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# BUSINESS SUCCESSION PLANNING

**by**

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## 1. INTRODUCTION TO BUSINESS SUCCESSION PLANNING

Owners of successful businesses need to have a succession plan. The business owner needs to think about what will happen to their business in the event of their retirement, disability, or death.

Income taxes and estate taxes play a major role in succession planning. Business owners desire to structure their succession plan at no income tax, gift tax or estate tax cost. The mechanisms to do so are discussed below.

With the major political shifts in Washington, D.C., there are pending substantial changes to federal income tax, estate tax and gift taxes that will directly affect the transferring of businesses and the structuring of succession plans. For example, there are proposals to reduce tax rates, including capital gains rates and to eliminate the interest expense deduction. At this time it is uncertain whether any tax legislation will be enacted during 2017. Under some of the current discussions, tax law changes may result in an overhaul of the entire Internal Revenue Code and the most significant changes to the federal tax laws in our lifetimes.

Some of the discussion points for new tax legislation that will effect business succession planning are summarized below:

- Reduce the maximum individual income tax rate to 33%, along with having only three income tax brackets (12%, 25% and 33%).

- Proposals to lower the corporate tax rate to 20% or 15% (from the current 35% tax rate) and to reduce tax rates on pass-through business entities such as partnerships and limited liability companies.

- Eliminate certain business tax deductions to pay for the reduction in tax rates such as eliminating the interest deduction. However, there have been proposals to also allow expensing of certain properties (rather than amortizing and depreciating such properties).

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***Because each client's situation has unique facts, this Article is <u>not</u> legal or tax advice as to any specific situation or for any client. If you or a client desire legal or tax advice for a particular matter, please contact Robert A. Briskin.**

- Increase tax rates for carried interest such as promotional interest in limited liability companies and partnerships.

- Repeal of the federal estate tax system. Although there have been discussions to repeal the federal estate tax, many commentators have pointed out that the federal gift tax may stay in place. If the federal estate tax is repealed there have been proposals to repeal the current step-up in an assets' basis for income tax purposes at death. Under one proposal only a limited step-up in basis would be allowed (such as for the first $10,000,000 of asset value). Thus, the current tax law's unlimited increase in corporate stock and partnership interests (and LLC membership interests) income tax basis at death may no longer occur (or may be limited). A repeal of the step-up in income tax basis for community property could create a new substantial income tax cost for succession planning.

- If the federal estate tax is repealed there have been proposals to enact a new capital gains <u>tax at death</u> (after certain exemptions) on appreciated assets (such as a capital gains tax at death on assets over $10,000,000 in aggregate value), rather than waiting to tax those assets' appreciation until those assets are actually sold. Thus, the repeal of the federal estate tax system could be accompanied by an increase in the income tax burden for leaving business interests to the surviving spouse and to the next generation.

- Changing tax rates will also influence the valuation of businesses. For example, the manner of calculating a business' value based upon after tax earnings may produce a different result if the Internal Revenue Code is substantially modified.

- If interest is no longer tax deductible then this will affect the way family members sell their business interests to other family members in exchange for promissory notes.

1.1 ***<u>The Goals in Business Succession Planning</u>***. The business owner will want to accomplish the following basic goals in the succession plan of their business:

1.1.1 ***<u>Goal of the Business's Continuation</u>***. The owner wants to provide for the continuation of their business. This involves evaluating who will manage the business and become officers and directors should the current business owner retire, die or become disabled. Many times this issue comes to the forefront because the business's lender or major customers demand that a succession management team be designated and in place should something happen to the current owner. Questions to ask are: Can the business owner's children take over the business? Is the surviving spouse capable of managing the business? Is there middle level management who can take over the business?

If a business owner becomes disabled, who will have the voting control over that business? Will it be the surviving spouse or a certain child? The voting control may have to be incorporated into the owner's revocable living trust document in order for it to have an immediate effect. Similarly, at death (before a Buy-Sell Agreement is implemented), who is going to have the immediate right to vote the deceased parent's shares of the business's stock?

Who will become the directors of the corporation/business upon the parent's death or disability? Will it be employees, outside directors, the surviving spouse, or a child who works in the business?

The controlling owner must be concerned that if he or she dies, then there may be a negative impact to the business's lender relationships and its customer relationships. Lenders may call loans due upon the principal owner's death, and customers may not wish to deal with the business any further. It is advisable to verify if the business's loans will continue after the principal owner's death. Similarly, contracts with the business's customers and other third parties could contain default clauses that are triggered by the principal owner's death.

1.1.2 ***Goal of Minimizing Taxes in Succession Planning***. A business owner will want to minimize federal estate and gift taxes, and income taxes in the transfer of the business.

1.1.3 ***Goal of Providing Cash Flow to the Business Owner in Retirement Years***. The business owner may need to retain the business's cash flow for themselves in their retirement years. This may take the form of having a deferred compensation plan, continuing consulting agreements, or a buyout of the owner's stock of the business by an installment promissory note spread over many years.

1.1.4 ***Goal of Providing Succession of the Business to the Owner's Children***. The business owner, if they have children who work in the business, may want a succession plan to allow their children to continue to own and operate that business after the business owner's retirement, disability or death.

To do business succession planning you must understand the client's objectives. The business owner must disclose to the professional advisor who the business owner wants to succeed to their business. Is that client relying upon the business' cash flow for the client's retirement needs, or do they have other assets to provide for their retirement? What does the client want to do for family members currently working in the business, and for family members who might in the future work in that business?

Analyze if it is feasible for the particular business to have continuity in its present structure. For example, some businesses will outlive their usefulness. Look what happened to Kodak Film when digital photography eliminated film. Some businesses simply go out of existence because of changing economies. For example, a manufacturer of lamps in the United States can no longer compete with low overseas labor costs, or a domestic garment manufacturer is not able to competitively price its products because its manufacturing facilities are located in the United States.

1.1.5 ***Nonlegal Goals in Business Succession Planning***. Major aspects of business succession planning involve nonlegal issues and nonfinancial aspects. First, a business owner may not want to relinquish control of the business since they feel that they are best equipped to manage the business. Second, there may be conflicts among family members, including conflicts between the business owner and their own children. Third, the business owner may be uncertain which family members the business should be transferred to, and which family members are currently capable to run and manage the business. Fourth, there may be family rivalries among the children.

1.2 ***Ways For the Business Owner to Exit From the Business***. The business owner may phrase their succession plan as how they can "exit" from their business. Some choices for the business owner to "exit" from their business are as follows:

- Have the business's stock go public in order for the owner's shares to become marketable and salable.

- Have the business sold to an outside third party. To do this exit strategy, a business broker or investment banker can be employed. You need to evaluate the potential type of persons to whom the business could be sold, such as competitors, suppliers, a financial buyer, or an outside third party. Sales to an outside third party can be structured in many ways, such as a tax-free reorganization, a taxable asset sale, or a taxable stock sale.

- Sell the business to the business's current employees. It is better to have a binding agreement with employees now, rather than waiting until after the death (or disability) of the principal business owner, when the employees could threaten to leave the business.

- Leave the business to family members at death or by selling or gifting the business to family members during lifetime. As will be discussed below, this can be done through a series of trust provisions and a Buy-Sell Agreement. Statistics show that 80% of family owned businesses do not pass successfully to the second generation of that family; and of those family businesses that go to the second generation, 80% of those family businesses never make it to a third generation.

1.3 ***Example of a Business Succession Plan That Works***.

**Example: A great-grandfather in the 1920's started a business in Chicago to manufacture glass bottles (organized as a proprietorship). These glass bottles were sold to cosmetics makers and pharmacies in the Midwest. The business struggled financially, with limited expansion, through the Depression and World War II. The grandfather (son of the great-grandfather), after returning from World War II, took over the business in 1948, and in the early 1950's began utilizing plastic in lieu of glass for bottles, as well as expanding into**

**plastic tubes. The business's market territory increased from the Midwest to the East and West coasts.**

**The grandfather incorporated the business in 1954 in Illinois, issuing 100% of the common stock to grandfather. The business rapidly increased sales, reaching $10,000,000 in sales in 1965.**

**Eventually, in the early 1960's, the corporation made an election to be taxed as a Subchapter S corporation under the Internal Revenue Code.**

**In 1967, grandfather sought the advice of professional tax and estate planning advisors, who advised him to begin to have a succession plan among his three sons. Eventually, all three sons came to work in this family bottle manufacturing business. The grandfather, utilizing stock gifts and a new stock issue, eventually transferred 70% of his stock to his three sons gift tax free.**

**The business kept rapidly expanding, and there was a need for capital. In the late 1970's, the three sons had the corporation take on significant debt in order to finance the purchase of new machinery and for business expansion purposes. During the recession of 1979, the grandfather and the three sons took the opportunity of lower business valuations (due to reduced profits and increased debt) to transfer significant amount of the corporation's stock to the fourth generation grandchildren (who were the children of the three sons). After the 1979 stock transfers, the grandfather no longer owned any stock of the business, the three sons each owned 10% of the stock, and the fourth generation grandchildren owned 70% of the stock.**

**A Buy-Sell Agreement to protect the S election and to prevent stock ownership outside of the family is signed in 1979.**

**The governance of this bottle manufacturing business was then assigned to a board of directors consisting not only of family members, but of outside experienced executives, including a chief financial officer, and a non-family member chief operating officer. This board of directors remains in effect today, consisting of eleven members (of which six are family members).**

**Over the years, the family retained key executives by issuing stock to these executives in the form of <u>non-voting</u> stock, while the family retained <u>all</u> of the <u>voting</u> stock. The fourth generation, and likely the fifth and sixth generations, of this family will continue to control the business, while the day-to-day management is handled by professionals (with some family member involvement as directors and as employees). The result is that the family**

**continues today to retain cash flow from this corporation's business, continues to control this bottle manufacturing business through a widely disbursed series of trusts and stock ownership, and has professional management handle the corporation's day-to-day activities.**

1.4 ***<u>Example of What Happens if There is No Business Succession Plan</u>***. We expect that if multiple siblings are running a company, that they will not all die at once. However, what happens if both brothers who own a manufacturing business die unexpectedly together?

**<u>Example</u>: The fate of the Dodge Brothers Motor Car Company in the 1920's is a good example of not planning for the survival of the business in the event of the unexpected deaths of both owners. In the 1920's, Dodge Brothers Motor Car Company was considered the "cutting edge" and leader among U.S. automobile manufacturing companies. Two brothers, Horace Dodge and John Dodge, each owned 50% of the corporation's stock. John Dodge died unexpectedly at age 56, leaving his 50% stock interest to his family. A few months later Horace Dodge died, also leaving his 50% stock interest to his family.**

**The wives and children of Horace Dodge and John Dodge were inexperienced, and spendthrifts. Furthermore, there were no contingency plans on how to run Dodge Brothers Motor Car Company after the deaths of the two brothers. With this lack of planning, the company began to decline in value and eventually was sold to the investment banking firm of Dillon, Read in 1925, followed by its sale in 1928 to Walter P. Chrysler.**

1.5 ***<u>Goal To Avoid Estate and Gift Taxes in Business Succession Planning</u>***. The current maximum estate tax and gift tax rate is 40%. If the value of the business, along with the client's other assets exceeds the unified credit amount, then a substantial tax cost can be imposed upon the transfer of the business to children and other family members, either during lifetime or at death.

Clients can shift their family business interests to younger generations and eliminate or minimize transfer taxes through such techniques as: (i) annual gifts; (ii) installment sales; (iii) sales for a self-canceling installment note; (iv) sales or gifts to a grantor trust (also known as a defective income trust); (v) GRATs; (vi) recapitalization of the business; and (vii) transfer of business opportunities to younger generation levels. These tax planning techniques are discussed further in Section 3 of this Article.

Over the past 40 years, Congress has eased the estate and gift transfer tax burden on transferring a business to family members through[1]:

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[1]Few estates for decedents dying in 2017 pay a federal estate tax because of the unlimited marital deduction and the 2017 $5,490,000 per person estate tax exclusion.

- Reducing the unified estate and gift tax rate to 40% currently.

- Increasing the gift tax annual exclusion (currently in 2017 for each donee it is $14,000 per donor and $28,000 per husband and wife donors, and is indexed in future years to increase for inflation).

- Providing for the unlimited marital deduction.

- Revising the special use valuation under §2032A[2] for real estate used in the family business.

- Increasing and unifying the gift and tax exclusion (currently, in 2017 it is $5,490,000 per person, or $10,980,000 for a husband and wife, and is indexed in future years to increase for inflation).

- Providing for portability of the estate and gift tax exclusion from the deceased spouse to the surviving spouse.

- Revising the estate tax payment deferral provisions under §6166.

1.6 ***How to Have Your Client Start Their Business Succession Planning.*** For many clients it is difficult to begin to implement a business succession plan. Some ideas on how to get your clients to begin implementing their business succession planning are as follows:

1.6.1 ***First, Sit Down With the Principal Business Owner***. Nothing will happen unless the principal owner who controls the business makes their goals known to you. This should be a private one-on-one meeting between you and the principal business owner.

1.6.2 ***Have the Client Develop a Mission Statement***. One way to get a client to think about how they will have a business succession plan, is to develop a mission statement, This will involve the participation of all of the family members who are involved with the business. Some ideas of a mission statement would be for the family to set forth their long-term business goals, and the relationships between any family members working in the business. This mission statement should include financial projections and a business plan for five or ten years.

1.6.3 ***Have the Client Have Regular Meetings Regarding the Business***. This could take the form of a board of directors meeting or an informal meeting among family members. At the meetings family members or board of directors members could exchange ideas and opinions on the business's succession planning and business operations.

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[2]Unless otherwise stated, all Code references are to the Internal Revenue Code of 1986, as amended.

1.7 ***Amend the Client's Revocable Living Trust and Other Trusts to Allow Retention of Business Interests***. Having a large part of a client's estate composed of the business presents trust issues, such as to the trustee's fiduciary duty of diversification of trust assets. Although many trust documents contain general language regarding the fact that the trustee has no duty to diversify investments, it is advisable to have a special provision in the trust allowing the trustee to retain the specific business interests, and for the trust to state that the trustees of the trust do not have a duty to sell that specific business interest.

Corporate trustees (such as banks) are very sensitive to the issue of a disgruntled trust beneficiary later claiming that the trustee failed to sell the business or failed to properly diversify the trust's assets when the trust retained as its major asset the business interest. As an example of a trust provision for retaining in trust the business interest, the trust and other estate planning documents could contain a clause requiring the trustee to retain ownership of that particular business, unless the trustee is directed by a specified percentage of the trust's beneficiaries (or by a special trustee) to sell that business.

## 2. IN ORDER TO TRANSFER THE BUSINESS TO FAMILY MEMBERS OBTAIN VALUATION DISCOUNTS FOR THAT BUSINESS

Valuation discounts are a key component to being able to transfer business interests from older to younger generations of a family at little or no transfer tax cost. Transfer taxes (whether they are estate, gift or generation-skipping taxes) are imposed on the "fair market value" on the applicable valuation date of the property being transferred. The estate tax Regulations state that for purposes of estate taxes:

> "[t]he fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."[3]

Generally, with a closely held family business there is no comparable sales of similar stock, partnership or LLC interests. The Treasury Regulations provide that shares of closely held stock are valued by taking into account the corporation's net worth, prospective earning power, dividend-paying capacity, and other relevant factors.[4] The IRS in Revenue Ruling 59-60 specifies various factors for valuing a closely held business interest.[5]

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[3]Reg. §20.2031-1(b). The gift tax regulations have a similar definition of fair market value at Reg. §25.2512-1.

[4]See Reg. §20.2031-2(f).

[5]1959-1 CB 237.

To arrive at the "fair market value" of the entire business, the appraiser will apply one or a combination of the valuation methods. After the "fair market value" of the business has been determined in accordance with these valuation principles, then the family member's particular business interest can be adjusted for the various discounts described below.

Chapter 14 of the Internal Revenue Code may require adjustments to valuing an interest in a family business under §§2701, 2703 and 2704.

The courts have applied the following valuation discounts to reduce the value of an owner's interest in a business entity:

- Discount for **minority interest**.
- Discount for **lack of marketability**.
- Discount for **built-in corporate tax** for C corporation's liabilities.
- Discount for loss of **key personnel**.

2.1 ***IRS in the Past Has Unsuccessfully Tried to Aggregate Family Ownership to Deny Minority Valuation Discounts***. The IRS for many years attempted to aggregate the family members' interests in the business to deny minority valuation discounts. These IRS efforts met with little success.

2.1.1 ***Historic Court Positions***. The courts held that the relationship between the transferor and transferee of stock (or partnership interests) is not relevant and the family attribution principals do not apply for estate and gift tax purposes.[6]

2.1.2 ***The IRS Acquiesced in Revenue Ruling 93-12 and Recognizes That There is No Attribution of Family-Owned Business Interests***. In Rev. Rul. 93-12[7], the IRS finally acquiesced to the court decisions in the family attribution area. In Rev. Rul. 93-12, the parent transferred 20% of the shares of the corporation to each of the parent's five children. The IRS ignored the family relationship of the parent and children, and held that the gifted shares of the

[6]See ***Estate of Bright***, 48 AFTR2d ¶81-6292 (Ct.Ap.5th 1981) in which the Court of Appeals held that family attribution rules do not apply for estate tax purposes based in part on the fact that the family attribution rules are inconsistent with the willing buyer/willing seller test contained in the Regulations. Similarly, a valuation discount was applied to the decedent's one-half community property interest in real estate in ***Propstra***, 50 AFTR2d ¶82-6153 (Ct.Ap.9th 1982).

[7]1993-1 CB 202.

children would not be aggregated to determine whether the gifted shares should be valued as part of a controlling interest.

### 2.1.3 ***The IRS Agrees That the Surviving Spouse's Interest Does Not Have to Be Aggregated With a QTIP Trust's Interest for Valuation Discount Purposes***.

> **Example: Under a revocable living trust, a QTIP trust and a Unified Credit Trust (also known as By-Pass Trust")are established upon the death of the first spouse for the deceased spouse's community 50% stock interest in the family corporation, and a Survivor's Trust is established for the community 50% stock interest of the surviving spouse. How is the first spouse's 50% stock interest valued upon the death of the first spouse? What about the second spouse's 50% stock interest upon the death of the second spouse? Upon the death of the second spouse, is the stock of the Survivor's Trust, the QTIP Trust (and the Unified Credit Trust) aggregated to determine "control" for valuation purposes?**

In ***Estate of Mellinger***,[8] the Tax Court held that the various trust interests were not aggregated for valuation purposes and that the QTIP Trust's stock should be valued separately from the surviving spouse's stock held in the Survivor's Trust.[9]

On the same day that the ***Estate of Mellinger*** decision was issued, the Tax Court issued the ***Estate of Ethel S. Nowell*** decision.[10] In ***Estate of Ethel S. Nowell***, the surviving spouse died with a partnership interest in a QTIP trust (which included marketable investments and over which the surviving souse had a limited power of appointment). The valuation discounts claimed ranged

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[8]112 T.C. 26 (1999), acq. AOD 1999-006. In the IRS's acquiescence in ***Estate of Mellinger***, the IRS pointed out that when the QTIP Trust is funded, a minority discount should be reflected in satisfying the marital bequest. The Tax Court in ***Estate of Mellinger*** followed the decision of the Fifth Circuit Court of Appeals in ***Estate of Bonner***, 77 AFTR2d ¶96-2369 (5th Cir. 1996).

[9]***Estate of Mellinger*** is a published Tax Court opinion, and therefore binding on all Tax Court judges. In ***Estate of Mellinger***, the spouse's revocable trust owned a 27.8% stock interest in Frederick's of Hollywood, a family-controlled corporation which sold lingerie. The husband's and wife's shares were originally owned as community property. On the husband's death, the husband's community interest was left in a QTIP trust, of which a bank and third party were co-trustees. The surviving spouse contributed her community share interest to her own revocable trust, of which the same bank and third party were co-trustees. On the wife's death, the Tax Court refused to aggregate the QTIP trust's 27.8% stock interest (which was included in the surviving spouse's taxable estate under §2044) with the surviving spouse's revocable trust's 27.8% stock interest (which was included in the surviving spouse's taxable estate under §2033) to create a "control premium." Instead, the Tax Court applied a 25% discount for blockage or marketability.

[10]T.C. Memo 1999-15.

between 50% and 65%. The Tax Court held that the QTIP Trust interest was not aggregated with the Surviving Spouse's interests for valuation purposes.

**Planning Idea: Clients should split their business interests between a QTIP Trust (and Bypass Trust) and a Survivor's Trust upon the death of the first spouse in order to produce minority valuation discounts. After the death of the first spouse, gifts of the business interests can then be made from the Survivor's Trust using valuation discounts.**

2.1.4 ***New IRS Proposed Regulations on Valuation Discounts***. The IRS issued Proposed Regulations in August 2016 under §2704 which would affect all types of family business if they become final in their current proposed form.

There has been some discussion in the Treasury Department since the issuance of these Proposed Regulations to exempt family businesses and family farms from the application of these new Proposed Regulations. Notably, there has also been a movement in Congress to prevent the implementation of these Proposed Regulations by a number of Republican Congresspersons. Finally, if the federal estate tax is repealed it is also probable that these Proposed Regulations may never be finalized (or may be very limited to certain specific gift situations assuming the gift tax stays in place).

Basically, these Proposed Regulations expand the categories of restrictions under §2704(b) which are "disregarded restrictions" for valuation purposes. The Proposed Regulations' new "disregarded restrictions" for valuation purposes include provisions that limit or permit limitations of a persons ability to compel liquidation or redemption of the business interest; provisions that limit the amount that may be received on liquidation or redemption of an interest to an amount less than a minimum value; provisions that defer or permit deferrals for certain time periods; and provisions that allow payment of liquidation or redemption proceeds other than in cash or property. Importantly, the Proposed Regulations reverse the concept under existing §2704(b) Regulations as to the default restrictions imposed by state law.

In summary, these new Proposed Regulations may never be enacted in final form because of the potential repeal of the federal estate tax. Additionally, Congress has put pressure on the Treasury Department to either withdraw these Proposed Regulations or to prevent these Proposed Regulations from applying to closely held businesses or farms.

2.2 ***Minority and Lack of Marketability Discounts. How Much of a Discount Is the Client Entitled To?***

2.2.1 ***Minority Discount***. A minority discount can be applied to a limited partnership interest, or a minority voting stock interest. The minority discount reflects the fact that the interest holder does not possess "control."

2.1.1.1 ***<u>What Does Lack of Control Mean</u>***? The elements of "control" which the interest holder does <u>not</u> possess relate to the receipt of income; managing and controlling the assets of the entity; being paid compensation or fees from the entity; admitting new owners into the entity; withdrawing from the entity; assigning the holder's interest in the entity; liquidating and dissolving the entity; controlling the day-to-day and other managerial decisions of the entity; controlling efforts for future growth of the entity; compelling the distribution to the holder of the holder's capital in the entity; demanding financial and other information on a regular basis from the entity; and the ability to pledge the holder's interest in the entity to secure a loan.[11]

2.1.1.2 ***<u>How to Calculate Minority Discounts</u>***. If a minority interest in a closely held business is valued based upon a capitalization of earnings approach, book value or adjusted book value approach, <u>but</u> such approach is <u>based upon comparable controlling interest transactions</u>, then those comparable controlling interests must be discounted if the interest being valued is a minority interest. It is common for appraisers to value a minority interest by first valuing what a willing buyer would pay for a <u>controlling interest</u> of an entity (such as where the entire business is purchased). The minority discount is then applied to this controlling interest.

> **<u>Planning Idea</u>: If a client owns a controlling interest in the stock of the business, consider gifting enough shares of stock to the client's children in order that the client is left with a minority (i.e., less than 50% of the voting rights) interest. Alternatively, the client could gift one-half of the controlling interest to each of two children (splitting the control among two children). The Tax Court and the IRS allow splitting a gift of a controlling interest among multiple donees to produce a minority discount.[12] The client could even gift stock to children immediately before death to reduce the client's stock ownership below 50%, thereby producing a minority discount.**

2.2.2 ***<u>Lack of Marketability Discount</u>***. A lack of marketability discount is a discount based upon the fact that the interest holder cannot quickly convert the holder's stock, LLC or partnership interest into cash within a brief time period. Because of this inability to quickly convert the interest into cash, a prospective purchaser of the interest would discount the price which such purchaser would pay for that interest. A marketability discount can apply to the value of stock,

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[11]One Tax Court case supported a discount for "lack of super-majority control," where a 7.5% discount was allowed for a decedent who owned 62.96% of the stock of a corporation. Here, the shares lacked the power to compel a liquidation, a sale of all or substantially all of the assets, or a merger of the corporation, all of which required a two-thirds vote under applicable state law. See ***Estate of Dunn***, T.C. Memo 2000-12.

[12]See ***Estate of Mario E. Bosca***, T.C. Memo 1998-251, where the Tax Court stated that separate gifts should be valued separately, and that a donor can split and convey a controlling interest to two persons thereby producing a minority discount. Also, see IRS's holding in Rev. Rul. 93-12, discussed above.

partnership and LLC interests or even to a promissory note (such as a corporate promissory note received by the parents in exchange for redeeming all of their stock of the family business).[13]

2.2.1.1 ***Factors to Determine Marketability Discount****?* The marketability discount is dependent upon the size of the entity, the entity's capitalization, the entity's earnings, and its distributions to its owners.

The Tax Court in ***Bernard Mandelbaum***[14] listed and analyzed various factors to be utilized to determine marketability discounts.

2.2.3 ***How Much of a Combined Minority and Lack of Marketability Discount Applies to the Business Interest****?* Clients often ask: "How much of a valuation discount can I get for gifts of my business to my children (or at my death)?" The correct answer is that only a qualified appraisal taking into account the specific facts and circumstances of the client's business interest can answer this question.

Facts and circumstances include: (i) the type of business being appraised; (ii) the type of underlying assets of the business; (iii) the entity being utilized and the organizational documents; (iv) any restrictions on the shares or partnership interests and any transferability restrictions imposed by agreement or law; (v) what comparable partnership interests or shares of stock would sell for; and (vi) are there any comparable sales. All of these factors, and others, will be considered by the appraiser in preparing their appraisal report.

Clients <u>cannot</u> rely on a particular Tax Court case's percentage valuation discount amount for authority to deduct these same valuation discount percentages from their business interests' values.

Courts have found combined minority and lack of marketability discounts ranging between 30% to 65% of the fair market value of the aggregate entity. For example, in ***Estate of Ethel S.***

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[13]See, for example, the case of ***Estate of Sidney Friedberg***, T.C. Memo 1992-310, where the Tax Court held that a promissory note issued in connection with a stock redemption was entitled to a 20% valuation discount for estate tax purposes. The Treasury Regulations at §20.2031-4 state that a promissory note is valued based upon such factors as the security for the note, interest rate, creditworthiness of obligor, etc.

[14]T.C. Memo 1995-255, aff'd 78 AFTR2d ¶96-5159 (3d Cir. 1996). ***Bernard Mandelbaum*** listed the following factors to determine marketability discounts: (i) financial statement analysis of the entity; (ii) dividend policy of the entity; (iii) nature of the company, its history, industry position and economic outlook; (iv) the management of the entity, whether it was proven and experienced; (v) control of the transferred shares since a lack of control would indicate a greater discount; (vi) any transfer restrictions on the shares of stock; (vii) the holding period of the stock; (viii) the entity's redemption policy of its stock; and (ix) the cost of doing a public offering in order to make the stock marketable.

***Nowell***, the Tax Court allowed without comment a valuation discount of 65% on certain partnership interests.[15] In ***Gallagher***,[16] the Tax Court in valuing a closely held publishing company applied a 23% minority discount plus a 31% lack of marketability discount for a total blended discount of 46.8%. In ***Estate of Bailey***,[17] the Tax Court valued corporate stock of a corporation owning motels, utilizing a 50% blended valuation discount.

Note that for each case the amount of valuation discounts stands on its own unique facts.

2.3 ***Valuation Discount For Corporate Taxes That a Corporation Might Have to Pay in the Future***. A discount is allowed for potential future income taxes on corporate built-in gains, even if the corporation is not currently liquidating.[18]

The Second Circuit in ***Irene Eisenberg***,[19] found that such a discount was proper under general business valuation principals. The value of a C corporation's stock must take into account the fact that the C corporation has a contingent built-in income tax liability due to the difference between the fair market value of the corporation's assets and those assets' tax bases. The appraiser should, therefore, consider what a willing buyer would pay for the corporation's stock considering

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[15]See also ***Estate of Helen J. Smith***, T.C. Memo 1999-368 where the decedent died owning a minority interest in two closely held corporations. One closely held corporation owned and operated a farm, for which the estate received a 35% lack of marketability discount. This was in addition to what was a 50% minority discount in determining the value of the corporation, producing an effective overall 76% valuation discount.

[16]T.C. Memo 2011-48, as modified by T.C. Memo 2011-244.

[17]T.C. Memo 2002-152.

[18]See ***Estate of Jensen***, T.C. Memo 2010-182 and ***Estate of Artemus D. Davis***, 110 T.C. 530 (1998). Taxpayer's argument for a discount in the value of a C corporation for the corporate level built-in gains tax arose after the repeal of the General Utilities doctrine under the Tax Reform Act of 1986. The repeal of the General Utilities doctrine resulted in a corporate level gain when the corporation was liquidated. Taxpayers thus argued that this corporate level tax was a corporate liability to be taken into account in valuing the stock.

[19]82 AFTR2d ¶98-5757 (Ct.Ap.2d 1998) acq. AOD 1999-001. The ***Irene Eisenberg*** and ***Estate of Artemus D. Davis*** results have been acquiesced to by the IRS. The IRS's acquiescence indicates that the amount of the reduction in value of the corporate stock will be based upon the facts and circumstances of each case. The corporate built-in gains tax has also been allowed as an reduction in the value of the corporate stock in ***Estate of Jameson***, T.C. Memo 1999-43; ***Estate of Rodgers,*** T.C. Memo 1999-129; and ***Estate of Simplot***, 112 T.C. 1930 (1999). In ***Estate of Dunn***, 90 AFTR2d ¶2002-5527 (Ct.Ap.5th 2002), the Court discounted the entire amount of the capital gains tax.

this corporate contingent income tax liability. In ***Estate of Jensen***, a dollar for dollar discount for built-in gains was allowed.[20]

2.4 ***<u>Key Person Valuation Discount</u>***. Another type of valuation discount is the "key person" discount. The value of the stock of a closely held family business may be depressed because of the loss of executive talent through the death of its principal manager. The extent of the loss and value will depend on the availability of qualified replacement personnel and the degree to which the key person's qualities contributed to the success of the business. Also, the nature of the business is important to determine the importance of the key employee.[21]

In ***Maude G. Furman***[22], the Tax Court allowed a 10% "key person" discount in valuing gifts of minority stock interests. The Court allowed a combined 40% discount for minority interests and lack of marketability <u>plus</u> a 10% "key person" discount because the son (the recipient of the gifted shares) might have left the company. The risk of the son leaving substantiated this additional 10% discount.

2.5 ***<u>IRS Argues For Increased Stock Valuation For a "Swing Vote" Interest</u>***. The IRS has, without success, argued that minority interests in a family business entity should carry a valuation premium if that minority interest represents a "swing vote." In two 1994 Technical Advice Memorandums, the IRS brought up the swing vote argument.[23]

2.6 ***<u>Parents Can Increase Valuation Discounts by "Layering" Ownership of the Business's Operations</u>***. If one business entity owns an interest in another entity, then the parents get the benefit of two valuation discounts being applied (one for the underlying business and another for the business interest entity owned by the parents).[24]

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[20]The Tax Court in ***Estate of Walter L. Gross, Jr., supra***, refused to apply a valuation discount for the built-in-gains tax of an S Corporation. However, in ***Estate of Welch***, 85 AFTR2d ¶2000-534 (6th Cir. 2000) the court held that a discount for potential built-in capital gains for a corporation owning real estate should be considered in valuing a minority stock position, despite the fact that a §1033 condemnation deferral of the gain was possible.

[21]Rev. Rul. 59-60, 1959-1 CB 237.

[22]***Maude G. Furman***, T.C. Memo 1998-157.

[23]See TAMs 9436005 and 9449001 in which the IRS indicated that the parent who controlled a closely held corporation and gifted minority shares of stock to their children should have their minority discount reduced because each child's gifted stock voting block represented a "swing vote." The Tax Court in ***Estate of Wright***, T.C. Memo 1997-53, rejected the IRS's swing vote argument.

[24]In ***Roy Martin, Jr.***, T.C. Memo 1985-424, the Tax Court allowed a 50% minority discount for the stock owned by the parent corporation, and an additional 5% discount for the taxpayer's minority stock interest in the parent corporation.

2.7 ***Summary of Principles on Valuation Discounts***. The following principles can be gleaned from the valuation cases:

- Taxpayers must hire a respected business appraiser. A qualified appraisal is important in defending valuation discounts before the IRS and in court.

- Case law supports minority, lack of marketability, corporate tax liability/built-in gain, and key person valuation discounts.

- The new proposed §2704 regulations are unlikely to go into effect as final regulations in their current form.

- When partnership interests, LLC membership interests, and corporate stock are transferred by parents to their children, there is no family aggregation or constructive ownership rules in the valuation discount area.

- It is important that taxpayers and their advisors create favorable fact patterns by gathering evidence on the date of death and the time the gifts or transfers are made to support valuation discounts.

- Despite IRS claims to the contrary, the sum of the parts do not equal the whole in the area of valuation discounts.

2.8 ***Burden to Prove the Amount of the Valuation Discounts***. The taxpayer's burden of proof in court only shifts to the IRS in cases where the taxpayer presents "credible evidence" with respect to the valuation issues. [See §7491.] Under §7491 for the burden of proof to shift, the taxpayer must satisfy record keeping requirements, cooperate with the reasonable requests of the IRS for witnesses, information and interviews.

2.9 ***How to Refute IRS Arguments Against Valuation Discounts***. Below are discussed some IRS arguments against valuation discounts previously raised by the IRS on audit, and ways to refute these IRS arguments.

2.9.1 ***The Murphy Argument that the Transaction Has No Substance***. In ***Estate of Elizabeth B. Murphy***, the Tax Court valued the decedent's 49.65% common stock interest in a closely held corporation as a controlling interest because the decedent had given her children a 1.76% block of stock only eighteen (18) days before her death. The Tax Court found that nothing of "substance" changed by the stock gift and disregarded the stock gift because it was done solely to reduce taxes.[25] Thus, a minority valuation discount was not recognized. However, ***Estate of Frank*** came to an opposite conclusion than ***Estate of Murphy***, under similar facts.[26]

Even though ***Estate of Elizabeth B. Murphy*** and ***Estate of Frank*** came to opposite conclusions, both of these cases are only Tax Court Memorandum Decisions.[27]

2.9.2 ***Refute IRS's Arguments Against Gifts Made Within a Few Years of Death By Pointing Out that the IRS Failed to Consider §2035***. Under the 1981 changes to §2035, §2035 (with some specific exceptions) no longer contains provisions causing gifts made within three years of date of death to be included in the decedent's gross estate. Thus, because of §2035's repeal, parents' gifts of stock to their children within three years of date of death, arguably, cannot be brought back into the decedent's taxable estate to create control and eliminate minority valuation discounts.

2.9.3 ***Refute IRS Argument of "No Business Purpose" for Gift of Business Interests, by Showing the Need for Children to Manage the Business***. To refute the IRS's arguments of "only a tax motivation" in making gifts of business interests to create minority valuation discounts, parents should stress the need to have their children manage the business. Shifting management of the business's control to children should be a sufficient business purpose.

2.10 ***Tax Court Has Become More Critical of Appraisers***. Hiring a qualified and respected appraiser is essential to substantiate valuation discounts. In some cases the Tax Court alleged that the appraiser did not consider all facts and methodologies, and in other cases the Tax Court criticized the appraiser for being biased.

2.10.1 ***Planning Tips for the Business Valuation Appraisal***. **First**, it is important that the appraiser address all valuation methods (or explain why a particular valuation method does not apply to that business). **Second**, the appraiser should be careful to apply the

[25]T.C. Memo 1990-472.

[26]In ***Estate of Frank***, T.C. Memo 1995-132, two days before the decedent died, the decedent made gifts of stock to reduce the decedent's ownership interest to less than 50%. The Tax Court held that the decedent's estate was entitled to a minority discount in the corporation, and allowed a discount of 30% for lack of marketability and 20% for lack of control. The Tax Court disagreed with the IRS and recognized the stock gifts. The Court held that if tax avoidance was the sole motive for transferring the shares, a substantially smaller number of shares could have been transferred. The Tax Court held that the Court was not going to become involved in the motive of the decedent's son for transferring the shares. The Tax Court went on to state that as a general rule the Tax Court will respect the form of a transaction.

[27]The Tax Court is not bound to follow a "Memorandum Decision" in subsequent cases. A Tax Court Memorandum Decision is not binding on the Tax Court (only published, regular reported Tax Court opinions are binding on the entire Tax Court under §7462).

specific facts of a business to the appraisal and not just apply general valuation principals. **Finally**, the appraiser should not appear to be an "advocate" and appear biased.

2.11 ***Tips for Hiring a Qualified Appraiser and How to Prepare the Appraisal Report*.**

2.11.1 ***Qualifications of the Appraiser***. The appraiser should be reputable, qualified and independent. Accounting firms that perform that family business's regular tax and financial accounting services should not prepare the appraisal report. Independent accounting firms can still be used as the appraiser of the business.

2.11.2 ***Form of the Appraisal Report***. The IRS will carefully examine the taxpayer's appraisal report where valuation discounts are used. Given the fact that the IRS works on a budget, the IRS may not choose to expend monies to challenge a well presented taxpayer appraisal from a respected appraiser who uses accepted valuation techniques.

2.11.3 ***Discuss the Draft of the Appraisal Report With The Appraiser Before the Final Appraisal Report is Issued***. The appraiser should submit a draft of the appraisal report to the attorney for their review. The attorney should then carefully review the underlying facts, assumptions and analysis of the appraisal report to be sure that they are logical. Any concerns should be discussed with the appraiser before the appraisal report is put into final form. Remember if drafts of the appraisal report are retained, then these drafts are subject to disclosure to the IRS in any litigation. Consider having the attorney, rather than the client, retain the appraiser to maintain the attorney-client privilege.

2.11.4 ***The Appraisal Report Should Discuss in Detail All Valuation Methods***. The business's appraisal report should discuss each of the following three valuation methods. If the appraiser concludes that any of the following valuation methods does not correctly establish the business's fair market value (or should not be applied to that particular business), then the appraisal report should explain why in detail:

- **Market comparative method**. This method depends on identifying comparable businesses and their sales, making adjustments for the differences between a comparable sold business and the business being valued.

- **Income method.** This method includes the discounted cash-flow method and is based upon the premise that the current value of a business is determined by presently valuing future benefits derived from that business. The anticipated return from that business (which in many cases is based upon actual returns of prior years) is determined and then capitalized. The capitalization rate used is developed through several methodologies.

- **Cost method.** This approach determines the value of the equity of the business by examining the business's underlying asset values (i.e. inventory, accounts receivable, equipment, etc.) and the business's liabilities. Sometimes it is difficult to apply solely the cost method to an operating business because this method fails to take into account goodwill.

2.11.5 ***The Appraisal Report Should Discuss Any Recent Sales of Similar Businesses to the Business Being Valued***. The Tax Court places great emphasis on recent sales of similar business stock, partnership or LLC interests for determining fair market value. An arm's-length sale of the same stock, partnership or LLC interest (for example, the same business's stock to a third party) close to the valuation date is indicative of the business interest's fair market value. However, if the former sale of the business interest was to a family member, then the appraisal must justify why that sale was "arm's-length" such as by evidencing any potential family conflicts. The appraisal report should discuss how the buyer in a prior comparable stock interest sale analyzed their purchase to arrive at the sales price, and how the seller of the comparable stock maximized his/her profit from the sale.

2.11.6 ***The Appraisal Report Should Tie Specific Valuation Discounts to Specific Fact Patterns***. The appraisal report should apply valuation studies to the specific facts of the business being valued. The report should not just be a summary of valuation methods or the types of valuation discounts. Rather, the appraisal report should be analytical and lay out in detail the methods and calculations of how that particular business's value, and any valuation discounts, were arrived at.

2.11.7 ***The Appraiser and Appraisal Report Should Comply With the Gift Tax Return Regulations***. The statute of limitations on assessing a gift tax deficiency will only commence running if a filed gift tax return adequately discloses the gift. If such a gift tax return is filed with the IRS, then the IRS cannot then revalue such gift for either gift or estate tax purposes after the period for assessing a gift tax deficiency expires.[28] Adequate disclosure requires that the gift tax return, or a statement attached to the return, include information sufficient to describe the gift completely and accurately, including: (i) a description of the transferred property and any consideration received by the donor; (ii) the parties involved with the gift and their relationship; (iii) the taxpayer identification number of any trust to which the property is gifted; (iv) a brief description of the terms of the trust or a copy of the trust instrument; (v) the value of the gifted property and how the gift was valued; and (vi) a statement of any position taken by the taxpayer with respect to the gift that conflicts with the Regulations or Revenue Rulings.[29]

[28]§6501(c)(9).

[29]Reg. §301.6501(c)-1(f)(2).

The description of how the gifted property was valued must include, under the Regulations, a statement of all discounts, premiums and other adjustments used in the valuation, and a description of any transfer restrictions taken into account in valuing the gifted property. A statement of the value of 100% of the interest in the business entity should be included.[30] These gift tax return disclosures may be separately explained on the gift tax return, or by attaching a copy of the appraisal to the gift tax return. The Regulations require that the appraisal report be prepared by an appraiser who meets specific requirements.[31]

2.12 ***Have Client's Memos and Correspondence Prepared to Help Support Valuation Discounts for Lifetime Gifts and For Bequests at Death***.

2.12.1 ***Have Correspondence to Clients Stressing Business Purposes (and Not Tax Reasons) for the Gifts of the Business Interests***. On audit, the IRS may ask you to produce correspondence to your client on why a business interest was transferred to the client's children. Your correspondence or memos to the client regarding the gifts of business interests should emphasize the business purposes (and not tax purposes) for such gifts.

2.12.2 ***Preserve the Attorney-Client Privilege***. There is an attorney-client privilege which protects disclosure of confidential communications (for legal advice) between the estate planning attorney and the client. However, communications with accountants, non-client family members or other third parties are generally not privileged.

The "tax practitioner privilege" under §7525 does not apply in all cases. That privilege as applied to accountants is only limited to non-criminal tax matters before the Internal Revenue

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[30] See these and other disclosure requirements at Reg. §301.6501(c)-1(f)(2)(iv).

[31] The appraiser must meet the following requirements: (i) the appraiser must be a public appraiser who performs appraisals on a regular basis; (ii) the appraiser must have the qualifications described in the appraisal report that details the appraiser's background, experience, education, etc.; and (iii) the appraiser is not the donor or the donee of the property or a member of their family, or any person employed by the donor, the donee, or a member of the family of either.

The appraisal report must include the following data: (i) the date of the gift, the date on which the gifted property was appraised, and the purpose of the appraisal; (ii) a description of the gifted property; (iii) a description of the appraisal process; (iv) a description of the assumptions, limiting conditions, restrictions on the gifted property that affected the analysis and conclusions; (v) information considered in determining the appraised value in sufficient detail that another person can reproduce the process and arrive at the appraised value; (vi) the appraisal procedures followed and the reasoning that supports the analysis, opinions and conclusions; (vii) the valuation method utilized, the rationale for the valuation method, and the procedure used for determining the fair market value of the asset gifted; and (viii) the specific basis for the valuation, such as specific comparable sales or transactions, or sales of similar property interests. Reg. §301.6501(c)-1(f).

Service or noncriminal proceedings in Court brought by or against the United States, and does not apply to promoting a tax shelter.

Also be sensitive that the assertion of the attorney-client privilege may lead the IRS field auditor (or IRS appellate officer) to assume that something is being "hidden" by you. For example, it is better to have correspondence in your file discussing the business purposes (and not tax reasons) for transferring the business's control to the children, rather than having correspondence in your file for which you must assert the attorney-client privilege.

2.13 ***When Using Valuation Discounts Must Keep in Mind Potential Tax Penalties***. Section 6662 states that if there is an underpayment of estate and gift taxes by more than $5,000, and if the value of the property claimed on the estate tax return is 65% or less of the "correct" value, then there is imposed a civil penalty of 20% of the underpayment of estate or gift tax attributable to the undervaluation. This penalty increases to 40% of the tax if the valuation claimed is 40% or less of the "correct" value.[32] An exception to the penalty is that if the underpayment of the estate tax was due to "reasonable cause" and the taxpayer "acted in good faith."[33]

2.14 ***Application of Chapter 14 Rules***. Chapter 14 of the Internal Revenue Code (which includes §§2701, 2702, 2703 and 2704) was enacted in 1990, with final Treasury Regulations issued shortly thereafter. Chapter 14 was enacted to deal with perceived valuation abuses, and has specific provisions applicable to family members. See the discussion above of the Proposed Regulations under §2704.

## 3. **DIFFERENT WAYS TO TRANSFER THE BUSINESS TO YOUNGER FAMILY MEMBERS**

Transferring family business interests to younger family members should consider the following factors:

- What are the income estate and gift tax consequences of the transfer?

- Who currently controls the family business and who is intended to control the family business after the transfers are completed? Who should control the business during the parents' lifetimes or after their deaths?

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[32]§6662(h)(2)(C).

[33]§6664(c)(1).

- Should restrictions be placed on family members conveying their family business interests to persons outside of the family? (See discussion of Buy-Sell Agreements at Section 6).

- To which family members should future appreciation in the value of the business be shifted?

- Consider protecting any S corporation or other special tax status of the corporation.

3.1 ***Make Annual Gifts Using the Annual Gift Tax Exclusion to Transfer the Family Business to the Younger Generation***. The simplest way to transfer ownership of the family business to the younger generation is to gift interests by using the annual gift tax exclusion (such as gifting shares of stock, partnership interests or LLC membership interests) to younger generation levels over a period of several years.

> **Example: Assume that father and mother have four children and 12 grandchildren (for a total of 16 potential donees). The parents desire to gift 49% of the family-owned corporation (the entire corporation is worth $50,000,000) to their children and grandchildren. Using the gift tax annual exclusion of $14,000 per spouse per donee ($28,000 for husband and wife)[34], the parents can gift a total of $448,000 each year gift tax free to their children and grandchildren (16 issue multiplied times $28,000). The parents obtain a valuation appraisal of the corporate stock using minority, lack of marketability, key man and built-in corporate tax valuation discounts showing that a 49% stock interest is entitled to a combined 45% valuation discount, for a total value of $13,475,000 (49% of $50,000,000 is $24,500,000 less a 45% discount equals $13,475,000). The parents make gifts using their gift tax combined exclusion amount of $10,980,000 ($5,490,000 for each parent) leaving $2,495,000 for annual gifts under the gift tax exclusion. Then the parents gift $448,000 per year gift tax free under the annual exclusion, meaning that the $2,975,000 remaining interest can be gifted gift tax free in six years.**[35] **Thus, at the end of**

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[34]The current $14,000 per donee gift tax annual exclusion amount will increase in the future for inflation under §2503(b)(2).

[35]There is the practical issue of having to get an appraisal of the gifted stock each year in order to value the stock for the annual gift tax exclusion gift. Such an appraisal is necessary, for among other reasons, in order to file the gift tax return for the annual exclusions in order to have the gift tax statute of limitations run. Most clients will not want to spend money each year to update the valuation appraisal for annual stock gifts. A "rough solution" to this problem is to obtain the valuation appraisal the year of the first gift, showing the valuation discount percentage amounts and applying this same first year percentage minority and lack of marketability percentage discount amounts to the stock's value in each subsequent year. Each year the entire value of the corporation can either be estimated (based on such factors as increases or decreases in book value

**six years the children and grandchildren own 49% of the family business free of paying any gift taxes.**

3.1.1 ***Lifetime Gifts of the Business Can Produce Greater Valuation Discounts Than Waiting Until Death*.** In the above example, each minority gifted stock interest is entitled to the same valuation discount of 45%. Based upon Rev. Rul. 93-12, there is no family attribution between family members. If, on the other hand, in the above example the parents made no gifts during the parents' lifetimes and the last surviving parent owns 100% of the family business's stock in their estate at their death, there would be no minority discount, resulting in increased transfer tax costs to the family. Therefore, lifetime gifting can achieve greater valuation discounts.

3.1.2 ***Use of Trusts With Annual Gifts*.** Assume in the above example that the parents desire to gift 100% of the family corporation stock to their four children and 12 grandchildren, with each receiving an equal number of shares (or 6.25% to each person). To retain control of the grandchildren's stock, the grandchildren's shares could be owned in "Crummey" trusts, with each grandchild's parent as the trustee.

3.1.3 ***Use of the Unified Exclusion Amount to Make Lifetime Gifts of the Business*.** Parents, in addition to making annual gifts using the $14,000 annual gift tax exclusion, can make further tax free gifts to their issue by utilizing the parents' unified exclusion amount

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from the initial appraisal year) and other financial factors. The gift tax return must include the disclosures as described above. If the IRS questions these gift values and discounts on audit at a later date, final appraisals can then be obtained for each of these prior year gifts. This author's experience is that the IRS on audits has accepted this "rough solution" method for valuing annual gifts using the annual exclusion amounts.

With respect to taxable gifts, the statute of limitations on assessing a deficiency on a taxable gift will begin to run only if a gift tax return is filed that adequately disclosed the transfer. §6501(c)(9).

(currently in 2017 $5,490,000 per donor or $10,980,000 for a husband and wife).[36] There is also "portability" of a deceased spouse's unused exclusion amount to the surviving spouse. Thus, the surviving spouse during 2017 can use a deceased spouse's unused estate tax exclusion to make gifts during 2017.

3.2 ***Parents Can Sell Their Business's Stock to Their Children***. Parents can sell their stock and other family business interests to their children in exchange for cash or an installment promissory note. The advantage of a stock sale in exchange for a promissory note is that the promissory note can be repaid by the younger generation from the corporation's future earnings. If the parents receive back an installment promissory note and own that promissory note at their

[36] The unified credit amount or exclusion amount has increased over the years as follows. It will increase in the future pursuant to an inflation adjustment in the statute.

| In the Case of Decedent's Dying and Gifts Made During | The Applicable Exclusion Amount (or Credit Equivalent) |
|---|---|
| 2000 and 2001 | $675,000 |
| 2002 and 2003 | $1,000,000 |
| 2004 | $1,500,000 |
| 2005 | $1,500,000 |
| 2006 to 2008 | $2,000,000 (but gift tax exclusion at $1,000,000) |
| 2009 | $3,500,000 (but gift tax exclusion at $1,000,000) |
| 2010 to 2011 | $5,000,000 (both gift and estate taxes; and in 2010 there was no federal estate tax) |
| 2012 | $5,120,000 (both gift and estate taxes) |
| 2013 | $5,250,000 (both gift and estate taxes) |
| 2014 | $5,340,000 (both gift and estate taxes) |
| 2015 | $5,430,000 (both gift and estate taxes) |
| 2016 | $5,450,000 (both gift and estate taxes) |
| 2017 | $5,490,000 (both gift and estate taxes) |

deaths, then the value of that promissory note can possibly be discounted for lack of marketability or other factors. However, a discounted promissory note at death may create later income taxes due to the promissory note's reduced income tax basis.

3.3 ***Using an Installment Promissory Note Combined with Regular Annual Forgiveness of That Promissory Note's Installment Payments***. The parents could sell their stock interest to their children in exchange for an installment promissory note. The parents then each year can forgive some, or all, of that promissory note's annual installment payments as such payments become due, or in the alternative the parents could make annual cash gifts to their children to enable their children to pay the promissory note's annual installment payments. The parents have taxable income on the forgiveness of each installment note payment under §453(f).

> **Example: Parents desire to gift to their two children stock worth $100,000 with a $0 income tax basis. The parents sell a 50% stock interest to each of their two children (for $50,000 each) in exchange for each child giving the parents an installment promissory note for $50,000. Each promissory note requires monthly payments of $1,014, amortized over 60 months at the rate of 8% per annum (or $12,166 per year). Each year the parents forgive the $12,166 of note installments for each child. Alternatively, the parents could each year gift $12,166 to each child in order for that child to make the promissory note payments. In either alternative the parents have tax on $100,000 of capital gains (spread over the promissory notes' installment payments under §453) on the stock's sale to their children (the difference between the $100,000 amount of the note realized on the stock's sale and the $0 stock's income tax basis).**

In the above example, the parents should not have any correspondence or agreements indicating that the parents intend to forgive the promissory note's installment payments each year, in order to prevent the IRS from implying two gifts of $50,000 ($100,000 total) by the parents in the first year (rather than the parents making annual gifts by the annual promissory notes' installment forgiveness).[37]

3.4 ***Using Self-Canceling Installment Notes Known as "SCINs"*****.** If, in the above example, the parents still held the unpaid installment promissory note on their dates of death, then the fair market value of the promissory note is included in the parents' estate for estate tax purposes. On the other hand, if the promissory note contains a provision which states that all of the promissory

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[37]The IRS in Rev. Rul. 77-299, 1977-2 C.B. 343 asserted that an immediate gift (and not an installment sale) occurred because it appeared that there was no intention of making any payments on the installment note. Correspondence from the attorney indicated that there was an intention to forgive all of the promissory note's installments at the time of the sale. Thus, the IRS disregarded the installment sale form of the transaction, and instead treated the transaction as a gift. However, the Tax Court disagreed with this IRS position in ***Estate of Kelley***, 63 T.C. 321 (1974), non-acq. 1977-2 C.B. 2.

note's then obligations are <u>canceled</u> upon the last-to-die parent's death, then this installment promissory note on the date of the last-to-die parent's death is worth $0. This self-canceling promissory note is referred to as a "SCIN." SCINs are useful to sell stock and other family business interests.

A SCIN is based upon the Tax Court case of ***Estate of Moss***.[38] In ***Estate of Moss***, Mr. Moss sold all of his stock in a closely held business (which operated funeral homes) to his employees in exchange for a promissory note. That promissory note provided that the note's payment obligations would terminate on Mr. Moss's death if he died before all note amounts were paid. The Tax Court held that the promissory note had no value on the date of Mr. Moss's death. In ***Estate of Moss,*** there was evidence of an arm's-length negotiation so that the promissory note's principal amount took into account the fact that the promissory note terminated on Mr. Moss's death.

Similar to a regular installment promissory note, a SCIN freezes the value of the stock in the children's hands, and the parents recognize taxable gain on the stock's sale under §453. The parents can still forgive each annual SCIN installment as it comes due as an installment gift. The additional advantage of a SCIN over a regular installment note is that if the parent dies during the term of the promissory note, no amount of the promissory note is included in the parent's taxable estate. In order for the SCIN value to equal that of the stock being transferred by the parents (and thus, avoid a taxable gift), there must be a "premium" amount included in the SCIN in exchange for the SCIN's self-canceling feature.

Although the IRS has issued no guidance on how to calculate the SCIN "premium," the premium should reflect the probability that the seller (i.e., the parents) will be alive on the date of the payment. Therefore, the older the seller/parent, the larger the premium required because the chances of the seller/parent dying before the SCIN payments are paid in full is greater than with a younger seller.[39] The SCIN "premium" can be produced by either: (i) increasing the SCIN interest rate; or (ii) increasing the SCIN principal amount to be paid. Additional items that affect the promissory note's value is the length of the obligations and the adequacy of the security. Thus, the

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[38]74 T.C. 1239 (1980), acq. in result 1981-1 CB 2. However, <u>if the facts show</u> that the SCIN was <u>not</u> a bona fide promissory note then the note will not be recognized for tax purposes. ***Estate of Musgrove***, 33 Fed. Cl 1657 (1995).

[39]Most SCIN's premium calculations are based on Treasury actuarial tables. However, these tables do not apply to a seller whose death is imminent. Regulations state that the actuarial tables apply unless "there is at least a 50% probability that the individual will not survive for more than one year from the valuation date." An individual who survives for at least 18 months is presumed to have not been terminally ill, unless the contrary is established by clear and convincing evidence. Reg. §1.7520-3(b)(3).

SCIN premium is reflected in either a greater purchase price (i.e., a greater principal amount) or an above-market interest rate (i.e., a higher interest rate).[40]

3.5 ***Using Corporate Recapitalizations to Transfer Ownership to a Younger Generation***. Prior to 1990 and the enactment of §2701, a popular technique to transfer equity in a corporation to a younger generation was through the use of corporate recapitalizations. The recapitalization would create common and preferred classes of stock whereby the parents would retain the preferred shares giving the parents a preferred distribution on liquidation, while the common stock (representing rights to future appreciation) would be transferred to the children. The parents and their preferred stock would receive a fixed amount of earnings and liquidating capital (i.e. "freezing" the parents' value). Because of the restrictions of §2701, recapitalization of corporations with preferred stock have fallen out of favor in family-held corporate planning.[41]

3.6 ***Using a Grantor Trust to Transfer the Family Business to the Children***. Parents can sell limited partnership interests, corporate stock, or LLC interests to a "grantor trust" (also known as a "defective income trust") benefitting their children. This trust is classified for income tax purposes as a grantor trust. Under a grantor trust, the parents recognize no taxable gain on the sale of their business interests to this trust, and all of the grantor trust's income and deductions pass through that trust and are taxed to the parents (and not to the children). However, the trust's family business interests pass gift and estate tax free to the children (since this trust is irrevocable).

The parents are taxed on the grantor trust's income because that trust contains provisions which cause the trust's deductions and income to be taxed to the grantor parents (thus, the trust is

[40]There is no published IRS position as to whether an interest premium or principal premium needs to be utilized for a SCIN. However, several software programs are available for calculating SCIN interest and principal premiums.

[41]Section 2701 results in an increase in the value of the common stock given to the younger generation, thereby increasing the gift tax cost. Section 2701 values the common stock by subtracting the preferred stock value from the value of the parents' total stock holdings. Section 2701 reduces the value of the preferred stock where the corporation has discretionary powers to issue dividends.

classified as a grantor trust for income tax purposes).[42] The trust is irrevocable for gift tax purposes and the trust's assets are not included in the parents' estate for federal estate tax purposes.

The parents then sell their discounted partnership interests, stock, or LLC interests to this grantor trust (also known as a "defective income trust") in exchange for an installment promissory note, recognizing no gain on the sale under Rev. Rul. 85-13, 1985-1 CB 184.

The parents still pay the income taxes on all of the grantor trust's income, which further increases the trust's worth (and transfers further equity to the children gift tax-free) at no income tax cost to the children or grandchildren trust beneficiaries under Rev. Rul. 2004-64. In other words, the parents pay all of the income taxes on the income of the grantor trust's assets.

**Example: S corporation operates the family business, and its stock is all owned by the parents. Assume that the parents retain 31% of the total issued stock, and sells to a grantor income trust 69% of the total stock, all of which is nonvoting stock.**

**Assume that the S corporation has a total $10,000,000 value, and that the 69% sold stock is reduced in value 45% for "minority," "lack of marketability" and "key man" discounts, or a total discounted stock fair market value of $3,795,000 (69% of $10,000,000 less a 45% valuation discount). Assume that this 69% stock interest generates dividend distributions to the trust of $46,000 per month ($552,000 per year).**

**The defective income trust purchases 69% of the stock in exchange for such stock's $3,795,000 fair market value (after discounts). This $3,795,000 fair**

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[42]There are a number of techniques by which practitioners create a "grantor trust" for income tax purposes, but which do not cause inclusion of the grantor trust corpus in the parents' estates for federal estate tax purposes. One technique is to allow an individual other than the parents/grantors to reacquire the trust corpus by substituting other property of equivalent value pursuant to §675(4)(C). In order to prevent the IRS from asserting that this trust power has been held in a fiduciary capacity (which might then prevent the trust from being a grantor trust), the trust document should state that this power to substitute assets is being held by the third party without any fiduciary duties towards any trust beneficiary.

The IRS in Rev. Rul. 2008-22 ruled that the power to substitute assets did not result in the trust assets being included in the transferor/grantor's gross estate under §2036.

An alternative technique to create a grantor trust for income tax purposes is to have a non-adverse (but not the grantor) party retain a power to distribute the trust's principal to the trust beneficiaries where the power is not limited by any reasonable definite standard set forth in the trust instrument. The trust instrument should specify that the non-adverse party's powers are not limited to any fiduciary standard. See §674(a).

**market value is paid by an installment note payable to the client in the amount of $3,795,000, which note bears interest at the rate of 2.78%[43], and is payable and amortized monthly over 120 payments (promissory note payments of $36,122 per month by the trust to the parents).[44] Thus the trust receives $46,000 per month from the S corporation (in stock dividends), and pays $36,261 per month to the parents on the promissory note's debt service, netting the trust $9,739 per month.**

**Because this is a defective income trust, the parents pay all of the income taxes on the <u>entire</u> $46,000 per month dividend amount received by the trust, <u>and</u> the parents pay <u>no</u> tax on the $36,261 amount received by the parents under the installment note.**

**At the end of 10 years, the grantor trust (the defective income trust), which benefits the children, owns 69% of the corporation's stock and any appreciation thereon, gift tax-free, while the parents have received a total of $3,795,000 of principal payments (plus interest) over 10 years on the installment note.**[45]

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[43]The interest rate should be at least equal the applicable federal rate ("AFR") under §1272. Note that recent long-term AFR rates (for notes longer than 9 years) has been less than 3% for several years.

[44]In order for the defective income trust technique to produce the favorable estate tax result, the promissory note must be recognized as a sale for tax purposes, and <u>not</u> a retained life estate by the parents, causing inclusion of the trust's assets in the parents' estates under §2036. In order to avoid inclusion under §2036: (i) the interest rate under the promissory note should <u>not</u> be based upon the income generated to the trust; (ii) the promissory note should be a personal obligation of the purchaser/trust; and (iii) the promissory note obligation should <u>not</u> be charged to the trust property. In order to satisfy this test, commentators have suggested that the trust contain additional assets other than those assets which were sold in the sales transaction. The greater the value of these other non-sale assets, the better the result is to avoid §2036. Based upon informal conversations with the IRS, assets equal or exceeding 10% of the purchase price of the trust assets should be a sufficient amount to transfer to the trust. This 10% amount also is equivalent to the 10% minimum value which is required to be assigned under §2701(a)(4) in the growth equity area. See M. Mulligan, ***Sale to An Intentionally Defective Irrevocable Trust for a Balloon Note–An End Run Around Chapter 14?***, 32nd Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1505.2 (1998).

[45]It is preferable from a tax standpoint that the promissory note be paid in full prior to the parents' deaths. Since the trust is taxed as a grantor trust, no gain or loss is recognized upon the payment before death of the promissory note.

It is unsettled as to what are the income tax consequences if the last to die parent dies while still holding the unpaid promissory note. The most favorable tax result is that there is no income tax consequence on the parents' deaths, and the promissory note's value is included in the deceased parents' estate. Under this favorable tax result, the assets of the trust are simply treated for income tax purposes as having passed from the deceased parent to the trust at death, there is no income tax basis adjustment in the assets, the promissory

3.7 ***Use of a Grantor Retained Annuity Trust to Transfer the Business***. Under a Grantor Retained Annuity Trust (also known as a "GRAT") the parent business owner transfers the business interests to a trust, and the parent retains from the trust a fixed annual dollar amount over a period years (known as the trust "annuity"). After the expiration of the annuity term, the GRAT's assets are then distributed to the children trust remainder beneficiaries. The gift tax value of the GRAT's remainder gift to the children equals the value of the business interest transferred to the GRAT, less the value of the retained parent's GRAT annuity interest under §2702. This §2702 gift tax calculation is done by valuing the parent's retained GRAT annuity based upon the §7520 rate. The §7520 rate equals 120% of the federal mid-term interest rate.

Use of a GRAT to transfer the business interests to children is tax efficient so long as the business interest value increases by more than the §7520 rate. Recently, for the past several years the §7520 rate has been less than 3%, so GRATs have been viewed favorably for parents transferring their business assets to their children gift tax free.

A major disadvantage of a GRAT is that if the parent dies prior to the end of the GRAT annuity term, then the GRAT assets are included in the parent's taxable estate under §2036(a) for federal estate tax purposes (because the parent by the GRAT's annuity has retained during the parent's life the right to enjoy the income from the GRAT's assets). However, the value of the parent's retained interest is only to the extent that the value of the GRAT assets are necessary to provide the annuity payments to the parent.

One of the goals in forming a GRAT is to have the GRAT's remainder amount which goes to the children be valued at zero dollars for gift taxes (sometimes known as a "zeroed-out GRAT"). This is accomplished by having a higher annuity rate and a long enough annuity term of the GRAT to produce a zero dollar gift tax cost of the GRAT remainder interest.

GRATs are not tax efficient to leave assets to grand- children. The reason is that the parent cannot allocate their generation-skipping tax exemption to the transfer of assets into the GRAT until the parent's annuity interest terminates.

3.8 ***Transfer the Business Tax Free By Transferring Business Opportunities to the Children***. A simple way to transfer portions of the family business to children is to transfer a business opportunity to a new entity which is only owned by the children. The parents would not transfer to this new entity machinery, cash or inventory. Rather, the parents only provide advice to the children's new business entity, allow the new business entity to have favorable contractual relationships, allow the new entity to use technology (at a fair price). In other words, the parents introduce this children's new entity to a business opportunity.

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note is not income in respect of a decedent, and the promissory note receives an income tax basis equal to its estate tax value. The IRS may not agree with this income tax result and instead may try to argue that a taxable sale occurred on the parent's death, which produced taxable gain to the parent's estate.

**<u>Example</u>: Father's 100%-owned corporation, California Wire, Inc., imports electrical wiring which is sold primarily in California. This wire is manufactured in Korea under an importing agreement between California Wire, Inc. and the Korean manufacturer. Father's two children work for California Wire, Inc. Father wants to expand the wire business by selling electrical wiring throughout the United States. The two children form a new corporation called "U.S. Wire, Inc.," which the children entirely own. U.S. Wire, Inc. then contracts with the Korean manufacturer to import electrical wire for sales throughout the remainder of the United States (other than California). The father assists the children's corporation, U.S. Wire, Inc., in negotiating its contracts with the Korean manufacturer and provides other advice for its business operations. U.S. Wire, Inc. borrows its necessary start-up operating capital from California Wire, Inc. at a fair interest rate and terms.**

3.8.1 ***<u>Income Tax Issues</u>***. In the above example, there is the potential IRS argument that the father's gratuitous advice is "inadequate compensation" to the father which requires reallocation of compensation to the father. The partnership and S corporation tax provisions specifically address this inadequate compensation issue.[46] There are also the general reallocation rules of §482 which permits the IRS to reallocate income and deductions among two or more organizations controlled directly by the same interests.

3.8.2 ***<u>Be Careful Not to Make a Constructive Dividend Distribution to the Parent</u>***. If a corporate benefit is distributed to a shareholder, can a constructive dividend be imputed by the IRS?[47] There should be no constructive dividend if the value of the business opportunity is valueless or the opportunity cannot be valued with a reasonable degree of accuracy.[48] Thus, in the above example, the IRS should <u>not</u> be able to impute that a business opportunity was distributed to the father from California Wire, Inc., and then the father gifted this opportunity to the children, who in turn contributed the business opportunity to U.S. Wire, Inc.

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[46]See §§704(e) and 1366(e).

[47]The answer is probably no. See the District Court decision of ***McCabe Packing Co.***, 71 AFTR2d ¶93-672 (C.D. Ill., 1992), where the Court rejected the IRS's claim of a constructive dividend. Here the corporation (which was a slaughterhouse) distributed to one of its officers the business opportunity to extract fetal calf blood.

[48]See B. Bittker & J. Eustice, ***Federal Income Taxation of Corporations and Shareholders***, 7th ed., Warren, Gorham & Lamont (2006), at ¶8.05. The IRS <u>unsuccessfully</u> tried to assert in ***Bross Trucking, Inc.***, TC Memo 2014-107, that the corporation's goodwill (of a corporation owned by father) was gifted by father to his children where that goodwill was first distributed by the corporation to father. The Tax Court decided there was <u>no</u> corporation level goodwill, and instead found that the goodwill was always owned by the father individually (and <u>not</u> by the corporation).

3.8.3 ***Gift Tax Issues***. The federal gift tax is imposed on the transfer of property, and a gift of "advice" is, arguably, not a taxable gift.[49] In Rev. Rul. 81-54[50], the parents owned a manufacturing corporation in which they allowed their children to own 100% of the stock in the international sales corporation. There was a very favorable contract between the children's corporation and the parents' manufacturing corporation. The IRS held that there was a gift every time the parents' manufacturing corporation sold its products through the children's corporation which generated the children's corporation a profit higher than that which would have been generated in an arm's-length transaction.

3.9 ***Using the Marital Deduction to Assist Transferring the Business to the Children*.** Many parents use the unlimited marital deduction so that the family business is left to the surviving spouse (either outright or in a QTIP Trust) upon the death of the first spouse. The family business is then only left to the children upon the death of the second spouse. This puts off the payment of the federal estate taxes until the death of the second spouse, but the children end up paying death taxes on the appreciation in value of the business (between the first spouse's death and the second spouse's death) upon the death of the second spouse.

## 4. **HOW FAMILIES CAN RETAIN CONTROL OF THE BUSINESS OVER MANY YEARS, AND THROUGH MULTIPLE GENERATIONS**

4.1 ***Parents Retaining Voting Rights in the Corporation Must Avoid the Tax Trap of §2036(b)***. Many parents gifting the business's corporate stock to their children and grandchildren desire to retain that gifted stock's voting rights in order to continue to control the corporation. However, any retention of stock voting rights must avoid the tax trap of §2036(b). Section 2036(b) includes in the parents' gross estate the value of any controlled corporation stock transferred where the parents retain the stock's voting rights, unless the parents make the transfer for full and adequate consideration. The rules of §2036(b) only apply to controlled corporations. Taxpayers can fall into §2036(b)'s tax trap by retaining voting rights through written shareholders' agreements, voting trusts, grantor trusts, or other arrangements.[51]

> **Example: Parent own 100% of the stock of Smith Manufacturing corporation. Parent creates a trust under which the parent retains the right to vote the trust's stock. Parent sells 20% of the shares to the trust in exchange for $5,000**

[49]However, the taxable gift doctrine was applied in ***Dickman***, 465 U.S. 330 (1984), to gratuitous loans which the Supreme Court found was a transfer of property rights having value.

[50]1981-1 CB 476.

[51]In a Private Letter Ruling, the IRS applied §2036(b) to include corporate stock attributable to a limited partnership interest in the parents' estate where the parents transferred the corporate stock into a family limited partnership in which the parents were general partners and the children were given limited partnership interests. See PLR 199938005.

**at such time when the shares are worth $20,000. At the parent's death, the trust's 20% stock interest has a fair market value of $100,000. The value of the stock includable in the parent's taxable gross estate under §2036(b) is $95,000, which is calculated as follows: $100,000 fair market value of stock at parent's death less the $5,000 amount of consideration received by the trust.**

One solution to avoid the §2036(b) tax trap is to recapitalize the corporation and have both voting stock and non-voting stock. In Rev. Rul. 81-15[52] the IRS held that if a transferor owns both voting and non-voting stock, the transferor can give away non-voting stock and retain the voting stock without §2036(b) applying.[53]

4.2 ***Using Buy-Sell Agreements to Retain Control***. Buy-Sell Agreements can accomplish the following goals:

- Prevent the transfer of the business stock to non-family members.
- Assist in establishing the stock's value for estate tax purposes (subject to the §2703 restrictions discussed below).
- Purchase the parents' and non-participating children's stock upon the death or retirement of the parents.
- Purchase the stock of a surviving non-working spouse upon the working parent's death.

See Section 6, below, for a detailed discussion of Buy-Sell Agreements.

4.3 ***How to Retain the Business in the Same Family's Control for Multiple Generations***. Very few businesses remain in the same family's control for multiple generations (or for that matter survive as a business). Many reasons contribute to the nonsurvival of a business. However, with proper planning estate taxes should never be a reason for nonsurvival. Successful businesses use various planning methods to keep the family's control of the business for multiple generations.

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[52]1981-1 CB 457.

[53]There is always the risk that the IRS could attempt to apply the step transaction doctrine to include the non-voting stock in the parent's estate under §2036, where a corporation is recapitalized to voting and non-voting stock, followed immediately be a parent's gift of some or all of the non-voting stock to the children.

**Example: The Ford Motor Company has been under the control of the Ford family for four generations (since Henry Ford I obtained majority control in 1906), even though today its stock is publicly traded on the New York Stock Exchange.**

**In 1936, all of the stock in the Ford Motor Company was privately owned by Henry Ford I and his only child, Edsel. The Ford family wanted to avoid estate taxes (which in 1936 subjected most of the Ford estate to the top estate tax bracket of a 70% tax rate) and at the same time retain control of Ford Motor Company within the Ford family.**[54]

**Although Henry Ford had no special affinity for either attorneys or complicated corporate structures, his dislike of Franklin Roosevelt, taxes, and New Deal government programs caused Henry Ford to restructure Ford Motor Company in 1936. After the Ford family consulted with attorneys the following plan was implemented: The Ford Motor Company was recapitalized in 1936 by issuing two classes of stock, Class A nonvoting stock which was allocated 95% of the value, and a Class B voting stock which represented only 5% of the company's value but had all of the voting power. The Class A non-voting stock which represented 95% of the company's value was transferred to the Ford Foundation (which transfer to a private foundation was permitted under the tax laws in 1936). The Ford Foundation was set up by Henry Ford I and Edsel Ford in 1936 (and they controlled this foundation) as a private foundation and tax-exempt charity.**[55] **Henry Ford and Edsel Ford then by this recapitalization of Ford Motor Company in 1936 individually received all of the Class B voting stock.**

**When Edsel Ford died in 1943 and Henry Ford died in 1947, their respective federal estate taxes were relatively low (even with the high estate tax rates) since Edsel and Henry Ford only "owned" 5% of Ford Motor Company even though they still had 100% of the voting control (in the form of owning all of the Class B stock).**

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[54]The top estate tax rate increased even higher than 70% with the need for more revenues due to World War II and the military build-up leading up to the war. In 1940, a 10% surcharge was imposed on all estate taxes. In 1941 the top estate tax rate became 77% on transfers at death in excess of $55 million. The son, Edsel Ford, died first in 1943, four years before his father Henry Ford I's death in 1947.

[55]Ironically, Henry Ford in his 1925 autobiography disapproved of charities. He stated that "Professional charity is not only cold, but it hurts more than it helps. It degrades the recipients and drugs their self-respect." He went on to state "let weaklings take charity." Henry Ford, ***My Life and Work***, at 207 and 221, Doubleday, Page & Company, 1925.

**When the Ford Motor Company's stock went public in the 1950s, because of New York Stock Exchange and SEC requirements, the Class A shares owned by the public had to be modified to carry a certain amount of voting rights.**[56] **However, the Ford family still retained voting control by owning all of the Class B stock, which kept the Ford family owning 40% of the total voting rights (40% of the voting rights was effective control for a publicly-traded corporation). The remaining 60% of the voting rights were in the publicly-traded Class A stock which went public in 1955 and became traded on the New York Stock Exchange.**

**The Ford family today continues to preserve its 40% voting stake by its ownership of all of the Class B shares (which today have 16 votes per share compared to one vote per share for other shareholders of the Class A shares). Furthermore, the Ford family today has a substantial part of their Class B shares governed by a voting trust in order that the widely-disbursed Ford family votes most of their B shares as one voting block.**[57] **Today, the Ford family only owns approximately 2% of the company's issued stock in the form of Class B shares, but still exercises 40% of the company's voting rights. If you buy today Ford Motor Company stock on the NY Stock Exchange you are buying Class A shares with those Class A shares' limited voting rights.**

**Thus the Ford family, through the use of a family voting trust and two classes of stock, has retained control of Ford Motor Company for over 100 years, and Ford Motor Company today remains publicly owned and actively traded on the NY Stock Exchange.**

4.3.1 ***Use of Voting and Non-voting Stock to Keep the Business's Control in the Same Family***. If outside shareholders must be brought into a family-owned business, then consider the use of voting and non-voting stock. Voting stock can be given to the family members, with non-voting stock given to non-family members such as employees. To provide an incentive to non-family employees, these employees can be granted option rights to buy stock at a specific strike price.

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[56]In the early 1950s the Ford Foundation was the largest American foundation and was responsible for the Ford Motor Company going public. In the 1950s the foundation needed to diversify its Class A stock holdings, but had no voting rights in Ford Motor Company. To carry out the foundation's fiduciary duty as trustees of over $1 billion in 1950 dollars, the foundation in 1955 offered its Ford Motor Company Class A shares in an initial public offering.

[57]See SEC Form 14A for May 11, 2017 Shareholders Meeting filed with the Securities and Exchange Commission. Each B share today has enough votes per share to give the B shares in the aggregate approximately 40% of the voting rights. For various reasons, not all of the B shares are held in the Ford family voting trust.

4.3.2 ***Use of a Voting Trust to Preserve Family Control***. Family members in a voting trust can agree to vote their stock in a certain manner (such as in the same manner that a majority of the family members vote). Voting trusts are especially useful if there are outside shareholders owning stock in the family business. The voting trust allows the family to vote as one unit (as a majority of the family desires), rather than voting in multiple ways.[58]

4.3.3 ***Use of a Board of Directors With Outside Experts Serving on the Board to Preserve Family Control***. For well-established family corporations, it may be advisable to have persons outside of the family participate in the management and operation of that family corporation. Thus, a board of directors or board of trustees can be established to administer the corporation's business. Outside experts and active employees could serve on these boards. Ultimate voting control could still be left within the family unit under any such board-run entity.

Having a set board of directors with outside experts and family members can provide for the successful continuation of the business upon the disability or death of the principal shareholder. Outside directors who are experienced and expert in a particular industry can bring valuable business contacts and experience to the corporation, and can even act as neutral parties to resolve family disputes involving the business.

One significant issue in having outside directors is that these directors have fiduciary duties to the corporation and to the other shareholders, including to minority shareholders, which could put them at odds with the principal family owner of the corporation, or expose these outside directors to liability (including tax liabilities) if they do not monitor the principal owner's activities. Many outside directors will require that the corporation purchase D & O (directors and officers) liability insurance to provide protection. Thus, many closely held businesses have found it difficult to have outside directors actually serve on their board of directors.

An alternative to having outside directors on the board of directors is to instead establish an "advisory board" of outside experts and persons with experience in a particular industry. Members of an advisory board generally do not have the liability exposure that directors would have, and these outside advisors do not have any power to challenge the family's activities. An advisory board member can listen and learn about the family business, and upon the parent's death or disability would be in a position to step in and either render advice or to formally assume a position as a director.

**Example: The Hearst Corporation, since the death of William Randolph Hearst in 1951, has been owned and run by the Hearst Family Trust, which today**

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[58]Under a voting trust, the ownership of the shares is transferred to a trustee who votes the shares, with the stock owners retaining all other beneficial interests. For California corporations, voting trusts are governed by Corp. Code §706, which imposes a 10-year maximum limit for voting trusts. However, owners prior to the voting trust's expiration may consent to extensions in excess of 10 years.

**consists of a 13-member board of trustees, six of whom are family members and seven are non-family members (which non-family board members are part of management or have special expertise and who work for the Hearst Corporation).[59] Upon his death in 1951, William Randolph Hearst left his stock in a voting trust under which his mistress Marion Davies controlled the Hearst publishing empire. However, after some legal wrangling, Marion Davies agreed to give up control as voting trustee of the stock.**

5. **<u>HOW TO AVOID CONFLICTS AMONG FAMILY MEMBERS WHO HAVE AN OWNERSHIP INTEREST IN THE BUSINESS</u>**

In doing business succession planning, consideration must be given to prevent conflicts among family members. Examples where conflicts can arise include:

(i) A working parent owning the business, and has a second spouse and children from a first marriage;

(ii) Siblings working together in the business;

(iii) Some children working in the business, while other children do not work in the business;

(iv) The business is owned by a wide group of family members and only a few family members work in the business (such as where the business is owned through multiple family generations resulting in the business being owned by distant cousins); and

(v) The parents do not want to give up control of the business because they need the business's cash flow to support themselves.

In addressing the potential conflicts among family members, you should focus on the following issues:

- Which family members are to be currently employed and in the future employed in the business.
- Who should control the business currently and after the working parent's death.
- Which family members should have an ownership interest in the business, currently and after the working parent's death.

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[59]See D. Nasaw, ***The Chief, the Life of William Randolph Hearst***, Houghton Mifflin Company, at 606, 2000; and Wikipedia, April 2017.

- Are there other assets in the parents' estate to leave to non-working children, other than the family business?

- Does the working parent or their non-working spouse need the family business earnings to support themselves?

- Does the working parent have children from another marriage working in the business? Is there a second spouse?

- Are there any tensions among the family members currently working in the business?

5.1 ***The Working Parent Must Consider the Needs of Their Non-working Surviving Spouse***. In many cases, the business is the major income source for the parents. If the working parent dies, the non-working spouse may require the business's continuing cash flow for his or her support. Accordingly, many parents choose not to transfer the business to their children upon the death of the first spouse since this would cut off cash flow to the surviving spouse.

> **Example: The story of Getty Oil is a good example of the deceased spouse leaving the business to the surviving spouse rather than the child working in the business.**
>
> **George Getty, the founder of the original Getty oil business, on his death in 1930 left his entire estate to his surviving spouse, Sarah, and nothing to what he perceived as his spendthrift son, J. Paul Getty. At George Getty's death, the son, J. Paul Getty, was a minority shareholder of George F. Getty Oil and served as the company's president.**
>
> **After George Getty's death, George's wife, Sarah Getty, concerned about her son J. Paul's spending habits, established the "Sarah C. Getty Trust" to benefit J. Paul's children (Sarah's grandchildren), but not her son, J. Paul. Sarah Getty died in 1941.**
>
> **The Sarah C. Getty Trust (which benefitted only the grandchildren) and J. Paul Getty then invested their respective capital jointly into various oil interests which evolved into Getty Oil Company. When J. Paul died in 1976, his one-half interest in Getty Oil Company was used to fund his foundation and the Getty Museum, while the Sarah C. Getty Trust amount (approximately $4.1 billion) was distributed to J. Paul Getty's children (Sarah's grandchildren).**

In the case of Getty Oil, George Getty chose to leave his entire estate (with a few minor exceptions) to his wife.

Another way to use the family business to support the surviving spouse is for the working parent at his/her death to transfer the family business interests to a QTIP Trust where his/her surviving spouse receives all income and principal for his/her needs for life, with the remainder to those children who work in the family business. The QTIP Trust trustees could be one or a combination of the surviving spouse, working children, and a financial institution. One problem in applying this QTIP solution to a corporation is that many family business stock interests are non-dividend paying (see footnote 62, below).

5.2 ***Planning for the Senior Family Member's Retirement***. When a senior family member retires from the business, they may still require that business's cash flow to support themselves. This desire for continuing cash flow is one reason senior family members desire to retain control over the business.

Solutions on how to provide cash flow to the retiring family member are:

- Provide a consulting agreement to the retiring family member.

- Provide nonqualified or qualified deferred compensation agreement to the retiring family member.

- Provide a rental stream to the retiring family member from the business's real estate, which real estate is retained by the retiring family member. The retiring parent, as an example, could have the business' real estate owned by a separate limited liability company and then lease that real estate to the corporation on a long term lease. The lease can provide for periodic rental increases comparable to market rent.

- Provide a license agreement to make royalty payments to the retiring family member for such items as the business' technology, name, logo or other intellectual property rights which the retiring family member would retain.

- The retiring family member could sell the business to the working children in exchange for an installment promissory note.

5.3 ***Planning the Succession of the Business Where There is a Second Spouse and Children By Another Marriage***. By any scenario, this is a recipe for conflict. Conflicts became even more probable where the children work in the family business and the second spouse inherits an interest in the family business.

**Example of Second Spouse: In 1979 the Los Angeles Rams football team was owned by Carroll Rosenbloom who had a second spouse.**

**Carroll Rosenbloom died unexpectedly in 1979 in a drowning incident in Florida, and left the Los Angeles Rams football team 70% to his second wife, Georgia Frontiere, and 30% to his five children by another marriage. Carroll Rosenbloom's son, Steven Rosenbloom, was the then vice-president of the Rams and thought by many to be the likely successor to his father. Carroll Rosenbloom's explanation as to why he was leaving a large portion of the Rams to his second wife, Georgia, was that it was to save death taxes and he "trusted Georgia to do the right thing," expecting Georgia to sit home and do social things.**

**Georgia Frontiere was married seven times during her lifetime and was a lounge singer and a TV personality in Miami. Carroll Rosenbloom met her at a party hosted by his friend Joseph Kennedy in Palm Beach in 1957.[60] Carroll Rosenbloom married Georgia Frontiere in 1966, since it took Carroll Rosenbloom ten years to divorce his first wife (Carroll Rosenbloom was Georgia Frontiere's sixth husband).**

**Even though Steven Rosenbloom was effectively managing the Los Angeles Rams, Carroll Rosenbloom trusted his second wife Georgia to do the "right thing" by leaving her 70% of the Rams. Four months after Carroll Rosenbloom's death, Georgia Frontiere terminated her stepson Steven Rosenbloom as an employee of the Los Angeles Rams.[61]**

**Thus, a second spouse owning a business that children of another marriage work in, is generally not a workable alternative.**

Some suggested solutions are:

- Consider having the surviving second spouse not be involved with, nor own an interest in, the business; and only have the working children involved in the business.

- On the death of the working parent who owns the family business, have assets <u>other than the family business</u> left to the surviving second spouse outright or in a QTIP Trust. Have the family business left solely to the working children. Consider using a life insurance policy to provide an immediate cash payment to the second spouse.

- Whether or not the children are working in the business, the parent should consider not giving their entire estate (including the business) to the surviving second spouse

[60]See Wikipedia, Biography of Carroll Rosenbloom.

[61]See Article in the *Florida Times Union*, January 31, 2002.

and QTIP trust. Rather, the parent should leave "something" outright to his/her children by the first marriage. The children can be given the family business with reduced or no taxes by using the planning techniques discussed at Section 3. Clients sometimes become enthralled by the unlimited marital deduction and its avoidance of estate taxes, and they fail to leave anything to their children by a first marriage. In other words, do not let the taxes "wag the dog."

- Leave all or a portion of the business to the second spouse in a QTIP Trust. One problem with this QTIP solution is that most businesses are owned in corporate form and are not income producing (i.e. are not dividend paying). Because estate tax law requires for marital deduction and for trust accounting principles that the surviving spouse be able to demand that the business become "productive," the business may have to issue dividends.[62] Paying corporate dividends may not be acceptable to the children who work in the business.

- If the working parent uses a QTIP Trust or other trust which benefits the surviving spouse as the current income and principal distributee, and the children as remainderman, then an independent trustee (such as a bank or other institutional fiduciary) can be used.

- If there is a second spouse, then have the working parent who owns the business as their separate property have a property agreement (preferably an antenuptial agreement) to protect against the surviving second spouse claiming a "community interest" or having other claim on the business. Such a marital property agreement provides certainty as to who owns the family business and avoids future conflicts between the second spouse and the children by the first marriage.

- Have a no-contest clause included in the Will and trust documents.

- The working parent should sit down and talk to his/her second spouse and children. The working parent can use the explanatory letter (see form at **Appendix A**). However, must be careful that this type of letter is consistent with parent's Will and trust documents, and does not have unexpected legal effects.

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[62]In order to qualify for the federal estate tax marital deduction, the surviving spouse must be able to compel unproductive property's conversion into productive property within a reasonable time period, or for the surviving spouse to receive compensation for loss of income by payments out of other trust assets. Reg. §20.2056(b)-5(f)(4). Also, see the California Uniform Prudent Investor Act, at Prob. Code §16045 **et. seq.** Because of the Treasury Regulations' requirement that the surviving spouse be able to convert non-productive property into productive property, the QTIP trust probably contains a provision allowing the surviving spouse to convert non-productive property, such as non-dividend paying stock, into productive dividend paying stock.

5.4 ***__Parents Who Feel that "My Stupid Children Do Not Know How to Run My Business__***." Parents sometimes believe that their children cannot make the proper business decisions to run the business. Additionally, parents may have the perception that a child or that child's spouse is a spendthrift. In such cases the parents may not want to give their children control of the business during the parents' lifetimes or even after their deaths. Some solutions to consider are as follows:

- Establish a board of directors or board of trustees where the children can participate with the working parent to administer the business, with the parents retaining voting control over the board.

- Have an independent trustee or trusted business advisor act as the "swing vote" trustee or director, with the parents giving up a controlling interest in the family business. Giving up control has the estate tax advantage of producing a minority valuation discount upon the deaths of the parents.

- Have the parents keep control of the business. On the death of the first parent, split the parents' stock (or other family business interests) between a QTIP Trust, Survivor's Trust and Unified Credit Trust to produce valuation discounts for estate tax purposes. The surviving parent can be the sole income and principal beneficiary of all three trusts. See discussion of the ***Mellinger*** case at Section 2.

- The parents could keep control over the main core business and have portions of the business owned by solely the working children in a separate legal entity.

- The family business corporation could be recapitalized to have voting and non-voting stock. Have all of the non-voting stock issued to the working children, while having the parents retain the voting stock. See footnote 53, above, for discussion of the §2036 issue.

5.5 ***__What Happens When Some Children Work in the Business While Other Children Do Not Work in the Business__***? Some children may work in the business, while other children do not. In such cases, you must consider the following factors in implementing the parents' estate plan:

- On the parents' death provide for the buyout of the non-working children's interests in the business. The non-working children may have received from their parents gifts of stock in the business or the non-working children may receive stock upon the deaths of their parents. Utilize a shareholders' Buy-Sell Agreement to purchase the non-working children's interests in the business. (See discussion of Buy-Sell Agreements at Section 6.)

- On the parents' deaths, consider equalizing the amount of the parents' estates that the non-working children receive from the parents. Some parents, however, may not be concerned that the children who work in the business receive a larger share of the parents' estates in the form of the business.

- If at the parents' deaths there is a specific gift of the business to the working children where the business interests are discounted for estate tax valuation purposes, then the parents may effectively be leaving "more assets" to the working children who receive the business interests. Therefore, if the parents want to equalize the amounts which each of their children receive the parents may have to leave additional assets to the non-working children to make up for the discounted value of the business interests.

- Where the parents own the business real estate in the parents' own names, the parents should consider leaving that business real estate solely to the child who will be owning and running the business. Leaving that real estate to the other children (who do <u>not</u> work in the business) could produce future conflicts among the children. For example, if in the future the business is not able to pay the rent or desires to pay under market rent, then the other non-working children could object.

- Some business succession plans transfer voting shares to those children who work in the business, while transferring nonvoting shares to the children who do not work in the business. The disadvantage of this type of a plan is that even though the children outside of the business have no votes, friction may result between siblings if the stock is non-dividend paying and the children that work in the business are drawing substantial salaries and benefits from that business. An alternative plan may be to have a Buy-Sell Agreement allowing the non-voting shareholders (who are not working in the business)to elect by a "put" to require the children working in the business to purchase their non-voting stock. The purchase price with the "put" would be determined under a formula. Providing for a "put" of the non-voting shareholder's shares allows the non-working children to monetize the value of their stock.

- Utilize a family letter to working and non-working children explaining the parents' hopes for their children (see **Appendix A**).

- Use a no contest cause in the parents' Wills and trust.

<u>Example</u>: **Parents desire to split their estate equally between their two children. Parents' estate consists of a minority stock position in a family business with a fair market value of $5,000,000 (before valuation discounts), with their remaining assets (after payment of expenses and taxes) having a net value of $3,000,000. Assume that a 40% valuation discount applies against the $5,000,000 fair market value of the business stock which will be left to the**

**working child (which means the family business stock has a value after discounts of $3,000,000). The parents may feel that it is not fair for their non-working child to receive $3,000,000 in other assets, while the working child receives effectively $5,000,000 in the business stock (which stock is valued with discounts at $3,000,000 for federal estate tax purposes). To equalize the two children's gifts, the parents could have the non-working child receive an additional $1,000,000 in other assets.**

5.6 ***How to Prevent the Working Siblings From Fighting Among Themselves***. Where more than one child works in the family business, jealousies or other tensions may develop between the working siblings.

Some solutions to this problem are:

- Do a split-up of the business among the quarreling working siblings. The split-up could consist of dividing the different divisions of the business among the siblings. Where the business may be composed of two or more distinct businesses, then could split these distinct businesses among the siblings.[63]

- Have a shareholders' agreement between the working siblings providing a mechanism for one sibling to buy the other sibling out of the business if a deadlock develops.

- Utilize family letter at **Appendix A** instructing the working siblings of the parent's wishes.

- Utilize a no contest clause in the parents' Wills and trust.

- Include a provision in parents' trust or buy-sell agreement giving an independent trustee, accountant or attorney the "swing" or controlling vote over the business if a conflict develops between the working siblings.

5.7 ***What If There Are No Children to Run the Family Business***? With today's educational and job opportunities, none of the client's children may elect to work in the family

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[63]The split-up of multiple businesses should be done in a tax-free manner pursuant to §355 of the Internal Revenue Code. A tax-free "split-up" or "split-off" could permit quarreling siblings to divide up a family business and to go their separate ways. Each sibling could then take his/her separate business from the corporation (or other family-owned business entity) and could focus on his/her individual business. A discussion of §355 and D reorganizations is beyond the scope of this outline. For a thorough discussion see B. Bittker and J. Eustice, ***Federal Income Taxation of Corporations and Shareholders***, 7th ed., Thompson Reuters (2006), at Chapter 11.

business. What happens when the parents have a closely held family business in which none of their children wish to work?

- Could sell the business upon the death of the working parent. Generally, it is better to sell the business while the working parent is alive in order to realize a higher sales price. The disadvantage of selling the business during the parents' lifetime is that the business interests do not receive a step up in income tax basis (this income tax issue is resolved on the death of the first spouse for community property).

- Consider waiting to sell the business until after the death of the first spouse in order to get a step up in the community business interest income tax basis under §1014(b)(6). A stepped-up basis will reduce or eliminate income taxes on the business's sale.

- Have the business continue after the parents' deaths with the non-working children (or trust for their benefit) owning the business. A board of directors, with family members acting as the directors, could govern the business (see the example of the Hearst family discussed at Section 4). The business could also hire outside officers and employees to run the business.

- Use an Employee Stock Ownership Plan ("ESOP") and have some of the business stock owned by employees.

5.8 ***Planning For the Divorce or Financial Problems of a Child Shareholder***. Divorces or financial problems can occur in a family at any time. Also, family members may experience bankruptcies and other financial crises. Additionally, family members may suffer a medical disability.

Some potential solutions are:

- Have a Buy-Sell Agreement which contains triggering events for a buyout of non-family member spouse such as on a family member's divorce if the non-family member spouse receives stock in the divorce (see a discussion of Buy-Sell Agreements at Section 6).

- Each family member should provide in his/her Will or revocable living trust for the disposition of their family business interest on their death.

- Have a property agreement between a child and a child's spouse (however, this may not be practical in many cases).

- To avoid the children's spouses having claims on the family business (such as in the event of divorce or death of the child family member), provide in the Buy-Sell Agreement for the buyout of the family business interest if that business interest passes to a child's spouse upon death or divorce.

- Have the non-family member spouse execute a "spousal consent" to the Buy-Sell Agreement whereby they promise to abide by the Buy-Sell Agreement.

- Have in the Buy-Sell Agreement a prohibition on the shareholders transferring shares to a non-family member spouse. Could permit, upon the death of the child, that the child can leave the corporate stock in a QTIP trust for the benefit of the non-family member child's spouse. The problem with this type of an arrangement is that the surviving child's spouse could require a dividend which may be inconsistent with a closely held business.

## 6. <u>USE OF BUY-SELL AGREEMENTS IN BUSINESS SUCCESSION PLANNING</u>

Buy-Sell Agreements are important tools for business succession planning, whether dealing with partnerships, corporations, or limited liability companies. The following discussion primarily focuses on corporations. However, many of these same principles apply to partnerships and to limited liability companies.

Buy-Sell Agreements, on the death of a business owner, assist the surviving shareholders (whether family members or other shareholders) to maintain continuity of that business by enabling the surviving shareholders to acquire that business from a deceased shareholder at a specified price. The deceased shareholder's family, in turn, is able to receive monies for the deceased shareholder's stock.

Buy-Sell Agreements fulfill several other goals:

- <u>First</u>, the Buy-Sell Agreement can contain lifetime restrictions on transferring shares. For example, there can be lifetime rights of first refusal in favor of the corporation and other shareholders in the event that a shareholder desires to sell their shares to a third party.

- <u>Second</u>, the Buy-Sell Agreement can facilitate the orderly transition of the business in the event of the disability, retirement or bankruptcy of a shareholder. Thus, the corporation could be given the right to purchase a shareholder's shares upon that shareholder's retirement, bankruptcy, divorce, disability, or termination of employment. Generally, the right of a corporation to purchase the shares on these triggering events would be at a discounted value. Generally, the majority shareholder may not want to be subject to certain of these provisions. For example, a majority shareholder may not want to be subject to having their shares repurchased upon an involuntary transfer, such as bankruptcy or divorce. However, a majority shareholder may wish to have their shares purchased by the corporation upon their permanent disability, as long as that majority shareholder receives fair market value for their shares.

• Third, the Buy-Sell Agreement can specify when shareholders disagree how to resolve deadlocks between shareholders. (See discussion at paragraph 6.2, below.)

• Fourth, the Buy-Sell Agreement can help maintain S corporation status by prohibiting a non-qualified shareholder from becoming an S corporation shareholder. The Buy-Sell Agreement could prohibit a transfer of shares which would violate S corporation rules on the allowed number of shareholders, and could also include a provision preventing an ineligible trust from becoming a shareholder.

• Fifth, the shareholders can agree in the Buy-Sell Agreement to confidentiality and non-competition provisions in order to protect the corporation's business.

• Sixth, the Buy-Sell Agreement can include provisions to assist in a potential future sale of the business by having "tag-along" provisions (whereby all shareholders agree or vote in the same manner as the majority) in the event that a majority of the shareholders want to take the business public, or to sell the stock or substantially all of the assets of the business.

6.1 ***Other Provisions to Consider Including in a Buy-Sell Agreement***. The Buy-Sell Agreement, in addition to having a provision to buy out shareholders, can include other provisions to protect the shareholders and to assist with business issues that could arise in the future. Examples of such provisions are:

• Give the corporation an option to purchase a shareholder's shares at a discounted value upon that shareholder's creditors liening that shareholder's stock or upon the claim of a shareholder's divorced spouse.

• If a buyout of a family member is to occur in exchange for a promissory note, then the Buy-Sell Agreement should specify the security for payment of that promissory note. Such security could be: to have the remaining shareholders personally guaranty the payment of the promissory note; to secure the promissory note's payments by a pledge of the corporation's stock; and/or to secure the promissory note's payments by a UCC-1 lien on the corporation's assets. UCC-1 liens on the corporation's assets may not be workable if the corporation has a bank line of credit, since the corporation's bank may require that the bank be secured by a first lien position in the corporation's assets with no other encumbrances.

• If a shareholder's stock is redeemed, then any corporate debts, bank loans or other obligations which the redeemed shareholder guaranteed should be released by the corporation's creditor or bank. If the corporation's creditor or bank refuses to release the redeemed shareholder's guaranty, then that former shareholder could be indemnified and held harmless by the remaining shareholders.

- If a selling shareholder's stock is redeemed by the corporation and the remaining shareholders continue to own the business, but subsequently sell the business within a short period of time thereafter for a "premium price," then the Buy-Sell Agreement could provide that the selling redeemed shareholder is paid a portion of this premium price.

- The Buy-Sell Agreement could permit the shareholders to transfer shares to their spouse, children and grandchildren without triggering a right of first refusal in the corporation or other shareholders. However, those transferred shares should still be required to be purchased on the death of the original transferor shareholder. Similarly, flexibility should be incorporated into the Buy-Sell Agreement allowing the shareholder to transfer their shares to their revocable living trust.

6.2 ***The Buy-Sell Agreement Could Address What Happens When the Owners of a Business Have a Deadlock***. Many times when there are multiple owners of the business, disagreements occur and there is a deadlock (whether in a family ownership situation or between unrelated third parties). A Buy-Sell Agreement can provide a mechanism by which one owner can buy out the other owner should a deadlock occur. Below is discussed one type of deadlock buy-sell provision to include in a Buy-Sell Agreement:

6.2.1 ***Example of a Deadlock Buy-Sell Clause***. A buy-sell clause allows one shareholder (the "electing party") to state a price at which that electing party will either sell their stock interest on a per share basis to the other shareholder (the "non-electing party"), or buy out the non-electing party's stock interest. The non-electing party, within a specified time period, may either accept the offer of the electing party to sell the electing party's stock interest to the non-electing party; or, in the alternative, the non-electing party may require that the electing party buy the non-electing party's stock at the offered price. The electing party controls the price, while the non-electing party can make the decision whether to buy or to sell.

This type of a formula is perceived to be equitable. If the electing party offers too high of a price, then theoretically the electing party would be forced to purchase the non-electing party's stock at this high price. Similarly, if the electing party were to offer too low of a price, the non-electing party would be able to purchase the electing party's stock interest at a discount. To make this type of a formula even more equitable, it should allow the purchase price to be paid by the buying party pursuant to an installment promissory note spread over several years (such as a 60-month period).

This type of a buy-sell clause for resolving a deadlock works most effectively when there are only two shareholders.

6.3 ***<u>Two Basic Types of Buy-Sell Agreements</u>***. There are **two basic types** of buyout provisions included in a Buy-Sell Agreement. **<u>The first type</u>** is called a "Redemption Agreement" whereby the corporation purchases the stock of the deceased or retired shareholder. **<u>The second type</u>** is called a "Cross-Purchase Agreement" whereby the other shareholders purchase the stock of the deceased or retired shareholder. Hybrid forms of Redemption Agreements and Cross-Purchase Agreements can be created. For example, one common hybrid form gives the corporation a first right to redeem a deceased shareholder's shares, and if the corporation fails to do so, then the other shareholders have the option to purchase such deceased shareholder's shares.

6.4 ***<u>Use of Buy-Sell Agreements with Employee Shareholders</u>***. Buy-Sell Agreements are useful to transfer shares to employees upon the principal owner shareholder's death. As an example, the Buy-Sell Agreement could require that at the principal owner's death the owner sells, and an inside management group of employees purchases, that principal owner's shares. This type of Buy-Sell Agreement could be funded with life insurance and/or the purchase could be done in part by a promissory note.

Another use of a Buy-Sell Agreement is where equity interests are given to employees (such as in the form of stock) and the Buy-Sell Agreement requires that those employees sell their stock back in the corporation in the event of that employee's death, disability, divorce, or an employee's creditor levying on that employee's stock interest.

Importantly, the Buy-Sell Agreement can be a method by which the corporation has the option to purchase an employee's shares should the employee's employment be terminated. The Buy-Sell Agreement may provide for different purchase price amounts and/or buyouts of an employee, depending on <u>how</u> that employee's employment was terminated — whether voluntarily, involuntarily for cause, or involuntarily without cause.

6.5 ***<u>Should the Employee Shareholder Buy-Sell Agreement Be a Mandatory or Optional Right of Purchase?</u>*** If the business owner (or corporation) is <u>required</u> to purchase an employee's shares upon that employee's death, disability and/or termination of employment, then this may impose an unreasonable financial burden on the business owner or the corporation. A more favorable approach for the business owner is to give the business owner or the corporation an <u>option</u> to purchase an employee's shares upon that employee's death, disability and/or termination of employment.

On the other hand, it is to the business owner's advantage to <u>require</u> that the business owner's shares be purchased by the employee group upon that business owner's death. To alleviate the financial burden on the remaining employees, life insurance and/or an installment promissory note can be utilized to purchase the business owner's shares at the death of the business owner.

6.6 ***<u>Address a Business Owner's Spouse's Community Property Ownership Rights</u>***. It is important that the business owner address any community property interest in the business stock which their spouse may have. If there is a recent second marriage of the business owner, then that business owner could consider having a marital property agreement whereby the new spouse waives any community property rights in the business stock.

If the non-working spouse has, and is expected to continue to have, a community property right in the business's shares, then have a spousal consent to the Buy-Sell Agreement executed by the non-working spouse in order to avoid claims against the purchase of the business stock by the non-working spouse.

6.7 ***How to Fix the Value of a Business Interest For Federal Estate Tax Purposes By the Use of a Buy-Sell Agreement***. In order for the Buy-Sell Agreement to fix the value of a shareholder's shares which are to be sold under that Buy-Sell Agreement for federal estate tax purposes four rules developed by statute and case law need to be followed. The price set in the Buy-Sell Agreement will be binding for federal estate tax purposes only if the following four rules are complied with:

(i) To fix the Buy-Sell Agreement's purchase price for federal estate tax purposes, the shares' purchase price at death must be fixed and determinable under a formula or price in the Buy-Sell Agreement, and that sales price must have been reasonable at the time the Buy-Sell Agreement was entered into;

(ii) The deceased shareholder's estate should be obligated to sell the stock at the price fixed in the Buy-Sell Agreement.[64] This type of obligation of the deceased shareholder's estate to sell can be done by a mandatory Buy-Sell Agreement at death, or by giving the corporation an option to purchase the deceased shareholder's shares at death (and the deceased shareholder's estate is then required to sell the estate's shares to the corporation upon the corporation's exercise of that option);

(iii) The Buy-Sell Agreement must restrict the transfer of the stock to the Buy-Sell Agreement's price, both during the deceased shareholder's lifetime and at the deceased shareholder's death.[65] Thus, a restriction in a Buy-Sell Agreement on the price which is effective only on the death of the shareholder will not necessarily fix the price for federal estate tax purposes. Although, if an agreement is at arm's length, the IRS may still respect the Buy-Sell Agreement's purchase price. Giving the corporation or other shareholders under the Buy-Sell Agreement a right of first refusal on a lifetime purchase of the shares can meet this Regulation's requirement as long as that right of first refusal states that it is at a purchase price that does not exceed the shares' exercise price paid at death; and

[64]See Regs. §20.2031-2(h) and -3(c).

[65]See Regs. §20.2031-2(h), and -3(c).

(iv) The Buy-Sell Agreement should represent a bona fide business arrangement and not simply a device to pass the stock to the owner's family without full and adequate consideration in money or money's worth. In other words, the Buy-Sell Agreement should not be a substitute for a testamentary disposition of the stock. This concept is contained in both the Regulations under §2031 and in §2703 (which is discussed below).

If any of these four requirements is not satisfied under the Buy-Sell Agreement, then the IRS may require an appraisal of the sold shares at death, which could then result in a higher federal estate tax value for the shares than the amount of monies which the decedent's estate actually receives from the corporation. Such a result could ultimately lead to significant problems. As an example, assume that the Buy-Sell Agreement price for the decedent's shares is $5,000,000. However, because the Buy-Sell Agreement does not satisfy the above four requirements, the IRS values the sold business interest at $40,000,000. Assuming an estate tax rate of 40%, this $35,000,000 additional increase in value by the IRS would result in an additional $14,000,000 in federal estate taxes.

6.8 ***<u>Section 2703 Imposes Requirements For Buy-Sell Agreements in Order to Establish the Estate Tax Value</u>***. Section 2703 codified a portion of the existing case law and regulatory law on Buy-Sell Agreements, and added one new requirement. In other words, Section 2703 supplements the existing tax law on Buy-Sell Agreements discussed at paragraph 6.7, above.

Section 2703 operates by first stating at §2703(a) that the value of the business's stock is determined <u>without regard</u> to a Buy-Sell Agreement (or similar agreement) to purchase the stock at <u>less</u> than fair market value. Then §2703(b) creates an exception to this §2703(a) general rule by stating that <u>if</u> three rules are met, then §2703(a) does <u>not</u> apply. However, even if §2073(a) does not apply (because of satisfying the three rules of §2703(b)), then the case law and rules (discussed at paragraph 6.7, above) must still be applied to determine if the Buy-Sell Agreement's price is binding for federal estate tax purposes.

In order for the Buy-Sell Agreement to establish the estate tax value of the stock, §2703(b) requires that:

(i) The agreement must be a bona fide business arrangement;

(ii) The agreement must not be a device to transfer the stock to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

(iii) The agreement's terms must be comparable to similar arrangements entered into by persons in an arm's-length transaction.

Even though §2703 only applies to shareholders' agreements entered into after October 8, 1990, §2703 codifies in general terms what was prior tax law, although the above third requirement is new. The Regulations under §2703 provide examples of safe harbors to meet the statute's requirements.[66]

There is an exception to the above three §2703(b) requirements under the Regulations. Under this exception, a restriction in a Buy-Sell Agreement is deemed to meet each of these three §2703(b) regulatory requirements if the value of more than 50% of the stock of the corporation is owned directly or indirectly by individuals who are not members of the transferor's family.[67] These third-party owners, in order to satisfy this Regulation exception, must be subject to the restrictions to the same extent as the shares which are owned by the transferor.

> **Planning Idea: In order for the Buy-Sell Agreement to establish the federal estate tax value for a family-owned corporation under §2703, there are several planning alternatives for setting the corporation's stock purchase price. One alternative is that the shareholder's agreement require the estate of the deceased family shareholder to sell its shares to the corporation for a price established by an independent appraisal. An independent appraisal would, arguably, meet the arm's-length test of §2703. On the other hand, this alternative does not freeze the estate tax value of the stock on the date of the shareholders' agreements' signing. In another alternative, the Buy-Sell Agreement could have a formula price which establishes the value of the deceased family member's stock. Section 2703 requires that this formula price, be an arm's-length negotiated formula.**

6.9 ***How to Determine the Share Purchase Price Under a Buy-Sell Agreement***. The purchase price under a Buy-Sell Agreement can be either a fixed price that is revised, from time to time; or it could be a formula price based on a financial calculation.

A formula price, as an example, could be the "book value" of the corporation which involves taking the assets and liabilities on the books of the corporation as of the date of death (or on the date of another triggering event), as calculated under the corporation's regular accounting method. However, book value may not be representative of the value of the corporation since book value is based upon the historical costs of the assets, as depreciated. Appreciation of the assets' value and goodwill may not be reflected in the corporation's book value. In determining book value, life insurance proceeds are normally excluded from the book value of the business. However, the cash value of the life insurance policy, immediately prior to date of death, could be included in book value.

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[66]See Reg. §25.2703-1(b)(3).

[67]See Reg. §25.2703-1(b)(3).

Another Buy-Sell Agreement formula price for determining the value of the corporation could be a multiple of earnings or of gross sales. Such a formula could require that earnings be adjusted by adding back excess compensation and other benefits paid to the principal owner.

Another Buy-Sell Agreement alternative to determine the corporation's value is to have an appraiser appraise the corporation on a regular basis.

6.10 ***<u>How to Fund the Buy-Sell Agreement in Order to Pay the Departing Shareholder For Their Stock</u>***. Will the corporation have the cash funds in order to purchase the shares of a deceased shareholder? One solution (in a redemption agreement) is to pay the deceased shareholder's estate by a corporate installment promissory note. However, the corporation must have enough future cash flow to pay that promissory note's debt service. Another alternative for paying the deceased shareholder's estate is to have a life insurance policy insuring the shareholder's life for all or a portion of the redemption amount.

<u>6.10.1</u> ***<u>Example of the Funding of the Buy-Sell Agreement</u>*****:**

**<u>Example</u>: Father desires to leave all of the family corporation stock at his death in two equal shares to his two children. However, only one child works in the business. It is anticipated that after father's death, all of the non-working child's stock will be redeemed by the corporation in exchange for a promissory note. It is anticipated that the corporation will have a value of $10,000,000 at the father's death, and the note will provide for the payment of the $5,000,000 purchase price to the one non-working child (assuming no valuation discounts) by a promissory note amortized over seven years, payable monthly (i.e. 84 payments), at 5% interest per annum, or required monthly payments of $70,670 (which equals $848,035 per year).[68] It must be verified that the corporation will have enough cash flow to afford this annual $848,035 debt service.**

**Alternatively the corporation could: (i) purchase a life insurance policy on the father's life; or (ii) have the non-working child continue as a 50% passive shareholder of the corporation, with the working child having voting control. The working child's voting control and compensation could be restricted under a Buy-Sell Agreement to protect the nonworking child.**

6.11 ***<u>Issue of Incidents of Ownership of Life Insurance Policy For Federal Estate Taxes</u>***. In purchasing a life insurance policy in a corporation, the deceased shareholder's estate needs to avoid the deceased shareholder from having "incidents of ownership" in that policy. If the deceased shareholder has incidents of ownership in the life insurance policy, then the policy proceeds received

[68] The principal payments of this promissory note's debt service are paid by the corporation with after-tax dollars, since the principal payments are not deductible for purposes of the corporation's income tax.

by the corporation could be included in that deceased shareholder's estate for federal estate tax purposes. Incidents of ownership, for example, can occur if the deceased shareholder was a "controlling" shareholder of the corporation (that is where the shareholder owned more than a 50% share ownership interest).[69]

6.12 ***Selling Shareholder Wants to Receive Capital Gain Tax Treatment Upon the Sale of Their Shares***. If in a business succession plan the owner is selling their stock interest while they are alive under a Buy-Sell Agreement, then that business owner will most likely want to receive lower tax rate long-term capital gain treatment on the stock sale, whether it is a lifetime stock sale or a stock sale at death.

A lifetime stock sale at long-term capital gain rates would be subject to a maximum 20% federal tax rate (instead of a maximum 39.6% federal ordinary income tax rate). If the sale is at death, then receiving sale or exchange treatment will most likely result in no income tax being imposed on the sale since the owner receives a step-up in the shares' income tax basis at death. If there is a death of the owner's spouse and those shares were owned as community property, then at the spouse's death the owner receives a step-up in those shares' income tax bases to those shares' fair market value (potentially resulting in no gain when the owner subsequently sells those shares during that owner's lifetime).

In a redemption Buy-Sell Agreement, the requirements of §302 or §303 must be satisfied for a shareholder's buyout at death in order to not have the proceeds received by the redeemed shareholder's estate from a stock redemption treated as a dividend and taxed as ordinary income (rather than being treated as a sale or exchange which results in little or no income tax cost). Section 302 specifies several alternative methods to receive "sale or exchange" treatment, rather than ordinary income dividend treatment. A detailed discussion of §302's provisions is beyond the scope of this outline. However, one way to qualify under §302 for sale or exchange treatment is to have a complete redemption of all of the shareholder's stock. In determining whether all of the shareholder's stock has been redeemed, the constructive ownership rules of §318 apply. These constructive ownership rules can be waived in the family shareholder area under §302(c)(2).

6.13 ***The Shares' Income Tax Basis Issues***. In a Cross-Purchase Buy-Sell Agreement, when the other shareholder purchases a deceased shareholder's shares, the purchasing shareholder receives an increase in the stock basis of the purchased shares equal to the purchase price. However, in a Redemption Buy-Sell-Agreement, where the corporation redeems the deceased shareholder's shares, the remaining shareholder's stock's income tax basis does not change.

6.14 ***Issues With Purchasing Life Insurance Policies Under a Cross-Purchase Agreement***. With life insurance under a Cross-Purchase Agreement, each shareholder needs to own a life insurance policy on the life of each of the other shareholders, which may result in a large

[69]See §2042(2).

number of life insurance policies. For example, a five shareholder corporation would require a total of 20 life insurance policies. The formula to determine the number of life insurance policies required under a Cross-Purchase Agreement is N multiplied times (N-1), where <u>N equals the number of shareholders</u>.

Thus, in a Cross-Purchase Agreement with a large number of life insurance policies: (i) each shareholder must <u>own</u> and be the beneficiary of a life insurance policy on every other shareholder; and (ii) each shareholder who owns such life insurance policies on the lives of the other shareholders would then pay those policies' insurance premiums, resulting in potential inequitable economic burdens among the shareholders.

One solution in a Cross-Purchase Agreement to avoid multiple life insurance policies might be to have one irrevocable trust own the life insurance policies on all shareholders' lives.

6.15 ***<u>Income Taxation of Life Insurance Proceeds</u>***. The general rule under §101(a) is that life insurance proceeds are <u>not</u> subject to income tax when paid to the policy beneficiary. However, need to avoid the "transfer for value" life insurance rule in order that the policy proceeds are not subject to income tax.

However, the premiums paid on the life insurance policy are <u>not deductible</u> for income tax purposes under §264(a)(1) where the corporation is the beneficiary (in a Redemption Agreement), or where the purchasing shareholder is the beneficiary (in a Cross-Purchase Agreement).[70]

Additionally, for <u>employer-owned life insurance on the life of an employee</u>, the amount of life insurance proceeds received by the corporation on the death of the shareholder/employee which is excluded from the corporation's income is limited. The life insurance proceeds excluded from the corporation's income is an amount not to exceed the sum of the premiums and other amounts paid by the corporation policyholder for that insurance policy contract.[71] This rule applies where the corporation owns and is a beneficiary of a life insurance policy on an employee shareholder's life. Thus, the excess death benefit paid by the life insurance policy to a corporation is included in the corporation's income. However, this inclusion in income <u>can be avoided</u> for employer-owned life insurance contract where proper <u>notice</u> and <u>consent</u> requirements are satisfied. These notice and consent requirements are that <u>before</u> the life insurance contract issue date, the employee (including an officer-director and a highly-compensated employee) whose life is to be insured must be <u>notified</u> in writing: that the company intends to insure the employee's life; the maximum face amount for which the employee could be insured; and the life insurance policy's face amount. Also, the employee must be notified that the insurance coverage may continue after their employment, the employee must <u>provide written consent</u> to being insured under the insurance policy, including if the

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[70]See Rev. Rul. 70-117.

[71]See §101(j)(1), which was added in 2006.

insurance policy continues after the employee's termination of employment. Furthermore, the employee must be informed that the employer company will be the beneficiary of the life insurance policy proceeds upon that employee's death. This notice and consent is even required for an owner-employee of a wholly owned corporation. Thus, for the corporation to avoid the income tax on the life insurance policy's proceeds, this form of notice and consent should be utilized for life insurance under the corporation's Buy-Sell Agreement for that owner-employee.

6.16 ***The Alternative Minimum Tax For Redemption Buy-Sell Agreements***. Life insurance can produce an income tax issue in funding a redemption form of Buy-Sell Agreement. For C corporations, the alternative minimum tax may apply because life insurance proceeds received by a C corporation at the shareholder's death increases the corporation's "adjusted current earnings" under §56(g), thereby potentially producing a corporate level alternative minimum tax.[72] One solution to this issue is not to use a Redemption Buy-Sell Agreement, and instead to use a Cross-Purchase Buy-Sell Agreement.

## 7. USES OF LIFE INSURANCE WITH BUSINESS SUCCESSION PLANNING

7.1 ***Different Uses of Life Insurance to Transfer and Preserve the Business***. Life insurance can be purchased on the lives of business owners:

(i) To provide for the payment of death taxes due upon the death of a business owner or a family member;

(ii) To hire additional employees to replace deceased shareholder/employee;

(iii) To provide for a distribution of assets to a non-working spouse or non-working child;

(iv) As described in Section 6, to purchase the business owner's shares under a Buy-Sell Agreement at death; and

(v) To pay the business's debts upon the death of a shareholder.

7.2 ***Use of Life Insurance with the Sale of Business to a Grantor Trust***. Life insurance can be combined with the use of a defective income trust or a grantor trust (described at Paragraph 3.6, below)by which the grantor trust would own a life insurance policy on the life of the parent. Upon the parent's death, the grantor trust would receive the life insurance proceeds and then use

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[72]The potential corporate level alternative minimum tax results because the C corporation's adjusted current earnings increases under §56(g), since life insurance proceeds are not taxable income, but are included in the corporation's earnings and profits under §56(g)(4)(B).

those proceeds to pay off the remaining amounts due under the promissory notes owed by the grantor trust to the parent's estate.

7.3 ***Use of Life Insurance to Transfer Business to Children***. Split-dollar life insurance arrangements can be utilized to transfer businesses among family members. By having split-dollar insurance wherein an account receivable is owed back to the estate of the parent, split-dollar life insurance can be an effective tax planning technique.

## 8. SPECIAL INTERNAL REVENUE CODE PROVISIONS FOR THE PAYMENT OF FEDERAL ESTATE TAXES ON BUSINESS INTERESTS

Sections 303 and 6166 are two Internal Revenue Code Sections which assist taxable estates composed of businesses to pay federal estate taxes.

8.1 ***Redeeming Stock From the Business Entity Under Section 303***. Section 303 allows the payment of federal and state death taxes and expenses by permitting the income tax free withdrawals of monies from the corporation (which owns the business). Without §303, an estate (and its beneficiaries) could have distributions from the corporation taxed to them as a dividend.

On the other hand, if §303's requirements are satisfied, corporate distributions to shareholder's estate in exchange for stock which distributed monies are then used to pay estate taxes and funeral and administration expenses deductible under §2053, are treated as distributions in "exchange" for the redeemed stock (and not as taxable dividend). Since the decedent's stock is adjusted to its fair market value on date of death[73], the stock's tax basis will equal the redemption amount for the stock, thus producing no gain to be taxed to the deceased shareholder's estate on a qualifying §303 distribution.

8.1.1 ***What Are the Ownership Percentage Requirements of §303?*** The benefits of §303 are limited to a distribution by a corporation whose stock of all classes included in the decedent's gross estate exceeds 35% of the excess of: (i) the value of the decedent's gross estate over (ii) the sum of the amounts allowable (not actually allowed) as a deduction under §§2053 or 2054 (which are funeral and administrative expenses, claims and tax losses).[74]

> **Example: Decedent's gross estate has a value of $1,000,000, funeral and administration expenses of $275,000, and a charitable gift at death of $25,000. Therefore, the decedent's taxable estate is $700,000 ($1,000,000 less $275,000 less $25,000). 35% multiplied times $725,000 (the gross estate) equals $253,750.**

[73] See §1014.

[74] §303(b)(2)(A).

**Thus, the corporation's stock of all classes must exceed $253,750 in value for the estate to receive §303 tax treatment.**

If the decedent owns stock in two or more corporations, of which 20% of more in value of the outstanding stock is included in the decedent's gross estate, then that stock is treated as stock of a single corporation for purposes of applying the 35% test. For purposes of applying the 20% rule, to determine if stock in two or more corporations can be aggregated (in order to determine if the 35% rule is satisfied), stock which represents the surviving spouse's interest in property which the decedent and surviving spouse held as community property, joint tenants, tenants by the entirety, or tenants in common is treated as having been included in determining the value of the decedent's gross estate.[75]

8.1.2 ***Multiple Redemptions of Stock Under §303.*** It is possible to have more than one redemption from the estate under §303. The total amount of the redemption qualifying under §303 cannot exceed the death taxes and funeral and administration expenses of the estate.

**Example: The decedent has a gross estate of $800,000, and death taxes and administration expenses totaling $225,000. The decedent's taxable estate is $500,000. The stock of the closely held business has an estate tax value of $450,000. In the first year, 33% of the stock is distributed to a beneficiary from whom it is promptly redeemed for $150,000. In the second year, an additional one-third of the stock is redeemed for $150,000. Since the death taxes and funeral and administration expenses were $225,000, the entire $150,000 of the first redemption qualifies under §303, but only $75,000 of the second redemption is eligible for §303.[76]**

8.1.3 ***The Shareholder Whose Stock is Being Redeemed Must Actually Bear the Economic Burden of the Taxes and Administration Expenses in Order for Such Shareholder's Stock Redemption to Qualify Under §303***. Section 303 requires that the shareholder whose stock is being redeemed have their stock interest directly reduced (or have a binding obligation to contribute to the estate) by the payment of the estate taxes or allowable §2053 funeral and administration expenses.[77] Thus, the redeemed shareholder must actually bear the economic burden of the death taxes and administration expenses.

8.1.4 ***Time Limitations in Which the §303 Stock Redemption Must Occur***. Section 303 applies only to amounts distributed after the decedent's death and which are distributed

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[75]§303(b)(2)(B).

[76]Reg. §1.303-2(g)(2).

[77]§303(b)(3).

within the three year §6501 statute of limitation period or if a Tax Court petition is filed within 60 days after the Tax Court's decision becomes final. If a §6166 election has been made, the §303 redemption period is the time within which to pay all or part of the estate tax in installments under §6166.[78]

8.2 ***<u>Deferring the Payment of Estate Taxes Under §6166</u>***. Under §6166 an estate may defer the payment of federal estate taxes to the extent these taxes are attributable to a closely held trade or business. Section 6166 applies to not only corporations, but also to partnerships, sole proprietorships, and LLCs. Generally, §6166 allows an estate to pay only the interest due on the estate taxes for the first four years. Then, beginning in year five, the estate must pay all accumulated interest and 10% of the deferred estate tax each year (thus, extending the time to pay the estate taxes to 14 years).

8.2.1 ***<u>Paying Estate Taxes in Installments Under the Alternate Provision of §6161</u>***. For family businesses and estates not qualifying under §6166, §6161 may allow the deferral of paying estate taxes. Section 6161(a)(2) contains a special estate tax rule that allows the IRS to grant an extension for "reasonable cause" to pay estate taxes for a "reasonable period" not to be greater than 10 years from the date on which the estate tax return was due. Additionally, under §6161 the IRS can grant an extension to pay a §6166 installment not greater than 12 months after the due date of the last §6166 installment.

8.2.2 ***<u>Summary of §6166's Operation</u>***. Section 6166 provides for the payment of estate taxes in installments (basically, that fraction attributable to the inclusion in the decedent's gross estate of the closely held business) over two to ten equal installments, and allows at least part of the interest on the unpaid balance to be paid at the rate of 2%[79], and for a reduced interest rate (equal to 45% of normal §6121 interest rates) on the remaining estate tax due.

8.2.3 ***<u>Requirements to Qualify Under §6166</u>***. The decedent's interest in the closely held business must have an estate tax value which exceeds 35% of the decedent's adjusted gross estate.[80] "Adjusted gross estate" means the decedent's gross estate value <u>less</u> the sum of amounts allowable as a §2053 or 2054 deduction.[81] Thus, to determine the adjusted gross estate, §2053 funeral expenses, administration expenses, claims against the estate, unpaid mortgages, etc.

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[78]§303(b)(1).

[79]§6601(j).

[80]§§6166(a)(1) and 6166(b)(6).

[81]§6166(b)(6).

are deducted. Gifts made by the decedent within three years of date of death are included in determining whether the 35% test is met, but such gifts are not included for purposes of determining the amount of tax that may be deferred under §6166.[82]

8.2.4 ***<u>What Are the Limitations on the Amount of Estate Taxes That Can Be Paid in Installments</u>***? Under §6166, the amount of estate taxes that can be paid in installments is equal to an amount which bears the same ratio to the decedent's estate tax (reduced by the credit against such tax) as the decedent's estate's closely held business amount bears to the amount of the decedent's adjusted gross estate.[83]

8.2.5 ***<u>How Many Estate Tax Installments Can Be Paid Under §6166</u>***? Section 6166 permits the payment of the qualifying portion of the estate tax in up to 10 installments. The first installment must be paid "on or before the date selected by the executor which is not more than five years after the date prescribed in §6151(a) for the payment of the tax."[84] In other words, the estate tax may be spread over a period of as long as 14 years from the date the tax is otherwise due.[85] The date on which each installment payment is due is the original due date for the payment of the estate tax without regard to any extensions. The first principal payment of estate taxes is due five years after such date, and subsequent annual estate tax installment payments are required on that same date in later years, of up to 10 years.

8.2.6 ***<u>What Interest Rates Apply to the Unpaid Estate Taxes Under §6166</u>?*** Section 6601(j) states that there is a 2% rate of interest payable on the deferred tax attributable to the first $1,000,000 (adjusted for inflation) in <u>taxable</u> value of a closely held business.[86] For decedents dying in 2016, the tax attributable to the first $1,480,000 in value of the closely held business in excess of the unified credit exemption is subject to an interest rate of 2%.[87] A favorable interest rate also applies to the remaining amount of the estate tax qualifying for §6166 treatment that exceeds the $1,480,000 amount. Interest on the deferred tax that exceeds the 2% portion is

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[82]See §2035(d)(4).

[83]§6166(a)(2).

[84]See Reg. §20.6166-1(e)(2).

[85]Thus, it is not 15 years. The last installment payment is due on the beginning of the 15th year after the initial tax due date. During the <u>first five years</u>, <u>only interest</u> needs to be paid.

[86]This lower 2% interest rate applies to estates of decedents dying after 1997.

[87]The qualifying estate's portion which accrues at 2% interest on unpaid estate taxes is adjusted for inflation.

payable at a low interest rate equal to 45% of the annual underpayment rate established under §6621.[88]

Because of the §6166 reduced interest rates, interest on federal estate taxes deferred under §6166 may not be deducted, either for estate tax purposes under §2053 or for income tax purposes under §163.[89] This non-deductability of interest for income and estate tax purposes eliminates the complexity of filing supplemental estate tax returns.

8.2.7 ***What Qualifies as a "Closely Held Business" Under §6166***? Section 6166 only applies to interests in a "closely held business," which can mean partnership interests, LLC membership interests or stock in a corporation. For a partnership, 20% of more of the capital interests in such partnership must be included in determining the gross estate of the decedent or such partnership must have 45 or fewer partners. In the case of stock in a corporation, 20% or more in the value of the voting stock of such corporation must be included in determining the gross estate of the decedent, or such corporation must have 45 or fewer shareholders.

Section 6166 is only intended to apply to active "businesses". There is a body of IRS rulings and case law interpreting what a "business" is for purposes of §6166. Section 6166 does not apply to "passive assets" held by an entity, such as rental real estate where the landlord has no duties or services.[90]

The IRS held in Rev. Rul. 2006-34 that there was a "business" for §6166 purposes where the decedent was actively participating in the management and operation of commercial rental properties owned by the decedent. In a private letter ruling, there was a business where the decedent's employees provided significant repair, maintenance, and janitorial services to the commercial tenants.[91]

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[88]This means, for example, that if the underpayment rate is 3%, the effective interest rate is 1.35% (45% of 3%).

[89]See §§163(k) and 2503(c)(1)(D).

[90]Where a decedent owned stock in a corporation, and individually (through a grantor trust) owned the real estate in which the business was conducted outside of the corporation, the IRS allowed the decedent's interest in the corporation and the real estate to be aggregated into one single closely held business for purposes of the applying the 35% test of §6166. See PLR 200006034. The IRS held that the real estate was not a "passive investment" because it was an active business asset used in the business's operations and was essential to the decedent's business. See PLR 201343004 for a discussion of what constitutes a trade or business for §6166 purposes.

[91]PLR 9832009.

On the other hand, in a private letter ruling, the IRS held that a corporation was not carrying on a trade or business, and the decedent did not receive §6166 treatment, where the decedent's corporation owned a 70-unit motel which was leased to a third-party operator. Here the tenant (and not the decedent) made all repairs, did all maintenance, and paid all insurance.[92]

> **<u>Planning Idea</u>: Where the client (or the client's business entity) owns rental real estate or hotel properties, consider restructuring these activities in order that the client becomes responsible for the day-to-day management and providing services (such as maintenance, repairs and janitorial services), in order to qualify for §6166 estate tax installment treatment.**

8.2.8 ***<u>How to Make a §6166 Election</u>***. The election under §6166 is made no later than the time for filing the federal estate tax return or on the last date of the extension of time for filing granted of such return.[93]

> **<u>Planning Idea</u>: When there is a closely held business comprising an estate subject to death taxes, which may satisfy the 35% test, make a protective §6166 election by filing a written election with the estate tax return.**

8.2.9 ***<u>Acceleration of Payments Due Under §6166</u>***. If a holder disposes of the closely held business, there is an acceleration of the payment of estate taxes which were deferred under §6166. Upon such disposal, the extension of time for the payment of estate taxes ceases, and the balance of tax which was previously payable in installments becomes payable upon IRS notice. The events which trigger this acceleration are: (i) the distribution, sale, exchange or other disposition of a portion of the qualifying closely held business; and (ii) the withdrawal from the underlying trade or business of "money and other property attributable to" the closely held business interest where the aggregate of such dispositions or withdrawals equals or exceeds 50% of the value of the closely held business interest.[94]

> **<u>Example</u>: The estate taxes attributable to Mr. Smith's 40% interest in Smith Manufacturing Co. qualify for §6166 installment payment treatment on Mr. Smith's death. Mr. Smith's executor properly makes the §6166(a) election. Thereafter, the executor receives an offer to sell Mr. Smith's estate's entire 40% stock interest to a third party. If this 40% stock interest is sold, the §6166**

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[92]PLR 8352086.

[93]See §6166(d) and Reg. §20.6166-1(a).

[94]§6166(g)(1)(A).

**installment extension is terminated, and the estate tax attributable to the 40% stock interest becomes payable upon notice of the IRS, together with accrued interest.**

There is a special provision governing §303 stock redemptions so as not to accelerate the §6166 installment payments.[95]

If a §6166 election is in effect clients must proceed cautiously in reorganizing or changing the corporate structure.

8.3 ***Keep §303 and §6166 Percentage Requirements in Mind When Making Gifts of Business Interests***.

**Planning Idea: In gifting and selling shares of stock in the business to younger family members, keep in mind the ownership percentage limitations of §§303 and 6166. Although in certain cases it may be more tax effective to make the gifts and sales of business interests to younger generations, if ownership is reduced below these "threshold" percentages then the benefits of §§303 and 6166 could be lost.**

## 9. SECTION 2032A REDUCTION IN ESTATE TAX VALUE OF REAL PROPERTY USED IN A CLOSELY HELD BUSINESS

Real property used in a closely held business may receive favorable valuation treatment under §2032A. If the real property qualifies under §2032A then, rather than being valued at its fair market value (i.e. the price which a willing buyer would pay a willing seller, taking into account the highest and best use of the real property), the real property can instead be valued at its actual use. The "actual use" value for trade or business held real estate (other than farming) is based upon the multiple factor method specified in the statute.[96]

Section 2032A is commonly used in the farm and ranching area, but can apply to real property used in closely held business activities. The Congressional intent of this Code Section is to encourage the use of real property for farming and small business activities and to prevent the forced sale of such real property to pay estate taxes.

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[95] §6166(g)(1)(B).

[96] §2032A(e)(8).

As a practical matter, §2032A is not regularly used in the closely held business area for a number of reasons. First, there are the highly technical pre-death and post-death requirements of the statute. Second, real property generally constitutes a small percentage of a closely held business's assets, as compared to a farm or ranch. Third, once the §2032A election is made, the income tax basis of the real property is reduced to its special use valuation amount. Finally, once the election is made, there is concern about the recapture at a later date of the estate taxes in the event that the family members cease to materially participate in the qualified use of the property.

9.1 ***Application of the §2032A Rules to Closely Held Businesses***. The §2032A rules to reduce value only apply to real property, and not to personal property. Thus, §2032A has no application to a business's machinery or fixtures.

> **Example: Decedent's estate consists of stock in a closely held business and equipment which the decedent had leased to the closely held business. Section 2032A has no application to the decedent's estate, since the decedent's estate did not own any real property used in connection with the decedent's closely held business.**

Real property may still qualify for §2032A treatment as special use property if that real property is owned in a corporation, partnership or trust, but only if the decedent's interest in that business qualifies as a closely held business for a period at least equal to five years of the eight-year period immediately preceding the decedent's death.

9.2 ***Amount of Value Reduction***. The reduction in value of the decedent's gross estate under §2032A may not exceed $750,000 (which figure is adjusted for inflation). This $750,000 limitation on valuation decrease is adjusted annually in increments of $10,000, but only if the amount of the inflation adjustment equals or exceeds $10,000.[97] Thus, the §2032A limitation is increased to $1,120,000 for estates of decedents dying in 2017.[98]

9.3 ***Qualifying for §2032A Treatment***. In order to qualify for the special §2032A provisions, the decedent's estate must satisfy the following conditions:

(i) The estate must be that of a citizen or resident of the United States;

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[97] §2032A(a)(3).

[98] Rev. Proc. 2016-55.

(ii) At least 50% of the adjusted value of the gross estate must consist of the adjusted value of real or personal property, used for a qualified use by the decedent or the decedent's family on the date of the decedent's death, which passes to a qualified heir; and

(iii) A minimum of 25% of the adjusted value of the gross estate must consist of the adjusted value of real property that passes to a qualified heir and that, for periods aggregating at least five years in the eight year period immediately preceding the decedent's death, was owned by the decedent or a member of the decedent's family and used for a qualified use generally involving material participation by the decedent or a member of the decedent's family.[99]

Assuming that the estate qualifies for §2032A valuation treatment, then the real property receiving the favorable tax treatment must be "qualified real property." "Qualified real property" must: (i) be located in the United States; (ii) have been acquired from or have passed from the decedent to a qualified heir of the decedent; (iii) been used on the date of the decedent's death for a qualified use by the decedent or the decedent's family; (iv) owned by the decedent or member of the decedent's family and used for a qualified use that required material participation by the decedent or a member of the decedent's family generally for periods aggregating at least five years in the eight year period immediately preceding the decedent's death; and (v) be designated in a written agreement signed by all persons having an interest in the property consenting to the potential recapture tax.[100]

9.4 ***<u>Recapture</u>***. If the use of the real property receiving §2032A treatment ceases being used in a qualified use (such as in the small business operation), then the estate tax saved by the special-use valuation may be recaptured in whole or in part.[101] The recapture is imposed by an "additional tax." The "additional tax" is imposed if within 10 years[102] of the decedent's death the qualified heir disposes of an interest in the §2032A property to a non-family member, or ceases to use the property for a qualified use.

> **<u>Planning Idea</u>: If §2032A is utilized and the decedent's Will or trust does not allocate the §2032A savings to the heirs receiving the special valuation use property, then the beneficiaries should enter into an agreement among**

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[99] §2032A(b)(1).

[100] §2032A(b)(1).

[101] §2032A(c)(1).

[102] The 10-year period commences on the date of the decedent's death or on the date the qualified heir commences the qualified use (which must commence within two years of the decedent's date of death).

**themselves under which those beneficiaries receiving the §2032A special valuation use property, agree to bear the burden of any recapture of estate tax.**