_\_ (hereinafter referred to as the “Agreement”) is made and entered into this \_\_\_\_\_ day of \_\_\_\_\_, 2001, by and among \_\_\_\_\_, a \_\_\_\_\_ corporation hereinafter referred to as the “Corporation”), and \_\_\_\_\_, \_\_\_\_\_ and \_\_\_\_\_ (hereinafter individually referred to as a “Shareholder” and collectively referred to as the “Shareholders”). As used herein, the terms “Shareholder” and “Shareholders” shall also refer to any future shareholders of the Corporation who become subject to the terms and conditions of this Agreement.

**WHEREAS**, the Shareholders own all of the issued and outstanding shares of stock of the Corporation as follows:

<i>Shareholder</i>	<i>Number of Shares</i>
_____	_____
_____	_____
_____	_____
	Total _____

**WHEREAS**, the Shareholders of the Corporation believe it is in their best interests to place certain restrictions on the sale, assignment, gift, pledge, encumbrance or other disposition of the shares of stock of the Corporation; and

**WHEREAS**, the Shareholders and the Corporation desire to set forth in this Agreement their agreements and understandings regarding the ownership of shares of stock of the Corporation.

**NOW, THEREFORE**, in consideration of the mutual promises and covenants contained herein, the parties hereto agree as follows:

1. *Restriction on Transfer.* The Shareholders of the Corporation shall not, while this Agreement is in force, sell, assign,

encumber, pledge, transfer, gift or otherwise dispose of any of the shares of stock of the Corporation, whether now owned or hereafter acquired by them (hereinafter referred to as the “Shares”), except pursuant to, and in compliance with, the terms of this Agreement.

2. *Transfers to Family Members.* Notwithstanding anything in this Agreement to the contrary, a Shareholder may transfer his or her Shares during such Shareholder’s lifetime, or at death, pursuant to the terms of a valid will, trust or by intestate succession, to a member (or members) of such Shareholder’s “Immediate Family” (as defined below) or to a “Family Trust” (as defined below); provided, however, that such family member (or members) or the trustee of such Family Trust (hereinafter referred to as the “Trustee”), must agree in writing to be bound by all of the terms and conditions of this Agreement, including any amendments made on or prior to the date of such transfer.

(a) *Immediate Family.* For purposes of this Agreement, the “Immediate Family” of a Shareholder shall mean only the ancestors, lineal descendants or spouse of such Shareholder. For purposes of determining members of a Shareholder’s Immediate Family under this Agreement, an adopted child shall be considered a natural born child of his or her adoptive parents and the adoptive parents shall be considered to be the only parents of such adopted child.

(b) *Family Trust.* For purposes of this Agreement, a trust shall qualify as a “Family Trust” only: (i) if such trust is either for the exclusive benefit of the Shareholder and/or members of such Shareholder’s Immediate Family or provides for an income interest only for the spouse of such Shareholder (either alone or in conjunction with one or more other members of such Shareholder’s Immediate Family) and all of the remaindermen of such trust are members of the Shareholder’s Immediate Family; (ii) if the Trustees of such trust are all members of a class consisting of the respective Shareholder, members of such Shareholder’s Immediate Family and corporate fiduciaries; and (iii) **if, in the event the Corporation is (at the time of the applicable transfer) an “S” corporation as defined in § 1361(a)(1) of the Internal Revenue Code of 1986, as amended, or any successor provision thereto (hereinafter referred to as the “Code”), such trust is a trust described in § 1361(c)(2) of the Code, including, but not limited to, a trust described in § 1361(d) of the**

**Code, the beneficiary of which has filed a valid election in accordance with § 1361(d)(2) of the Code to have such trust treated as a “Qualified Subchapter S Trust,” or a trust described in § 1361(e) of the Code, the trustee of which has filed a valid election in accordance with § 1361(e)(3) of the Code to have the trust treated as an “Electing Small Business Trust.”** For purposes of this Agreement, the “Immediate Family” of a Shareholder which is a Family Trust shall include the grantor of such trust and the members of the Immediate Family of the grantor of such trust, and the death of the individual who is considered under the Code to be the owner of that portion of the trust consisting of Shares of the Corporation shall be considered to be the death of the Shareholder. Any transfer from a Family Trust to a beneficiary of such Family Trust shall, for purposes of this Agreement, be deemed as if it were a transfer directly from the grantor of such trust to such beneficiary.

3. *Sale of Shares to Third Party.* If, at any time while this Agreement is in force, a Shareholder (hereinafter referred to as the “Offering Shareholder”) desires to sell, exchange, encumber or transfer all or any portion of his or her Shares (other than as expressly permitted pursuant to Paragraph 2 above), and the Offering Shareholder obtains a “bona fide offer from a qualified third party purchaser” (as defined in Subparagraph 3(a) below) to purchase such Shares, the Offering Shareholder shall first offer such Shares for sale in accordance with the provisions of this Paragraph 3.

(a) *Notice of Bona Fide Offer.* If the Offering Shareholder desires to accept the bona fide offer from the qualified third party purchaser, the Offering Shareholder shall deliver a copy of such offer to the Corporation and to the other Shareholders, together with a written offer from the Offering Shareholder to sell such Shares (hereinafter referred to as the “Offered Shares”) to the Corporation and to the other Shareholders in accordance with the terms and conditions of this Agreement. As used herein, a “bona fide offer from a qualified third party purchaser” shall mean a written and binding offer from any party, including, but not limited to, existing Shareholders, who is not a member of the Offering Shareholder’s Immediate Family, that: (i) sets forth the proposed purchase price and terms of the proposed purchase and

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sale of the Offered Shares; (ii) is accompanied by an earnest money deposit in an amount not less than \_\_\_\_\_ percent (\_\_\_\_%) of the proposed purchase price for the Offered Shares; and (iii) **is from a permitted S corporation shareholder under Subchapter S of the Code who has the financial ability to consummate the purchase.**

(b) *Right of First Refusal by Corporation.* The Corporation shall have the first option to purchase all, but not less than all, of the Offered Shares for the price and in accordance with the terms set forth in said bona fide offer **or, at the option of the Corporation, for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below.** If the Corporation desires to exercise its option to purchase all, but not less than all, of the Offered Shares, it shall notify the Offering Shareholder and the other Shareholders in writing within forty-five (45) days after the date of the Corporation's receipt of the Offering Shareholder's offer to sell the Offered Shares (as provided in Subparagraph 3(a) above) that the Corporation is exercising its option to purchase all of the Offered Shares **and whether it intends to purchase the Offered Shares for the price and in accordance with the terms set forth in the bona fide offer or for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below.** The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 3(b) shall occur at a reasonable time and place selected by the Corporation, which in no event shall be later than the date which is thirty (30) days after the date of expiration of the forty-five (45) day period during which the Corporation had the option to purchase the Offered Shares pursuant to Subparagraph 3(a) above.

(c) *Right of Second Refusal by Other Shareholders.* If the Corporation fails or is unable to exercise its option to purchase all of the Offered Shares pursuant to Subparagraph 3(b) above, then the other Shareholders shall have the option to purchase their "Proportionate Share," as defined in Subparagraph 3(d) below (or other mutually agreeable portion), of the Offered Shares for the price and in accordance with the terms set forth in said bona fide offer **or, at the option of each of the other Shareholders, for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below.** If any or all of the other Shareholders desire to exercise their option to purchase their Proportionate

Share (or other mutually agreeable portion) of the Offered Shares, such Shareholders shall notify the Offering Shareholder, the Corporation and the other Shareholders in writing within forty-five (45) days after the date of expiration of the forty-five (45) day period specified in Subparagraph 3(b) above during which the Corporation had the option to purchase all of the Offered Shares, that such Shareholder is exercising his option to purchase his Proportionate Share (or other mutually agreeable portion) of the Offered Shares **and whether he intends to purchase the Offered Shares for the price and in accordance with the terms set forth in the bona fide offer or for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below.** The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 3(c) shall occur at a reasonable time and place selected by a majority of the other Shareholders who elect to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares, which in no event shall be later than the date which is thirty (30) days after the date of expiration of the forty-five (45) day period during which the other Shareholders had the option to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares pursuant to this Subparagraph 3(c).

(d) *Proportionate Share.* As used in this Agreement, the term “Proportionate Share” shall mean the portion of the Offered Shares (or other Shares available for purchase hereunder) determined by multiplying the number of the Offered Shares (or other Shares available for purchase hereunder) by a fraction, the numerator of which is the number of Shares owned by each Shareholder who is entitled to and who elects to purchase his or her Proportionate Share of the Offered Shares (or other Shares available for purchase hereunder), and the denominator of which is the total number of Shares owned by all of the Shareholders who are entitled to and who elect to purchase their Proportionate Share of the Offered Shares (or other Shares available for purchase hereunder) pursuant to this Agreement. For example, if only one of the other Shareholders elects to purchase such Shareholder’s Proportionate Share of the Offered Shares (or other Shares available for purchase hereunder) pursuant to this Agreement, then such other Shareholder shall be entitled to, and shall

be required to, purchase all of the Offered Shares (or other Shares available for purchase hereunder).

(e) *Failure to Exercise Option.* If the Corporation and the other Shareholders fail to exercise their respective options to purchase all of the Offered Shares pursuant to this Paragraph 3, the Offering Shareholder may sell the Offered Shares to the third party purchaser designated in his written offer for the price and in accordance with the terms set forth in such written offer for a period of sixty (60) days following the date of expiration of the forty-five (45) day period specified in Subparagraph 3(c) above during which the other Shareholders had the option to purchase their Proportionate Share of the Offered Shares; provided, however, that such third party purchaser must agree in writing to be bound by all of the terms and conditions of this Agreement, including any amendments made to this Agreement on or prior to the date of such purchase, **and to assume and agree to discharge any obligation, debt or liability, in accordance with the terms of such obligation, debt or liability, of the Offering Shareholder to the Corporation, which assumption shall not constitute a novation or release of the Offering Shareholder by the Corporation.** At the expiration of said sixty (60) day period, the Offered Shares shall again be subject to all of the applicable requirements contained in this Agreement before the Offering Shareholder may transfer, sell, assign, encumber, pledge, gift or otherwise dispose of the Offered Shares.

(f) *Right of Offset.* **Notwithstanding anything contained in this Paragraph 3 to the contrary, and regardless of whether the Offered Shares are purchased for the price and in accordance with the terms set forth in the bona fide offer or for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below, the Corporation or the other Shareholder, as the case may be, shall have the right of offset set forth in Subparagraph 7(c) below.**

4. *Death of a Shareholder.* Except in the case of the transfer of a deceased Shareholder's Shares in accordance with the provisions of Paragraph 2 above, upon the death of a Shareholder, the Corporation and the other Shareholders shall have the right and option to purchase all, but not less than all, of the Shares (hereinafter referred to as the "Offered Shares") owned by the deceased

Shareholder in accordance with the terms and conditions set forth in this Paragraph 4, and upon the exercise of such option, the personal representative of the deceased Shareholder's estate, the trustee, heirs, beneficiaries or any other successor in interest to the deceased Shareholder's Shares, as the case may be (hereinafter referred to as the "Offering Shareholder"), shall be obligated to sell to the Corporation or to the other Shareholders all of the Offered Shares in accordance with the terms and conditions set forth in this Paragraph 4.

(a) *Corporation's Option to Purchase.* Upon the death of a Shareholder, the Corporation shall have the first option to purchase all, but not less than all, of the Offered Shares for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below. If the Corporation desires to exercise its option to purchase all, but not less than all, of the Offered Shares pursuant to this Subparagraph 4(a), the Corporation shall notify the Offering Shareholder and the other Shareholders in writing within forty-five (45) days after the date of death of the deceased Shareholder, that the Corporation is exercising its option to purchase all of the Offered Shares pursuant to the terms and conditions hereof.

The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 4(a) shall be effective as of the date of the deceased Shareholder's death and shall occur at a reasonable time and place selected by the Corporation, which in no event shall be later than the date thirty (30) days after the date of expiration of the forty-five (45) day period during which the Corporation had the option to purchase all of the Offered Shares in accordance with this Subparagraph 4(a).

(b) *Remaining Shareholders' Option to Purchase.* If the Corporation fails or is unable to exercise its option to purchase all of the Offered Shares pursuant to Subparagraph 4(a) above, then the remaining Shareholders shall have the option to purchase their Proportionate Share, as defined in Subparagraph 3(d) above (or other mutually agreeable portion), of the Offered Shares for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below. If any or all of the remaining Shareholders desire to exercise their option to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares, such

Shareholders shall notify the Offering Shareholder, the Corporation, and the other Shareholders in writing within forty-five (45) days after the date of expiration of the forty-five (45) day period specified in Subparagraph 4(a) above during which the Corporation had the option to purchase all of the Offered Shares, that such Shareholder is exercising his option to purchase his Proportionate Share (or other mutually agreeable portion) of the Offered Shares. The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 4(b) shall be effective as of the date of the deceased Shareholder's death and shall occur at a reasonable time and place selected by a majority of the remaining Shareholders who elect to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares, which in no event shall be later than the date which is thirty (30) days after the date of expiration of the forty-five (45) day period during which the remaining Shareholders had the option to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares pursuant to this Subparagraph 4(b).

**(c) *Purchase by Remaining Shareholders.* If the Corporation fails or is unable to exercise its option to purchase all of the Offered Shares pursuant to Subparagraph 4(a) above, then the remaining Shareholders shall purchase their Proportionate Share, as defined in Subparagraph 3(d) above (or other mutually agreeable portion) of the Offered Shares for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below, and the Offering Shareholder shall sell to the remaining Shareholders, all of the Offered Shares for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below. The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 4(b) shall be effective as of the date of the deceased Shareholder's death and shall occur at a reasonable time and place selected by majority of the remaining Shareholders, which in no event shall be later than the date thirty (30) days after the date of expiration of the forty-five (45) day period during which the Corporation had the option to purchase all of the Offered Shares pursuant to Subparagraph 4(a) above.**

**(d) *Failure to Exercise Option.*** If the Corporation and the remaining Shareholders fail to exercise their respective options to purchase the Offered Shares pursuant to this Paragraph 4, the

Offering Shareholder shall be permitted to retain the Offered Shares; provided, however, that the Offering Shareholder must agree in writing to be bound by all of the terms and conditions of this Agreement, including any amendments made to this Agreement on or prior to the date that the Offering Shareholder received the Offered Shares, **and to assume and agree to discharge any obligation, debt or liability, in accordance with the terms of such obligation, debt or liability, of the deceased Shareholder to the Corporation, which assumption shall not constitute a novation or release of the estate of the deceased Shareholder.**

(e) *Life Insurance.* **Notwithstanding anything contained in this Agreement to the contrary, in the event the Corporation receives (or will receive) life insurance proceeds under a life insurance policy (or policies) maintained by the Corporation on the life of the deceased Shareholder, the Corporation shall be required (rather than have the option) to purchase the Offered Shares. Additionally, notwithstanding anything contained in this Agreement to the contrary, in the event the remaining Shareholders receive (or will receive) life insurance proceeds under a life insurance policy (or policies) maintained on the life of the deceased Shareholder, the Corporation shall not have the option to purchase the Offered Shares, but the remaining Shareholders shall remain obligated to purchase all of the Offered Shares as provided in Subparagraph 4(b) above.**

*5. Termination of Shareholder's Employment with the Corporation.* Upon the termination of a Shareholder's employment with the Corporation for any reason or for no reason (including, but not limited to, disability, resignation or retirement), and whether by the Corporation or by the Shareholder, the Corporation and the other Shareholders shall have the right and option to purchase all, but not less than all, of the Shares (hereinafter referred to as the "Offered Shares") owned by the terminated Shareholder in accordance with the terms and conditions set forth in this Paragraph 5, and upon the exercise of such option, the terminated Shareholder (hereinafter referred to as the "Offering Shareholder") shall be obligated to sell to the Corporation or to the other Shareholders, all of the Offered Shares in accordance with the terms and conditions set forth in this Paragraph 5.

(a) *Corporation's Option to Purchase.* Upon the termination of a Shareholder's employment with the Corporation, the Corporation shall have the first option to purchase all, but not less than all, of the Offered Shares for the price and in accordance with the terms set forth in Paragraphs 6 and 7 below. If the Corporation desires to exercise its option to purchase all, but not less than all, of the Offered Shares pursuant to this Subparagraph 5(a), the Corporation shall notify the Offering Shareholder and the other Shareholders in writing within forty-five (45) days after the date of termination of the Offering Shareholder's employment with the Corporation, that the Corporation is exercising its option to purchase all of the Offered Shares pursuant to the terms and conditions hereof. The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 5(a) shall occur at a reasonable time and place selected by the Corporation, which in no event shall be later than the date thirty (30) days after the date of expiration of the forty-five (45) day period during which the Corporation had the option to purchase all of the Offered Shares in accordance with this Subparagraph 5(a).

(b) *Other Shareholders' Option to Purchase.* If the Corporation fails or is unable to exercise its option to purchase all of the Offered Shares, then the other Shareholders shall have the option to purchase their Proportionate Share, as defined in Subparagraph 3(d) above (or other mutually agreeable portion), of the Offered Shares for the purchase price and in accordance with the terms set forth in Paragraphs 6 and 7 below. If any or all of the other Shareholders desire to exercise their option to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares, such Shareholders shall notify the Offering Shareholder, the Corporation and the other Shareholders in writing within forty-five (45) days after the date of expiration of the forty-five (45) day period specified in Subparagraph 5(a) above during which the Corporation had the option to purchase all of the Offered Shares that such Shareholder is exercising his option to purchase his Proportionate Share (or other mutually agreeable portion) of the Offered Shares. The closing of a purchase and sale of the Offered Shares pursuant to this Subparagraph 5(b) shall occur at a reasonable time and place selected by a majority of the other Shareholders who elect to purchase their Proportionate Share (or other mutually agreeable portion)

of the Offered Shares, which in no event shall be later than the date thirty (30) days after the date of expiration of the forty-five (45) day period during which the other Shareholders had the option to purchase their Proportionate Share (or other mutually agreeable portion) of the Offered Shares pursuant to this Subparagraph 5(b).

(c) *Failure to Exercise Option.* If the Corporation and the other Shareholders fail to exercise their respective options to purchase the Offered Shares pursuant to this Paragraph 5, the Offering Shareholder shall be permitted to retain the Offered Shares and shall remain subject to all the terms and conditions of this Agreement, **but such Offering Shareholder shall not have the option to purchase his Proportionate Share of any future Shares which may be available for purchase hereunder.**

6. *Purchase Price.* Except as otherwise provided herein, the purchase price for any Shares to be sold and purchased hereunder shall be determined by the accountant regularly utilized by the Corporation in the manner prescribed in Subparagraphs 6(a) through 6(f) below.

(a) *Book Value.* The net book value of the Corporation as of the Valuation Date (as defined below) shall be determined by the accountant regularly utilized by the Corporation. Such accountant's determination of the net book value of the Corporation shall be binding on the parties hereto. In determining the net book value of the Corporation, the accountant making such determination shall use the method of accounting used by the Corporation for federal income tax purposes.

(b) *Appraisal of Real Estate.* The fair market value of any real property, together with any and all improvements located thereon which are owned by the Corporation (hereinafter referred to as the "Real Estate") as of the "Valuation Date" (as defined in Subparagraph 6(f) below), shall be determined by a qualified MAI appraiser mutually acceptable to the selling party or parties and to the buying party or parties. **In the event the fair market value of the Real Estate has been appraised on behalf of the Corporation by an MAI appraiser in accordance with the standards set forth in this Agreement during the six (6) month period preceding the Valuation Date, such appraisal shall be used to determine the value of the Real Estate as of the**

**Valuation Date.** In the event that such parties cannot mutually agree upon the selection of a qualified MAI appraiser, the selling party or parties shall select a qualified MAI appraiser with experience in appraising similar properties in the \_\_\_\_\_ area and the buying party or parties shall select a qualified MAI appraiser with experience in appraising similar properties in the \_\_\_\_\_ area. The two (2) appraisers so selected shall select a third appraiser. Each of the three (3) appraisers so selected shall then appraise the Real Estate as of the Valuation Date and, for purposes of this Agreement, the fair market value of the Real Estate shall be determined by averaging the three appraisals. The cost of all appraisals shall be borne fifty percent (50%) by the selling party or parties and fifty percent (50%) by the purchasing party or parties.

(c) *Adjusted Net Book Value.* The “adjusted net book value” of the Corporation as of the Valuation Date shall be determined by increasing the net book value of the Corporation as determined under Subparagraph 6(a) above, by the excess of the fair market value of any Real Estate owned by the Corporation as determined pursuant to Subparagraph 6(b) above, over such Real Estate’s book value (cost less accumulated depreciation) as determined pursuant to Subparagraph 6(a) above, or, in the event that the book value of any Real Estate exceeds the fair market value of such Real Estate, by decreasing the net book value of the Corporation as determined under Subparagraph 6(a) above, by the excess of the book value of any Real Estate owned by the Corporation as determined pursuant to Subparagraph 6(a) above, over the fair market value of such Real Estate as determined pursuant to Subparagraph 6(b) above.

(d) *Per Share Value.* The “adjusted net book value” of the Corporation as determined pursuant to Subparagraph 6(c) above shall then be divided by the number of Shares issued and outstanding as of the Valuation Date to determine the “adjusted net book value per share.”

(e) *Total Purchase Price.* The total purchase price for the Shares to be purchased and sold hereunder shall be equal to the product of the “adjusted net book value per share” as determined pursuant to Subparagraph 6(d) above, multiplied by the number

of Shares owned by the selling Shareholder or Shareholders to be purchased by the Corporation or the Purchasing Shareholder hereunder.

(f) *Valuation Date.* As used in this Paragraph 6, the term “Valuation Date” shall mean the last day of the month immediately preceding the date of the Shareholder’s offer to sell his Shares to the Corporation or to the other Shareholders pursuant to Paragraph 3 above, the date of death of a Shareholder, the date of termination of a Shareholder’s employment with the Corporation or the date of the transfer of any Shares in violation of this Agreement, as the case may be.

7. *Terms of Sale.* Unless otherwise provided in this Agreement, the purchase price of any Shares to be purchased and sold under this Agreement shall be payable as prescribed in Subparagraphs 7(a) through 7(c) below.

(a) *Terms of Purchase in the Event of Purchase and Sale Pursuant to Paragraph 3, 4 or 5 or Involuntary Purchase and Sale Pursuant to Paragraph 8.* In the event of a purchase and sale of Shares pursuant to the provisions of Paragraph 3, 4 or 5 of this Agreement, or in the event of a purchase and sale of Shares involuntarily transferred in violation of this Agreement pursuant to the terms of Paragraph 8 below, the total purchase price for the Shares to be purchased and sold hereunder shall be payable in the following manner:

(i) *Cash Down Payment.* The purchaser of any Shares to be purchased and sold hereunder (hereinafter referred to as the “Purchaser”) shall make a cash payment at closing equal to \_\_\_\_\_ percent (\_\_\_\_\_% ) of the total purchase price for such Shares.

**(i) *Cash Down Payment.* The purchaser of any Shares to be purchased and sold hereunder (hereinafter referred to as the “Purchaser”) shall make a cash payment at closing equal to the greater of: the life insurance proceeds on the life of the deceased Shareholder payable to the Purchaser by reason of the death of the deceased Shareholder (not to exceed the total purchase price for the Shares); or ten percent (10%) of the total purchase price for the Shares to be sold and purchased hereunder. Notwithstanding the**

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**foregoing, in the event the Purchaser of a deceased Shareholder's Shares has not received the life insurance proceeds which are payable to such Purchaser as of the date of the closing hereunder, the cash payment equal to the greater of the life insurance proceeds or ten percent (10%) of the total purchase price shall be paid by the Purchaser to the deceased Shareholder's estate immediately upon the receipt of such life insurance proceeds by the Purchaser.**

(ii) *Deferred Payments.* The balance of the purchase price shall be payable in \_\_\_\_\_ (\_\_\_\_\_) equal monthly installments of principal and interest at the rate determined in accordance with Subparagraph 7(a)(iv) below. The first such installment shall be payable on the date one month after the date of the closing of such purchase and sale and additional installments shall be made on the same day of each of the next \_\_\_\_\_ (\_\_\_\_\_) consecutive months thereafter (hereinafter referred to as the "Payment Dates").

(iii) *Promissory Note.* The obligation for the deferred portion of the purchase price shall be represented by a promissory note containing the terms described above and such other terms and conditions as are standard for similar transactions in the \_\_\_ area, including, but not limited to, the right of prepayment without premium or penalty at any time. **The obligations of the Purchaser or Purchasers under the promissory note shall be secured by a pledge of the Shares sold to the Purchaser or the Purchasers which Shares shall be held in escrow by an Escrow Agent reasonably acceptable to the Purchaser or Purchasers pending full payment of the promissory note. The Stock Pledge Agreement contemplated hereunder shall be in form reasonably satisfactory to counsel for the selling Shareholder or Shareholders.**

(iv) *Interest Rate.* Interest shall be payable monthly on the Payment Dates and shall accrue on the unpaid principal balance at a rate equal to the lowest rate which may be utilized without incurring any "original issue discount" as defined in § 1273 of the Code, which rate shall be determined as of the date of the event first creating a binding obligation to purchase and sell under this Agreement. **Interest shall be payable monthly on the Payment Dates and shall accrue on the unpaid**

**principal balance at a rate equal to the “prime rate” as publicly announced by \_\_\_\_\_, as its prime rate, which rate shall be determined as of the date of the event first creating a binding obligation to purchase and sell under this Agreement.**

(b) *Terms of Purchase in Event of Transfer In Violation of Agreement.* Notwithstanding the foregoing, the purchase price for any Shares voluntarily transferred in violation of this Agreement (hereinafter referred to as the “Transferred Shares”), to be purchased pursuant to the provisions of Paragraph 8 below, shall be payable in cash at closing or, at the option of the Purchaser or Purchasers, with no cash down payment and with the balance payable in ten (10) equal consecutive annual installments of principal, without interest. Each such installment shall be due and payable on the anniversary of the closing of the purchase and sale of the Transferred Shares under this Agreement. The obligation of the Purchaser or Purchasers to pay the deferred portion of the purchase price shall be evidenced by a non-negotiable unsecured promissory note (or notes) bearing the terms and conditions set forth above and such other terms and conditions as are customary for similar transactions in the \_\_\_\_\_ area, including, but not limited to, the right of prepayment without premium or penalty at any time.

(c) *Right of Offset.* Notwithstanding anything contained in this Paragraph 7 to the contrary, the Corporation shall have a right to offset the amount of any indebtedness, together with any accrued and unpaid interest thereon, owed to the Corporation by the Offering Shareholder or by the Transferor of the Transferred Shares, as the case may be, against any amounts payable by the Corporation to the Offering Shareholder or the Holder (as defined in Paragraph 8 below) of the Transferred Shares (hereinafter referred to as the “Selling Shareholder”) for any Shares to be sold and purchased hereunder, regardless of whether such indebtedness is evidenced by a promissory note (or notes) or whether such indebtedness has matured. In the event that such indebtedness is due and payable, the Corporation may offset the full amount of such indebtedness, together with any accrued and unpaid interest thereon, against any amounts payable by the Corporation to the Selling Shareholder for the Shares to be

**purchased hereunder. In the event that such indebtedness is not yet due and payable, the Corporation may offset the present value (based upon an interest rate equal to the interest rate announced by \_\_\_\_\_, as its prime rate as of the date of closing), of such indebtedness, together with any accrued and unpaid interest thereon, against any amounts payable by the Corporation to the Selling Shareholder for the Shares to be purchased hereunder.**

**In the event that the purchaser or purchasers are one or more of the other Shareholders (hereinafter referred to as the “Purchasing Shareholders”), rather than the Corporation, then such Purchasing Shareholders shall have the right to offset the amount of such Purchasing Shareholder’s “Portion” (as defined below) of any indebtedness owed to the Corporation by the Offering Shareholder or the Transferor of the Transferred Shares, together with any accrued and unpaid interest thereon, against any amounts payable by the Purchasing Shareholder to the Selling Shareholder for the Shares to be purchased hereunder, regardless of whether such indebtedness is evidenced by a promissory note (or notes) or whether such indebtedness has matured. In the event that such indebtedness is due and payable, the Purchasing Shareholders may offset their respective Portions of the full amount of such indebtedness, together with any accrued and unpaid interest thereon, against any amounts payable by the Purchasing Shareholders to the Selling Shareholder for the Shares to be purchased hereunder. In the event that such indebtedness is not yet due and payable, the Purchasing Shareholders may offset their respective Portions of the present value (based upon an interest rate equal to the interest rate announced by \_\_\_\_\_, as its prime rate as of the date of closing) against any amounts payable by the Purchasing Shareholders to the Selling Shareholder for the Shares to be purchased hereunder. As used in this Subparagraph 7(c), a Shareholder’s “Portion” of any indebtedness owed to the Corporation by the Offering Shareholder or the Transferor of the Transferred Shares, as the case may be, shall be determined by multiplying the amount of such indebtedness by a fraction, the numerator of which is the number of the Shares of the Selling Shareholder being purchased by such**

**Purchasing Shareholder, and the denominator of which is the total number of Shares owned by the Selling Shareholder which are being purchased by all of the Purchasing Shareholders under this Agreement. In the event that one or more of the other Shareholders exercises such Shareholder's right of offset under this Subparagraph 7(c), the amount of such offset as determined pursuant to this Subparagraph 7(c) must be immediately paid by such other Shareholder to the Corporation on behalf of the Offering Shareholder or the Transferor of the Transferred Shares.**

**Any offset made pursuant to this Subparagraph 7(c) shall be credited against the earliest amounts payable to the Selling Shareholder by the Corporation or the Purchasing Shareholders, as the case may be, for the Shares to be purchased hereunder.**

8. *Remedy for Violation.* Upon any completed or attempted sale, transfer, pledge, gift, encumbrance or other disposition of any Shares in violation of the provisions of this Agreement, whether voluntary or involuntary, in addition to any other remedies available at law or in equity, the Corporation and the other Shareholders shall have the right and option to purchase all or any part of the Shares transferred (or attempted to be transferred) in violation of this Agreement (hereinafter referred to as the "Transferred Shares") in accordance with the terms and conditions set forth in this Paragraph 8, and upon exercise of such option, the holder of the Shares transferred (or attempted to be transferred) in violation of this Agreement (hereinafter referred to as the "Holder") shall be obligated to sell the Transferred Shares to the Corporation and/or to the other Shareholders in accordance with the terms and conditions set forth in this Paragraph 8.

(a) *Corporation's Option to Purchase.* Upon the completed or attempted transfer of any Shares in violation of the provisions of this Agreement, the Corporation shall have the first option to purchase all or any portion of the Transferred Shares for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above, or if the Transferred Shares were transferred (or attempted to be transferred) by sale or exchange (as opposed to a gratuitous transfer), at the option of the Corporation, for the price and in accordance with the terms for which

such Shares were sold or exchanged (or attempted to be sold or exchanged) in violation of the provisions of this Agreement. If the Corporation desires to exercise its option to purchase all or any portion of the Transferred Shares pursuant to this Paragraph 8, the Corporation shall notify the Holder and the other Shareholders in writing within sixty (60) days after the date the Corporation first discovers the transfer in violation of the provisions of this Agreement: (i) that the Corporation is exercising its option to purchase the Transferred Shares; (ii) the number of the Transferred Shares it intends to purchase; and (iii) whether it intends to purchase the Transferred Shares (or portion thereof) for the price and in accordance with the terms for which such Transferred Shares were sold or exchanged (or attempted to be sold or exchanged) in violation of the provisions of this Agreement or for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above. The closing of a purchase and sale of the Transferred Shares (or a portion thereof) pursuant to this Subparagraph 8(a) shall occur at a reasonable time and place selected by the Corporation, which in no event shall be later than the date thirty (30) days after the date of notice from the Corporation to the Holder that the Corporation is exercising its option to purchase the Transferred Shares pursuant to this Subparagraph 8(a).

(b) *Other Shareholders' Option to Purchase.* If the Corporation fails or is unable to purchase all of the Transferred Shares pursuant to Subparagraph 8(a) above, then the other Shareholders shall have the option to purchase their Proportionate Share, as defined in Subparagraph 4(d) above (or other mutually agreeable portion), of the Transferred Shares for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above, or if the Transferred Shares were transferred (or attempted to be transferred) by sale or exchange (as opposed to a gratuitous transfer), at the option of each purchasing Shareholder, for the price and in accordance with the terms for which such Shares were sold (or attempted to be sold) in violation of the terms of this Agreement. If any or all of the other Shareholders desire to exercise their option to purchase their Proportionate Share (or other mutually agreeable portion) of the Transferred Shares, such Shareholders shall notify the Holder, the Corporation and the other Shareholders in writing within

thirty (30) days after the date of expiration of the sixty (60) day period specified in Subparagraph 8(a) above during which the Corporation had the first option to purchase all or any portion of the Transferred Shares: (i) that such Shareholder is exercising his option to purchase his Proportionate Share (or other mutually agreeable portion) of the Transferred Shares; (ii) whether such Shareholder intends to purchase his Proportionate Share of the Transferred Shares or some other mutually agreeable portion of the Transferred Shares; and (iii) whether such Shareholder intends to purchase the Transferred Shares (or a portion thereof) for the price and in accordance with the terms for which such Transferred Shares were sold or exchanged (or attempted to be sold or exchanged) in violation of the provisions of this Agreement or for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above. The closing of a purchase and sale of the Transferred Shares (or portion thereof) pursuant to this Subparagraph 8(b) shall occur at a reasonable time and place selected by a majority of the other Shareholders who elect to purchase their Proportionate Share (or other mutually agreeable portion) of the Transferred Shares, which in no event shall be later than the date thirty (30) days after the date of expiration of the thirty (30) day period during which the other Shareholders had the option to purchase their Proportionate Share (or other mutually agreeable portion) of the Transferred Shares pursuant to this Subparagraph 8(b).

(c) *Failure to Exercise Options.* If the Corporation and the other Shareholders fail to purchase all of the Transferred Shares pursuant to their respective options under this Paragraph 8, the Holder shall be permitted to retain the Transferred Shares not purchased by the Corporation and/or the other Shareholders hereunder, and shall remain subject to all the terms and conditions of this Agreement **but the Holder shall not have the option to purchase his Proportionate Share of any future Shares that may become available for purchase hereunder.**

9. *Corporation's Exercise of Options.* Any decision to be made by the Corporation regarding its option to purchase any Shares hereunder, the price, terms of purchase, closing date or any other decision hereunder, shall be reserved to the Shareholders and shall be made by a vote of the holders of the majority of the issued and

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outstanding Shares entitled to vote; provided, however, that any Shareholder (or the personal representative of a deceased Shareholder's estate or other successor in interest) whose Shares are the subject of an option or decision shall have no vote in such decision, but such Shares shall be included in determining the number of outstanding Shares for purposes of determining the presence of a quorum.

**10. Cross-Purchase Insurance.**

**(a) Life Insurance Policies.** Within thirty (30) days after the execution of this Agreement, Shareholder A shall purchase and obtain a policy of life insurance insuring the life of Shareholder B with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_), and shall purchase and obtain a policy of life insurance insuring the life of Shareholder C with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_). Within thirty (30) days after the execution of this Agreement, Shareholder B shall purchase and obtain a policy of life insurance insuring the life of Shareholder A with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_), and shall purchase and obtain a policy of life insurance insuring the life of Shareholder C with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_). Within thirty (30) days after the execution of this Agreement, Shareholder C shall purchase and obtain a policy of life insurance insuring the life of Shareholder A with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_), and shall purchase and obtain a policy of life insurance insuring the life of Shareholder B with a death benefit in an aggregate amount equal to \_\_\_\_\_ Dollars (\$\_\_\_\_\_).

The Shareholders mutually agree that during the term of this Agreement, each of them shall keep and maintain said policies of insurance, pay all premiums due thereon as such premiums become due and shall not cause or allow any termination or lapse of said policies of insurance. Any insurance policy maintained under this Subparagraph 10(a) shall provide that such policy shall not lapse or be terminated without thirty (30) days notice to the Shareholder on whose life such insurance policy is in effect (hereinafter referred to

as the “Insured Shareholder”). Upon the death of an Insured Shareholder, the other Shareholders shall use any insurance proceeds payable upon such Insured Shareholder’s death towards the purchase of the Insured Shareholder’s Shares as set forth in Subparagraph 7(a)(i) above. In the event that either the Insured Shareholder or the Shareholder (hereinafter referred to as the “Insuring Shareholder”) who is responsible to keep and maintain the life insurance policy or policies on the life of the Insured Shareholder shall receive notice of the pending lapse or termination of the policy on the life of the Insured Shareholder, then the Insuring Shareholder shall, within ten (10) days of the date of such notice of the pending lapse or termination of such policy, either: (i) take such steps as may be necessary to prevent the lapse or termination of such policy including, but not limited to, the payment of any premiums which may be due and payable; or (ii) cause a suitable replacement policy or policies with the same death benefit amount to be purchased insuring the life of the Insured Shareholder. In the event that the Insuring Shareholder cannot, within such ten (10) day period, provide evidence to the Insured Shareholder, in form and substance reasonably acceptable to the Insured Shareholder, that either such policy shall not lapse or terminate or that a suitable replacement policy or policies with the same death benefit amount has been purchased, then the Insured Shareholder, may either: (i) take such steps as may be necessary to prevent the lapse or termination of such policy including, but not limited to, the payment of any premiums which may be due or payable; or (ii) cause a suitable replacement policy or policies with the same death benefit amount to be purchased insuring the life of the Insured Shareholder. The Insuring Shareholder shall reimburse the Insured Shareholder for any sums of money expended by the Insured Shareholder in avoiding a lapse or termination of such policy or in obtaining a suitable replacement policy or policies, including, but not limited to, any premiums paid by the Insured Shareholder together with interest at the highest rate permitted by law from the date the Insured Shareholder incurred such expense until the date of full payment by the Insuring Shareholder.

Each Insuring Shareholder shall, upon the request of the other Shareholders, provide written evidence, in form and substance reasonably acceptable to the other Shareholders, that the life insurance policies required to be maintained by the Insuring Shareholder on the other Shareholder remain in full force and effect. In order to secure the obligations of each Insuring Shareholder under this Subparagraph 10(a), each Insuring Shareholder shall pledge and collaterally assign to the Insured Shareholder the policy or policies maintained by such Insuring Shareholder on the life of the Insured Shareholder. Each such collateral assignment shall be in form and substance reasonably acceptable to the Insured Shareholder.

(b) *Purchase of Life Insurance Policies by Terminated Shareholder.* In the event of a purchase and sale of all of the Shares of a Shareholder pursuant to the terms of this Agreement, other than by reason of the death of such Shareholder (hereinafter referred to as the “Terminated Shareholder”) the Terminated Shareholder shall have the right to purchase, at or before the closing of the purchase and sale of the Terminated Shareholder’s Shares pursuant to this Agreement, all contracts of insurance maintained on his life by the Corporation or by the other Shareholders, as the case may be. The purchase price for such insurance contracts shall be equal to the sum of any unearned premiums on such insurance contracts plus the total cash surrender value of such insurance contracts, if any, including the cash value of all dividends standing to the credit of such insurance contracts, less any indebtedness with respect to such insurance contracts. If the Terminated Shareholder fails to exercise his right to purchase such insurance contracts under this Subparagraph 10(b), the Corporation or the other Shareholders, as the case may be, shall have the privilege of holding or disposing of such insurance contracts at their sole discretion.

(c) *Purchase of Life Insurance Policies by Remaining Shareholders.* In the event of a purchase and sale of all of the Shares of a Shareholder pursuant to the terms of this Agreement, whether by death or for any other reason (hereinafter referred to as the “Selling Shareholder”), each remaining Shareholder shall have the right to purchase, at or before the

closing of the purchase and sale of the Selling Shareholder's Shares pursuant to this Agreement, all contracts of insurance maintained on the life of such remaining Shareholder. The purchase price for such insurance contracts shall be equal to the sum of any unearned premiums on such insurance contracts plus the total cash surrender value of such insurance contracts, if any, including the cash value of all dividends standing to the credit of such insurance contracts, less any indebtedness with respect to such insurance contracts. If a remaining Shareholder fails to exercise his right to purchase such insurance contracts pursuant to this Subparagraph 10(c), the Selling Shareholder shall have the privilege of holding or disposing of such insurance contracts at his sole discretion.

**11. *Corporate-Owned Insurance.***

(a) *Life Insurance.* The Corporation may at its discretion (with the approval of the Shareholders holding a majority of the issued and outstanding Shares entitled to vote), obtain and maintain policies of life insurance on the lives of the Shareholders for the purpose of purchasing the Shares of a deceased Shareholder in accordance with the provisions of Subparagraph 5(c) above. The premiums on such life insurance policies shall be a corporate expense. The amount of insurance obtained hereunder, if any, shall be reviewed by the Shareholders periodically to ensure that the coverage accurately reflects the purchase price to be paid for each of the Shareholder's shares.

Each life insurance policy purchased by the Corporation pursuant to this Subparagraph 10(a) shall designate the Corporation as the beneficiary thereunder. Notwithstanding any provisions of this Agreement to the contrary, any proceeds received by the Corporation by reason of the death of a Shareholder from life insurance policies purchased by the Corporation hereunder shall be allocated to the surviving Shareholders' Shares. No portion of any life insurance proceeds received by or on behalf of the Corporation by reason of the death of a Shareholder shall be allocated to the deceased Shareholder's Shares.

(b) *Purchase of Life Insurance Policies by Terminated Shareholder.* In the event of a purchase and sale of all of the

**Shares of a Shareholder pursuant to the terms of this Agreement other than by reason of the death of such Shareholder (hereinafter referred to as the “Terminated Shareholder”), the Terminated Shareholder shall have the right to purchase, at or before the closing of the purchase and sale of the Terminated Shareholder’s Shares pursuant to this Agreement, all insurance policies maintained on his life by the Corporation. The purchase price for such insurance policies shall be equal to the sum of any unearned premiums on such insurance policies plus the total cash surrender value of such insurance policies, if any, including the cash value of all dividends standing to the credit of such insurance policies, less any indebtedness with respect to such insurance policies. If the Terminated Shareholder fails to exercise his right to purchase such insurance policies under this Subparagraph 10(b), the Corporation shall have the privilege of holding or disposing of such insurance policies at its sole discretion.**

12. *Issuance of Additional Shares.* The Corporation shall not, while this Agreement is in force, issue additional Shares of its stock to any individual or entity, or revise its capital structure, other than the borrowing of funds, without the prior written consent of the Shareholders holding a majority of the issued and outstanding Shares entitled to vote, which consent shall not be unreasonably withheld.

13. *Procedures at Closing and Payment of Expenses.* At the closing of any sale and purchase of Shares hereunder, the selling Shareholder, the personal representative of a deceased Shareholder’s estate, the trustee or other successor in interest to the deceased Shareholder’s Shares, the terminated Shareholder or the Holder of any Transferred Shares, as the case may be (hereinafter referred to as the “Selling Party”), shall deliver to the Corporation or the other Shareholders purchasing the Shares, as the case may be (hereinafter collectively referred to as the “Purchaser”), in exchange for payment of the purchase price payable hereunder by the Purchaser (in cash or in cash and a promissory note (or notes), as the case may be), the certificates for the Shares being sold, free and clear of any liens, security interests or other restrictions (other than the restrictions imposed hereunder), endorsed for transfer, and such assignments, certificates of authority or tax releases, consents

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and transfer instruments or other evidence of ownership by the Selling Party as may be reasonably required by counsel for the Purchaser for compliance with this Agreement.

If a promissory note is to be executed and delivered by the Purchaser for a portion of the purchase price, the Purchaser shall obtain, at the Purchaser's expense, all documentary tax stamps required to be affixed to such promissory note and shall affix and cancel such stamps on the promissory note at the closing hereunder. All legal and accounting costs incurred in connection with a sale and purchase of the Shares hereunder shall be paid by the party incurring such expenses.

14. *Specific Performance.* The parties hereto hereby acknowledge and agree that the Shares cannot be readily purchased or sold on the open market and for that reason, among others, the parties hereto will be irreparably damaged in the event this Agreement is not specifically enforced. Should any dispute arise concerning the sale, encumbrance or other disposition of any Shares, an injunction may be issued restraining any such sale, encumbrance or other disposition pending the resolution of such controversy.

In the event of any controversy concerning the right or obligation to purchase or sell any Shares, such right or obligation shall be enforced in a court of equity by a decree of specific performance. Such remedy shall, however, be cumulative and not exclusive, and shall be in addition to any other remedies of the parties hereto. If any person or entity shall institute any action or proceeding to enforce the provisions hereof, the person or entity against whom such action or proceeding is brought hereby waives the claim or defense that the person or entity instituting such action has an adequate remedy at law, and shall not urge in any such action or proceeding that a claim or remedy at law exists.

15. *After-Acquired Stock.* Whenever any person (including a Shareholder) acquires any Shares other than the Shares owned by him at the time of execution of this Agreement, or at the time such person becomes bound by the terms of this Agreement, such Shares shall be subject to all the terms and conditions of this Agreement.

16. *Endorsement of Stock Certificates.* Upon the execution of this Agreement, all certificates for the Shares shall be surrendered to the Corporation and endorsed as follows:

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The shares of stock of this Corporation can be transferred by the owners thereof only by fully complying with the terms of that certain Stock Restriction Agreement for \_\_\_\_\_ dated the \_\_\_\_\_ day of \_\_\_\_\_, 2001, together with any amendments thereto, a copy of which is on file in the office of the Corporation. Any person, association or corporation who purchases, acquires or receives such stock (including by gift) accepts such shares of stock subject to such conditions.

After endorsement, the certificates shall be returned to the Shareholders who shall, subject to the terms of this Agreement, be entitled to exercise all rights of ownership of such Shares.

All stock certificates hereafter issued to any Shareholder of the Corporation shall bear the endorsement set forth above.

17. *Adjustment for Stock Splits.* Appropriate adjustments to the purchase price for any Shares to be purchased and sold hereunder shall be made for any stock dividend, stock split, recapitalization, reorganization or other similar transaction occurring on or after the Valuation Date (as defined in Subparagraph 6(f) above) and prior to or on the date of closing of such purchase and sale.

18. *Future Shareholders.* The Corporation shall not issue any Shares to any person, unless such person assumes and agrees in writing to be bound by all the terms and conditions of this Agreement, including any amendments made to this Agreement on or prior to the date of such issuance, and the term “Shareholder” as used in this Agreement shall thereafter include such person.

**19. S Corporation Provisions.**

**(a) Election.** The Shareholders and the Corporation acknowledge that an I.R.S. Form 2553, “Election by a Small Business Corporation”, was filed by the Corporation and its Shareholders pursuant to which the Corporation elected to be treated as an “S corporation” under Subchapter S of the Code effective \_\_\_\_\_. The Shareholders and the Corporation agree not to take any action which would cause the Corporation to lose its status as an S corporation as defined in § 1361 of the Code (unless otherwise determined by the Shareholders owning a majority of the issued and outstanding Shares of stock of the Corporation), and each

Shareholder further agrees not to sell or otherwise transfer his Shares, either during his lifetime or by will or trust instrument, to any party or parties who would cause the Corporation to lose its status as an “S corporation” including, but not limited to, a transfer to an individual who is a non-resident alien, a transfer to one (1) or more other persons who would cause the Corporation to have more than the permitted number of shareholders (presently seventy-five (75)), a transfer to a trust which is not a “permitted shareholder” under the Code, or a transfer to any other nonpermitted S corporation shareholder. Any such transfer of Shares by a Shareholder which would cause the Corporation to lose its status as an “S corporation” shall be void *ab initio*.

(b) *Opinion of Counsel.* Notwithstanding any other provision in this Agreement, the Corporation may require as a condition precedent to any transfer of Shares hereunder that the transferor Shareholder, at the sole expense of such Shareholder, furnish to the Corporation an opinion of counsel approved by the Corporation that the transfer of Shares will not cause the Corporation to lose its status as a “Small Business Corporation” as described in § 1361(b) of the Code, and that the transfer will not cause the Corporation to lose its eligibility as an “S corporation” as defined in § 1361(a)(1) of the Code.

(c) *Mandatory Dividends.* The Shareholders agree that they will cause the Corporation (to the extent it has funds available for distribution) to declare and pay a pro rata dividend (which shall be in proportion to the Shares held by each Shareholder of the Corporation without regard to class of stock), payable in cash or by check, either during, or within three (3) months after the close of, each taxable year of the Corporation during which it is an S corporation, except to the extent any such dividend may be prohibited by applicable law. The amount of such dividend shall be computed by multiplying the taxable income of the Corporation (as determined for federal income tax purposes) for such taxable year, by a percentage equal to the highest marginal federal income tax rate applicable to an individual taxpayer (determined without regard to any special “surtax” or “phase-out adjustment” rates) for such taxable year. This provision shall not

be construed as prohibiting the payment of dividends in an amount greater than those provided for hereunder.

(d) *Section 1377(a)(2) Election.* In the event of a purchase and sale pursuant to this Agreement which terminates a Shareholder's entire interest in the Corporation, the "Affected Shareholders" (as defined in § 1377(a)(2)(B) of the Code) and the Corporation agree to elect under § 1377(a)(2) of the Code to have the rules provided in § 1377(a)(1) of the Code applied as if the Corporation's taxable year consisted of two (2) taxable years, the first of which ends on the date of the closing of the purchase and sale hereunder. The Affected Shareholders and the Corporation further agree to consent to such election in the manner required under § 1377(a)(2) of the Code and any Treasury Regulations promulgated thereunder. In the event of such election, all income and expenses of the Corporation allocable to the Shares sold and purchased from the beginning of its taxable year during which the purchase and sale occurs to and including the date of the closing of such purchase and sale hereunder shall be allocated to the seller of the Shares pursuant to § 1377(a)(2) of the Code, and all income and expenses of the Corporation allocable to the Shares sold and purchased after the date of the closing of such purchase and sale shall be allocated to the purchaser of the Shares hereunder.

(e) *Treasury Regulation Section 1.1368-1 Qualifying Disposition Election.* In the event of a Qualifying Disposition of Shares during any thirty (30) day period during the Corporation's taxable year pursuant to Treasury Regulation Section 1.1368-1(g), the Corporation may elect to treat the year as if it consisted of two (2) separate taxable years, the first of which ends on the close of the day on which the Qualifying Disposition occurs. Each Shareholder who has held stock in the Corporation during the taxable year agrees to consent to such election in the manner required by the Treasury Regulation. In the event of such election, the Corporation shall treat the taxable year as separate taxable years for the purpose of allocating items of income and loss, making adjustments if any to the accumulated adjustments account, earnings and

profits and basis, and determining the tax effect of distributions under § 1368 of the Code.

A “Qualifying Disposition,” as presently defined in Treasury Regulation Section 1.13168-1(g)(2), means: (i) a disposition by a Shareholder of twenty percent (20%) or more of the Shareholder’s Shares in one (1) or more transactions during any thirty (30) day period; (ii) a redemption treated as a sale or exchange of twenty percent (20%) or more of the outstanding Shares of the Corporation from a Shareholder in one (1) or more transactions during any thirty (30) day period; or (iii) an issuance of additional stock by the Corporation equal to or greater than twenty-five percent (25%) of the outstanding stock to one (1) or more new shareholders during any thirty (30) day period during the Corporation’s taxable year.

(f) *Inadvertent Termination.* If at any time prior to a dissolution of the Corporation or a formal revocation of its election as an S corporation in accordance with § 1362(d) of the Code, the Corporation’s election is terminated due to inadvertence, then the Corporation shall, as soon as practicable after discovery of the circumstances resulting in such termination, seek a determination from the Internal Revenue Service in accordance with § 1362(f) of the Code that the circumstances resulting in termination of the S election were inadvertent and that the status of the Corporation as an electing small business corporation under Subchapter S shall be restored. In such event, each person who was a Shareholder at any time during the period of such inadvertent termination agrees to consent to the action of the Corporation in requesting a determination of inadvertent termination and the Corporation and each Shareholder agrees to make such adjustments consistent with treatment of the Corporation as an S corporation as may be required by the Internal Revenue Service with respect to the period of inadvertent termination.

(g) *Special Rules Applicable to Trusts.* If, at any time during which the Corporation’s S Corporation election is still in effect, a trust which is a Shareholder is in danger of losing (or will lose in two (2) years or less) its status as a “permitted shareholder” under either § 1361(c)(2)(A) or (d) of the Code,

then, unless the trust can demonstrate to the satisfaction of the Corporation's tax counsel or certified public accountant that it can and will remain a "permitted shareholder" for Subchapter S purposes, the Corporation shall have the option to purchase all (but not less than all) of the Shares held by such trust for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above. If the Corporation desires to exercise its option under this Subparagraph 18(g), it shall give written notice to the trust and the other Shareholders that it is exercising its option hereunder. The closing of a purchase and sale pursuant to this Subparagraph 18(g) shall take place at a reasonable time and place selected by the Corporation, which in no event shall be later than the date thirty (30) days after the date the Corporation's written notice exercising its option to purchase any Shares under this Subparagraph 18(g) is delivered to the trust, but which shall in any event be prior to the date on which such trust would lose its eligibility as a "permitted shareholder" for purposes of Subchapter S of the Code.

(h) *Loss of Resident Alien Status.* If, at any time during which the Corporation's S corporation election is still in effect, a Shareholder is in danger of being classified as a non-resident alien under the Code, then, unless such Shareholder can demonstrate to the satisfaction of the Corporation's tax counsel or certified public accountant that he will not be classified as a non-resident alien under the Code, the Corporation shall have the option to purchase all (but not less than all) of the Shares held by such Shareholder for the price set forth in Paragraph 6 above and in accordance with the terms set forth in Paragraph 7 above. If the Corporation desires to exercise its option under this Subparagraph 18(h), it shall give written notice to such Shareholder, the Corporation and the other Shareholders that it is exercising its option hereunder. The closing of a purchase and sale pursuant to this Subparagraph 18(h) shall take place at a reasonable time and place selected by the Corporation, which in no event shall be later than the date thirty (30) days after the date the Corporation's written notice exercising its option to purchase any Shares under this Subparagraph 18(h) is delivered to the trust, but which shall in any event be prior to the date on

**which such Shareholder would be classified as a non-resident alien under the Code.**

20. *Termination of Agreement.* This Agreement shall commence as of the date hereof and shall continue in full force and effect until terminated by the mutual agreement of the parties hereto or by the cessation of the Corporation’s business, or by the bankruptcy, receivership or dissolution of the Corporation. Upon the termination of this Agreement, each Shareholder shall surrender to the Corporation all certificates for Shares owned by him or her and the Corporation shall issue to such person in lieu thereof new certificates for an equal number of Shares without the endorsements set forth in Paragraph 15 above.

21. *Benefit.* This Agreement shall be binding upon, and inure to the benefit of, the parties hereto, their respective heirs, legal representatives, successors and permitted assigns. No party hereto may assign their rights or obligations hereunder without the prior written consent of the other parties.

22. *Severability.* The invalidity or unenforceability of any particular provision of this Agreement shall not, to the extent possible, affect the other provisions hereof, and this Agreement shall, to the extent possible, be construed and enforced in all respects as if such invalid or unenforceable provision had not been contained herein.

23. *Modification.* No change or modification of this Agreement shall be valid unless in writing and signed by all the parties hereto.

24. *Notices.* All notices, requests, demands and other communications hereunder shall be in writing and personally delivered or sent by certified or registered mail, return receipt requested, postage prepaid, to the following addresses:

If to the Corporation:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Attention: \_\_\_\_\_

If to the Shareholders:

\_\_\_\_\_  
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\_\_\_\_\_

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Provided, however, that any party hereto may, from time to time, give to the other party written notice, in the manner provided for herein, of some other address to which communications to such party shall be sent, in which event notices to such party shall be personally delivered or sent by registered or certified mail to such address. Notice shall be deemed effectively given hereunder when personally delivered or deposited in the United States mail, postage prepaid, registered or certified, return receipt requested, as the case may be.

25. *Completeness of Agreement.* This Agreement constitutes the entire agreement and understanding of the parties hereto with respect to the subject matter hereof.

26. *Legal Fees.* If any party hereto, including the Corporation, institutes any action or proceeding to enforce this Agreement, the prevailing party in such action or proceeding shall be entitled to recover from the non-prevailing party or parties all legal costs and expenses incurred by the prevailing party in such action, including, but not limited to, reasonable attorney fees, paralegal fees, law clerk fees and other legal costs and expenses, whether incurred at or before trial, and whether incurred at the trial level or in any appellate, bankruptcy or other legal proceeding.

27. *Survival.* The terms, conditions, obligations and covenants of this Agreement shall survive its execution by the parties hereto, the closing of any transactions contemplated hereunder, and the execution of all contracts hereafter entered into between the parties hereto, except to the extent that such transactions and contracts may be inconsistent with this Agreement.

28. *Governing Law; Venue.* This Agreement shall be governed by and construed in accordance with the laws of the State of \_\_\_\_\_. In the event of any legal or equitable action arising under this Agreement, the venue of such action shall lie exclusively within either the state courts of \_\_\_\_\_ located in \_\_\_\_\_

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County, \_\_\_\_\_, or the United States District Court for the \_\_\_\_\_ District of \_\_\_\_\_, \_\_\_\_\_ Division, as the case may be, and the parties hereto do hereby specifically waive any other jurisdiction and venue.

29. *Counterparts.* This Agreement may be executed in several counterparts, each of which shall be an original, and all of which shall constitute one and the same instrument.

30. *Pronouns.* Any reference herein to the masculine gender shall also be deemed to include the feminine and neuter gender as the context may require.

31. *Further Actions.* Each party to this Agreement shall take such further actions to execute, file, record, publish and deliver such additional certificates, instruments, agreements and other documents as the other parties may, from time to time, reasonably request, in order to effectuate the transfer and sale of any Shares to be transferred pursuant hereto, or otherwise to accomplish the purposes of this Agreement.

32. *Waiver.* No waiver of any breach of any term or condition of this Agreement shall be deemed to be a waiver of any subsequent breach of any term or condition of a like or different nature.

33. *Captions.* The captions used herein are inserted only as a matter of convenience and are not to be used in the interpretation of any provision hereof.

34. *Draftsmanship.* The fact that one of the parties may have drafted or structured any provision hereof shall not be considered in construing the particular provision either in favor of, or against, such party.

35. *Power of Attorney.* Each of the Shareholders constitutes and appoints the President and/or the Secretary of the Corporation as his true and lawful attorney to make, execute, assign, acknowledge and file any and all documents (including, but not limited to, stock powers and election consents) necessary to effectuate any action required to be taken by a Shareholder under the terms and conditions of this Agreement.

**36. *Decision Making.* The business of the Corporation shall be managed by its Board of Directors. The Shareholders agree that during the term of this Agreement, the Board of Directors**

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of the Corporation shall consist of \_\_\_\_\_ (\_\_\_\_\_) members. The Shareholders agree to vote their Shares to elect each Shareholder as a member of the Board of Directors of the Corporation. Notwithstanding anything contained in this Agreement to the contrary, the actions set forth in Subparagraphs (a) through (l) below shall require the unanimous approval of all of the Shareholders.

(a) *Termination of S Election.* The termination of the Corporation's S corporation status under § 1361 of the Code.

(b) *Issuance of Additional Shares.* The issuance of any additional Shares.

(c) *Transactions with Shareholders and their Affiliates.* Any transaction between the Corporation and any of the Shareholders or any affiliates of any of the Shareholders.

(d) *Acquisition of Equity Interest.* Any decision by the Corporation to purchase or obtain an equity interest in another person or business.

(e) *Loans.* Any loans made by the Corporation to another person or business.

(f) *Sale of Assets.* Any decision by the Corporation to sell or otherwise dispose of any assets of the Corporation outside the ordinary course of its business.

(g) *Capital Expenditures.* Any decision by the Corporation to make or not make a capital expenditure (in excess of \_\_\_\_\_ Dollars (\$\_\_\_\_\_)).

(h) *Reorganization.* Any decision by the Corporation to engage or not engage in the proposed merger, consolidation or reorganization of the Corporation.

(i) *Borrowing.* Any loan to be made to the Corporation (in excess of \_\_\_\_\_ Dollars (\$\_\_\_\_\_)).

(j) *Salaries.* Payment by the Corporation of salaries or other compensation to any Shareholder or to any related party to, or affiliate of, any Shareholder (in excess of \_\_\_\_\_ Dollars (\$\_\_\_\_\_)).

(k) *Amendments to Articles of Incorporation or Bylaws.* Any amendment to the Articles of Incorporation or Bylaws of the Corporation.

(l) *Amendment to Agreement.* Any amendment to be made to this Agreement.

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**As used in this Paragraph 35, the term “affiliate” shall include any person or entity, who, directly or indirectly, through one or more intermediaries, controls, or is controlled by or under the common control with, another person or entity, including (i) any person or entity owning or controlling ten percent (10%) or more of the outstanding voting securities in another person or entity, (ii) any officer, director, partner or trustee of such person or entity, and (iii) if such person or entity is an officer, director, partner or trustee of a person or entity, the person or entity for which such person or entity is acting in any such capacity.**

**IN WITNESS WHEREOF**, the parties hereto have executed this Agreement on the \_\_\_\_\_ day of \_\_\_\_\_, 2000.

**“CORPORATION”**

\_\_\_\_\_  
By: \_\_\_\_\_  
\_\_\_\_\_, President

**“SHAREHOLDERS”**

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COMPOSITION RUN COMPLETED --- ERRORS: NONE --- PAGES: 82