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ESTATE PLANNING FOR THE FAMILY BUSINESS
by
Robert A. Briskin

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ESTATE PLANNING FOR THE FAMILY BUSINESS

by

Robert A. Briskin*

INTRODUCTION

Today's booming economy has increased the value of family businesses. In transferring business interests to younger generations, parents desire to minimize transfer taxes (i.e., estate, gift and generation-skipping taxes). Parents also focus on non-tax issues affecting the family business such as:

(i) How to properly manage and operate the family business after the working parent's death or retirement.

(ii) Which family member will control the business after the parents' retirement or death.

(iii) What percentage of the business should be left to each child.

(iv) How do the parents treat non-working children equitably while at the same time leave the family business to the children who work in the business.

(v) How to provide the business's cash flow to the surviving non-working parent while at the same time transferring the family business to the working children upon the death of the working parent.

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 defective income trust;

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*Please contact Robert A. Briskin at rablaw@earthlink.net or at (310) 201-0507 with any questions or comments regarding the materials herein.

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(v) recapitalization of the business; and (vi) transfer of business opportunities to younger generation levels.[1]

Over the past 20 years, Congress has eased the transfer tax burden on closely-held family businesses through: (i) increasing the gift tax annual exclusion (currently $10,000 per donor and indexed for inflation); (ii) providing for the unlimited marital deduction; (iii) revising the special use valuation under §2032A[2] for real estate used in the family business; (iv) enacting the qualified family-owned business deduction under §2057; (v) increasing the unified credit (currently $675,000 and increasing to $1,000,000 by 2006); and (vi) revising the estate tax payment deferral provisions under §6166.[3]

In recent years legislation has been proposed to significantly modify the federal transfer tax system, ranging from completely eliminating the estate, gift and generation-skipping transfer taxes, to raising the unified credit. Some proposals have been coupled to income tax changes to eliminate in whole or in part the adjustment to assets' tax bases at death. Many of these proposals have been promoted by politicians under the guise of protecting the family business. The recent deadlock between Congress and President Clinton on these tax issues, and the political realities of the 2000 election year, reduce the likelihood of enacting transfer tax legislation prior to 2001.[4] However, as part of the estate planning process we should inform our clients of the possible

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[1]See a detailed discussion at paragraph 3 on how to transfer the family business to the younger generation.

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

[3]Only about 2% of the estates of persons that die each year pay a federal estate taxes. In 1998 this 2% of taxable estates paid $20.35 Billion of estate taxes, of which $10.39 Billion was paid by the top 6% of valued estates. See Schlesinger and Kulish, ***As Millionaires Multiply Estate Tax Takes a Public Beating***, Wall St. Jrnl., July 13, 2000, at A1, Col. 6.

[4]In 2000 the Senate and House of Representatives passed the Death Tax Elimination Act of 2000, H.R.8, a phased out elimination of the estate tax. This Act was vetoed by President Clinton on August 31, 2000.

In another example, Senate Bill S. 3098 was recently introduced by Senator Byron Dorgan of North Dakota. This Bill would increase the §2057 estate tax deduction for farms and small businesses, with a total abolition of all estate taxes for farms and small businesses by 2005.

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modification of the federal transfer tax system and related changes to the income tax basis adjustment rules.

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1. **CHOOSING THE TYPE OF LEGAL ENTITY TO OWN THE FAMILY BUSINESS**.

The choice of the type of legal entity to own the family business has both tax and non-tax consequences. For example, certain business entities (such as corporations and limited liability companies) protect their owners against the business's liabilities. The type of business entity will affect the tax treatment of earnings and distributions, as well as the future tax consequences if the business is sold or liquidated.

1.1 **What are the Different Types of Legal Entities Which Can Own the Family Business**? California taxpayers can choose from among several types of legal entities, including:

- Sole proprietorships
- General partnerships
- Limited partnerships
- Limited liability companies ("LLCs")
- Corporations taxed as C corporations
- Corporations taxed as S corporations

1.2 **Client's Goal to Have the Entity Provide Liability Protection**. Owners of closely-held businesses want to have personal liability protection from the family business's debts, accounts payable, and other business creditors. This goal can be achieved through the use of corporations (whether an S or a C corporation), an LLC, or limited partnership.[5] The exposure to liability of a general partner in either a general partnership or a limited partnership can be eliminated by the use of a corporation as the general partner.[6]

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[5]Creditors can potentially attack limited liability protection under theories of ultra vires acts. Also, parents turning over their closely-held businesses to their children must be careful if the parents remain as an officer or director, that the parents are not deemed to be a "responsible person" for collecting employee wage withholding taxes under §§6671 and 6672. Parents remaining as corporate "responsible persons" can unwittingly have their assets subject to IRS liens and claims after they have retired from the business. If the parents do remain as officers or directors, have the business use a payroll service with automatic payroll tax deposits.

[6]The one-time concern that a sole corporate general partner of a limited partnership causes the limited partnership to be taxed as an association (i.e., a corporation) has been eliminated by the "check-the-box" Treasury Regulation §301.7701-3(a). Thus, limited partnerships with a sole corporate general partner can now rely upon the fact that the limited

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1.3 **Client's Goal to Have the Entity's Assets Protected from the Client's Creditors**. An advantage of having the family business owned by a legal entity, rather than as a proprietorship, is that the legal entity protects the business's assets from being levied upon by the business owner's personal creditors. In other words, when the family business is owned in a corporation, LLC, or limited partnership, the owner's personal creditors can only obtain a lien on the owner's interest (such as stock, partnership or membership interest) in that entity (which is not salable and may be a minority interest), but this lien may be of little worth to the creditor. For example, if the owner's creditor foreclosed on a lien and gained possession of a minority number of shares of a family-owned corporation, the creditor would only be entitled to the shares' proportionate share of dividends (which may be nonexistent if the corporation does not pay dividends) plus minority voting rights (which may be of little use to the creditor). Similarly, a creditor of a partner may only be able to obtain a charging order against the partner's partnership interest.[7] A charging order against a limited partnership interest only enables the creditor to receive that limited partnership interest's proportionate share of distributions when the general partner decides to make distributions. Additionally, a creditor's ownership of a limited partner's interest could result in that creditor receiving allocations of taxable income, but not distributions of cash.

1.4 **Income Tax Goals in Choosing the Type of Legal Entity to Own the Family Business**.

1.4.1 ***Goal to Avoid Double Level of Taxation on the Business's Earnings***. The earnings and profits of a C corporation are subject to a double level of taxation. First, a tax is imposed at the corporate level on the earnings, followed by a second tax at the shareholder level on the

---

partnership will be taxed as a partnership for income tax purposes.

[7]A charging order is a lien which may be foreclosed upon. The purchaser of a general partnership interest in the foreclosure procedure then has the right to receive distributions. Corp. Code §§16503(b)(1) and 16504(a). A limited partnership interest charging order is governed by Corp. Code §15673 which specifies that the judgment creditor only has the right of an assignee of a limited partnership interest.

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dividends distributed.[8] Additionally, a C corporation has the major disadvantage of having a double level of taxation when the business's assets are sold or the business is liquidated. One common technique to minimize or eliminate this double level of taxation to pay "reasonable" compensation, rents, and other deductible payments to the family member shareholders. However, where there are non-working family members, payments of compensation to these non-working members may not be possible. Also, there are social security and hospital insurance taxes on compensation income.

S corporations with no built-in §1374 gains will only have one level of taxation when its business assets are sold or it is liquidated.[9] The shareholders report at the shareholders level a pro rata share of the S corporation income, whether or not there are distributions.[10] However, an S corporation that has been converted from a C corporation may still have built-in gains that will be subject to a double level of taxation under §1374.[11] Additionally, shareholders of S corporations are restricted in deducting tax losses based on corporate level debt. Partnerships and LLCs are not subject to these same limitations on tax losses.

Partnerships (and LLCs) are not subject to an entity level income tax. The partners report their proportionate share of the partnership's income and deductions pursuant to §702 whether or not there are distributions. However, LLCs in California have a fee (equivalent to a tax) on the LLCs gross income.[12]

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[8]See §11 for corporate level tax rate of which 35% is the top rate. Section 301 tax imposes an income tax on dividends distributed to the shareholder, which is taxed at a maximum 39.6% rate.

California's current franchise tax rate on C corporation income is 8.84%. Rev. and Tax. Code §23151(e).

[9]California imposes a 1.5% tax on S corporation earnings.

[10]§1366

[11]The built-in gains tax is computed at the highest corporate tax rate under §11(b). S corporations that were formerly C corporations are subject to the built-in gains tax during the "recognition period" which is 10 years from the date that the corporation elected S status. §1374(d)(7).

[12]See paragraph 1.8.4 for the amount of this LLC gross income fee.

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1.4.2 ***Goal to Allocate Income to Other Family Members***. Parents may wish to allocate the income from the business entity among family members in order to reduce federal and state income taxes, allocate cash distributions and taxable income to family members for economic reasons, and build up children's and grandchildren's estates for gift and estate tax purposes.

For S corporations, §1366(e) permits the IRS to reallocate income among family members if this is necessary in order to reflect the value of services rendered by an individual who is in the family of one or more of the shareholders. The IRS's ability to reallocate income can occur if the following two conditions are both met: (i) an individual is a member of the family of a S corporation shareholder; and (ii) the individual works for or provides capital to the S corporation without "reasonable compensation." The regulations under §1366(e) allow the IRS to adjust the income allocations of an S corporation to reflect the value of the services rendered or the capital furnished without reasonable compensation.[13] In doing this reallocation, the IRS examines the amount that would be paid to obtain comparable services or capital from a person that is not a family member or shareholder.

For partners of family-owned partnerships, §704(e) states that a person will only be recognized as a partner if that person owns a capital interest in the partnership in which capital is a material income producing factor, whether or not such interest was acquired by purchase or by gift. If the partnership interest was created by gift, then §704(e)(2) states that the reasonable compensation paid to the donor may be reviewed. Partnership interests purchased by one family member from another family member are considered to be created by a gift from the seller, and the fair market value of the purchased partnership interest is considered to be donated capital to the partnership.

1.4.3 ***Goal to Comply with Tax Law Restrictions on Ownership***. For tax purposes, there are no restrictions on who may own an interest in an LLC or a partnership (either a limited partnership or a general partnership).

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[13] Prop. Reg. §1.1366-3(a).

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On the other hand, S corporations cannot have shareholders that are partnerships or LLCs.[14] S corporations can only have a U.S. citizen or a resident U.S. alien be an owner. Additionally, only certain specific trusts along with corporations under limited circumstances may be S corporation shareholders.[15] S corporations may also not have more than 75 shareholders (a husband and wife are treated as one shareholder for this purpose), which limitation can cause problems where shares of stock are left to multiple family generations producing large numbers of shareholders.[16] On the other hand, C corporations, partnerships, and LLCs can have an unlimited number of owners for tax purposes.[17]

S corporations present the dilemma of one family member being able to hold other family members "hostage" by threatening to unilaterally terminate the corporation's S election by transferring his/her shares to a non-qualified shareholder (such as a partnership). Despite the unfairness of one shareholder possessing this type of power, the IRS will treat this as a termination of the S election. Thus, one minority shareholder in a group of 75 shareholders potentially wields the power to revoke an S election.[18]

> **<u>Planning Idea</u>: A solution to avoid one disgruntled family member being able to terminate an S election is to have a shareholder's agreement signed by all of the shareholders prohibiting the assignment of shares to nonqualified shareholders (see Appendix A for a sample S corporation shareholders' agreement form).**

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[14]See §1361(b)(1)(B) which states that only individuals and certain type of trusts and estates, may own an interest in an S corporation.

[15]See §1361(b)(1)(c).

[16]See §1361(b)(1)(A).

[17]However, once the number of owners of a partnership exceed 100, the partnership will be treated as a publicly-traded partnership and taxed as a corporation for federal income tax purposes pursuant to Reg. §1.7704-1(g)(1)(ii).

[18]Some courts have held that a minority shareholder who transfers shares with the intention to terminate the corporation's S status has breached their fiduciary duties towards the other shareholders. See J. Eustice and J. Kuntz, ***Federal Income Taxation of S Corporations***, 3d ed. Warren, Gorham & Lamont, at 505-76.

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1.4.4 ***Goal to Form the Business Entity Tax Free***. A partnership, LLC or corporation can be formed tax free under the applicable Internal Revenue Code provisions. Thus, appreciated assets can be transferred to a corporation tax free under §351, and to a partnership and LLC tax free under §721.

In the case of a corporation, the owners transferring the appreciated assets must own after the transfer at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the total number of shares of all other classes of stock of the corporation.[19] This can present a problem for a mid-stream transfer of assets to the family corporation if family members owning less than 80% of the stock transfer appreciated assets to the corporation. On the other hand, the partnership tax rules allow mid-stream transfers of appreciated assets to partnerships and LLCs without gain recognition, even where the transferring family members own less than 80% of the equity and/or voting rights.

1.4.5 ***Goal to Withdraw Assets From the Business Entity Tax Free***. From time to time family members will withdraw cash and other assets from the family business which are in the form of appreciated assets or represent earnings. Withdrawing appreciated assets from a C corporation will be subject to a double level of taxation. However, partnerships and LLCS produce a more favorable tax result.

A distribution of appreciated assets from a C corporation to shareholders results in the corporation recognizing taxable gain on the distribution equal to the difference between that appreciated property's fair market value and the property's tax basis.[20] Additionally, the shareholders who receive appreciated assets will recognize income at the shareholder level, ordinary income if the distribution is treated as a dividend, and capital gain if the distribution is treated as a sale or exchange.

For S corporations, the gain on the distribution of appreciated assets may be subject to the built-in gains tax at the corporate level under §1374 and, additionally, the taxable

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[19]§351(a).

[20]See §311(a).

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gain may be passed through to the shareholders.[21] S corporation (with no C corporation earnings and profits) distributions will not be taxed to the recipient shareholders to the extent that such distributions do not exceed the shareholder's stock basis.[22]

Partnership distributions of appreciated property to a partner generally do not result in taxable income to the partnership or to the partners receiving the distributions.[23] There are exceptions to this rule such as where distributed cash and marketable securities exceed the partner's basis in his/her partnership interest under §731(a). Another exception involves "hot assets," such as where unrealized receivables or inventory items are distributed to partners under §751.

1.4.6 ***<u>Goal to Increase the Entity's Assets' Tax Bases Upon the Death of the Business Owner</u>***. At death, a decedent's stock and partnership interest tax bases are adjusted to their date of death (or alternate valuation date) values.[24] For community property, both the decedent's and the decedent's spouse's share of the community property receives a basis adjustment.[25] If the family business entity is able to step up their assets' tax bases on the owner's death, then there is a substantial income tax savings. The assets' stepped-up tax bases produce increased amortization and depreciation deductions, increased deductible expenses, and reduced taxable gain upon the assets' sale. Corporations and partnerships (and LLCs) are treated differently for purposes of stepping up the business entity's assets' tax bases.

When a family member who is a corporate shareholder (whether of a C corporation or an S corporation), dies there is <u>no</u> adjustment to the tax bases of the corporation's assets, although the shareholders' stock is adjusted to its date of death value (or alternate valuation date) under §1014.

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[21]See §§1366(a) and 1367.

[22]§1368(b).

[23]§731.

[24]§1014(a).

[25]See §1014(b)(6).

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On the other hand, partnerships (and LLCs) allows a special tax election (known as a §754 election) whereby the bases of the partnership's (or LLC's) assets are adjusted on the owner's date of death.[26] Thus, when a partner dies the tax basis of the deceased partner's partnership interest is adjusted to its fair market value under §1014.[27] A §754 election permits the partnership's assets bases to be adjusted to reflect the difference between: (i) the adjusted tax basis of the deceased partner's partnership's interest; and (ii) the basis of such partnership interest immediately prior to the deceased partner's date of death.

1.4.7 ***<u>Required Methods of Tax Accounting</u>***. A C corporation must use the accrual method of accounting unless the corporation is a qualified personal service corporation or has gross receipts of no more than $5,000,000.[28] On the other hand, an S corporation may use the cash method or the accrual method of accounting unless the S corporation is classified as a "tax shelter" (in which case the S corporation must use the accrual method of accounting).[29] An LLC or a limited partnership may have to use the accrual method of accounting if it is classified as a tax shelter or if a C corporation is a member or partner, unless the LLC is a qualified service corporation.

1.5 **<u>Estate and Gift Tax Goals in Choosing the Type of Legal Entity to Own the Family Business</u>**. When a family business

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[26]See §§754 and 743.

[27]The adjustment is based upon the deceased partner's partnership's interest's fair market value (including considering any valuation discounts) and is either based on date of death value or on the alternate valuation date value under §2032. The alternate valuation date is six months after the date of death, or the date that the asset is disposed of if sooner.

[28]See §§446 and 448.

[29]The term "tax shelter" is defined under §461(i)(3). A corporation becomes a "tax shelter" if it falls within one of three categories. The <u>first</u> category provides that the entity is a tax shelter if at any time its interests have been offered to sale and the offering required to be registered with any federal or state agency that regulates the offering of securities. There is an exemption if the state requires that all corporations offering securities for sale in the state files such notice to be exempt from registration. §448(d)(3). The <u>second</u> category is for a syndicate, which means S corporations if more than 35% of its losses during the taxable year are allocable to shareholders who do not participate in the management of the S corporation. The <u>third</u> category is a tax shelter classified under §6662(d)(2)(C), which includes a plan or arrangement with a principal purpose of avoiding or evading federal income taxes.

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owner transfers his/her interest to a younger generation, the owner wants to avoid any transfer taxes (i.e., estate, gift or generation-skipping taxes). Valuation discounts reduce the amount of transfer taxes. The type of entity can influence the amount of valuation discounts. For example, an interest in a general partnership, which under the California Corporations Code[30] allows for a partner's withdrawal from the partnership at anytime, produces a smaller valuation discount.[31] Limited partnership interests or LLC membership interests, even those representing more than 50% of capital, can provide valuation discounts for lack of control. One reason for this lack of control discount is that California law does not permit (unless the agreement says otherwise) limited partners or LLC members to withdraw from their respective entities and receive distributions of their proportionate share of the entity's assets.[32]

1.5.1 ***<u>Types of Valuation Discounts</u>***. Valuation discounts play an important role in choosing the type of legal entity to own the family business. Marketability discounts (because of the lack of a market for the business interests), as well as minority discounts (because the business interest represents no control and/or limited voting rights) can produce transfer tax savings to the family. See Section 2, below, for a more detailed discussion of valuation discounts.

1.6 **<u>Goal to Minimize Employment Taxes When Choosing the Type of Legal Entity</u>**. Employers and employees pay a social security tax of 6.2% each and a hospital insurance tax (known as the "Medicare Tax") of 1.45% on all compensation income.[33] For the year 2000 the 6.2% Social Security tax is computed on the first $76,200 of the employee's wages.[34]

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[30]See Corp. Code §16601.

[31]See for example ***Estate of Fred O. Goodley***, TC Memo 2000-242.

[32]See Corp. Code §15663 for prohibition of limited partners to withdraw assets from a limited partnership, and Corp. Code §17252 for restrictions on LLC members to withdraw assets from an LLC.

[33]See §§3101 and 3111.

[34]See §1401(b). For self-employed individuals there is an equivalent social security tax of 12.4% plus the 2.9% Medicare tax.

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Paying salaries from a C corporation to a family member avoids a double level of income taxation, but subjects the family members to social security and hospital insurance taxes on their wages.

With S corporations, dividends can be distributed to shareholders and avoid the double level of taxation, plus these dividends are not subject to employment taxes.[35] However, in California S corporation earnings are subject to a corporate level tax of 1½%.[36]

Limited partners do not have any employment taxes imposed on their portion of the limited partnership's distributive income. However, a limited partner can have a self-employment taxes imposed on guaranteed payments received under §707(c) for services rendered to the partnership. A general partner (of a limited or general partnership) can have employment taxes imposed on their share of partnership's income attributable to their general partnership interest under §1402(a)(13).

> **<u>Planning Idea</u>: Have the family member own a small percentage general partnership interest and a large percentage limited partner interest, in order to allocate more of the partnership's earnings to their limited partnership interests (and avoiding employment taxes thereon). The share of the partnership's income attributable to the partner's limited partnership interest will not be subject to self-employment income under §1402(a)(13).**

Members of member-managed LLCs <u>not</u> performing any services are not subject to employment taxes on the LLC distributions. However, a manager of a manager-managed LLC or a member providing services to a member-managed LLC could have income subject to employment taxes with respect to all or a portion of their LLC trade or business income. Proposed regulations interpret the application of employment taxes to LLCs.[37]

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[35] A shareholder of an S Corporation who is an officer and performs substantial services may be subject to a social security and hospital insurance taxes.

[36] Rev. and Tax. Code §23802.

[37] See Prop. Reg. §1.1401(a)-18 (issued December 29, 1994), as modified by Prop. Reg. §1.1402(a)-2 (issued January 13, 1997).

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1.7 **Creative Planning by Using Multiple Business Entities to Own the Family Business**. Using multiple business entities can achieve the family's tax and non-tax goals.

1.7.1 ***Own the Business's Real Estate Outside of the Business Operating Entity***. Owning the business's real estate outside of the operating business entity (and renting the real estate back to the operating entity) can shift rental income and future appreciation of the real estate to children, grandchildren and those family members who are not participating in the business's operations. Additionally, for income tax reasons real estate generally should not be owned by a corporation in order to avoid a double level of taxation, and to allow tax free distribution of financing and refinancing loan proceeds to family members.

1.7.2 ***Use a Management Corporation Where the Family Has Several Businesses***. Using one family management corporation to manage the family's multiple business enterprises (which may be owned in multiple corporations, partnerships or LLCs) provides the following advantages to the family members:

- Centralizes the management of diverse business entities.

- Avoids multiple employment tax ceilings in multiple corporations. Where the various family corporations are "related," can use one management corporation as a "common paymaster" to have one tax base for purposes of employment taxes.[38]

[38] When two or more "related" corporations concurrently employ the same person and compensate that person through a "common paymaster" which is one of the employing corporations, then each corporation is deemed to have only paid the compensation actually paid by that corporation to the employee, but the employee and employer tax is determined as though that individual had only one employer. [§§3121(s) and 3306(p)]. The corporations are "related" if at any time during the calendar quarter: (i) the corporations are members of a "controlled group of corporations" as defined in §1563 (with some percentage modifications); (ii) 50% or more of one corporation's officers are also officers of the other corporation; or (iii) 30% or more of one corporation's employees are also employees of the other corporation. There are other ways for corporations that are non-stock issuing corporations to be related in order to use this favorable tax position.

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- With proper structuring family members can receive employee benefits to the exclusion of non-family employees of the various businesses.

1.7.3 ***Simplify the Business Structure***. Most clients (especially older clients) desire simplified transactions (i.e., the "KISS" principal). Clients may wish to avoid complicated arrangements of multiple business entities which necessitate greater professional fees to form, incur greater compliance and tax filing costs to maintain, and may be difficult to understand. Thus, although a complicated organizational structure can produce greater liability protection, lower income and transfer taxes, and other favorable business results, the complicated structure must be balanced against a client's goals to "keep things simple."

1.8 **Summary of the Advantages and Disadvantages of Each Type of Legal Entity to Own the Family Business**.

1.8.1 ***C Corporation***.

Advantages of C corporations:

- Limited liability protection.
- No restrictions on types of owner of stock.
- Relatively inexpensive and simple to form.
- Corporations that incorporate or qualify to do business in California on or after January 1, 2000 are not subject to the minimum California franchise tax for the corporation's first and second taxable years.[39]

Disadvantages of C corporations:

- Potential double level of taxation on operating earnings.
- Potential double level of tax when business is sold or assets are withdrawn.
- Inability to increase tax basis of corporation's assets upon death of family member.

[39] This minimum tax of $800 per year formerly applied to all years. The first two years' exemption from the minimum tax does not apply to limited partnerships or limited liability companies.

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- Imposition of employment taxes on corporate earnings paid as wages.

1.8.2 ***S Corporation***.

Advantages of S corporations:

- Limited liability protection.
- Relatively inexpensive and simple to form.
- Exempt from minimum California franchise tax for the corporation's first and second taxable years.
- Single level of income tax (but there are exceptions).
- No employment taxes on dividend distributions to family members.

Disadvantages of S corporations:

- Recalcitrant family members could attempt to terminate S election.
- Potential §1374 built-in gains tax on appreciated assets from business operations.
- Restriction on who can own stock in S corporation and types of stock which can be issued.
- If family-owned business assets are sold, potential double level of taxation under §1374.
- Inability to increase shareholders' stock and debt basis for corporate level debt. Could result in lack of sufficient tax basis for shareholders to use tax losses, or result in potential shareholder gain on distribution of corporate loan proceeds to shareholders.
- Inability to increase tax basis of corporation's assets upon death of family member.
- In California there is a corporate level tax on S corporation income of 1.5%.

1.8.3 ***Limited Partnership*.**

Advantages of limited partnerships:

- Limited partners have liability protection (even though general partner does not). If the general partner desires limited liability

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protection, may have to form a corporate general partner.

- One level of taxation on earnings at the partner level.
- If assets or business sold, only one level of taxation.
- One level of taxation on distribution of appreciated assets.
- Increased tax basis of partnership's assets upon death of family member (or their spouse for community property) if a §754 election is made.
- Generally increased partnership interest "outside" basis for partnership level debt, allowing pass through to partners of increased tax losses.
- No employment taxes apply to limited partners' income.

Disadvantages of limited partnerships:

- General partner has no liability protection.
- May be employment tax on general partner's allocation of earnings.
- Underwriters will probably demand to convert to a C corporation if business is to be taken public in a public securities offering.
- May not be able to do a tax-free merger or sale to a public corporate entity as easily as with a corporation.
- May be more expensive to form due to greater flexibility in designing limited partnership agreement. The flexibility of being able to structure the limited partnership agreement increases the costs of establishing the entity and the costs of drafting documents.
- Must pay commencing in first year annual minimum California franchise tax of $800.

1.8.4 ***Limited Liability Company***.

Advantages of limited liability companies:

- Members (including managing members) have liability protection.

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- One level of taxation on earnings at the member level (except for fee on gross income as described below).
- If assets or business sold, only one level of taxation.
- One level of taxation on distribution of appreciated assets.
- Increased tax bases of LLC's assets upon death of family member (or their spouse for community property) if a §754 election is made.
- Generally, increased LLC members' interest "outside" basis for LLC level debt, allowing pass through to LLC members of increased tax losses.

Disadvantages of limited liability companies:

- May be employment taxes on managing members distributions.
- Underwriters will probably demand to convert to C corporation if business is to be taken public in a public securities offering.
- May not be able to do tax-free merger or sale to a public corporate entity as easily as with a corporation.
- May be more expensive to form due to greater flexibility in designing LLC operating agreement. The flexibility of being able to structure the LLC operating agreement increases the costs of establishing the entity and the costs of drafting documents.
- California imposes a fee on the LLC's total annual gross income as follows (which is in addition to the minimum annual $800 California franchise tax). For years beginning on or after January 1, 2000, the fee is:

California Fee[40]	Total Income
$1,042	$250,000 or more, but less than $500,000
$3,126	$500,000 or more, but less than $1,000,000

[40] Rev. and Tax. Code §§17942 and 17943.

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$6,251	$1,000,000 or more, but less than $5,000,000
$9,377	$5,000,000 or more[41]

[41]This California fee is imposed on the LLC's gross revenues (regardless of the amount of expenses or deductions). Thus, an unprofitable LLC may still have this fee imposed against it. See FTB Notice 2000-5 (issued May 12, 2000). The top LLC fee has increased from $4,500 in 1998 to $9,377 in 2000. Under current California law it is likely that this fee will increase in the future. Rev. and Tax. §17943 requires that the California Franchise Tax Board ("FTB") conduct an annual study to determine whether the law which established LLCs in California resulted in a net gain or reduction in the state income and franchise tax revenues. If there is a net reduction in such revenues, the FTB is required to increase the fees in order to offset the revenue loss. The FTB's studies which justified these fee increases are available at the following web site: www.ftb.ca.gov. One of the flaws in these FTB studies is that they assume that each LLC formed would rather have been formed as a corporation. However, entities owning real estate were primarily formed as general or limited partnerships, and not C corporations.

In light of these high California LLC fees, clients in California might consider forming limited partnerships with corporate general partners.

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2. **OBTAINING VALUATION DISCOUNTS FOR THE FAMILY-OWNED BUSINESS**.

Valuation discounts are the key component to transferring family business interests from older to younger generations 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."[42]

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.[43] The IRS in Revenue Ruling 59-60 specifies various factors for valuing a closely-held business interest.[44]

To arrive at the "fair market value" of the entire business, the appraiser will apply one or a combination of the valuation methods discussed at paragraph 2.13.4. After the "fair market value" of the closely-held family 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 and adjustments 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.

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

[43]See Reg. §20.2031-2(f).

[44]1959-1 CB 237.

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

- Discount for **minority interest** (see paragraph 2.3.1).
- Discount for **lack of marketability** (see paragraph 2.3.2).
- Discount for **built-in corporate tax** for C corporation's liabilities (see paragraph 2.4).
- Discount for loss of **key personnel** (see paragraph 2.5).

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 ***Historical 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.[45]

2.1.2 ***The IRS Acquiesces in Revenue Ruling 93-12 and Recognizes No Attribution of Family-Owned Interests***. In Rev. Rul. 93-12[46], 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 children would not be aggregated to determine whether the gifted shares should be valued as part of a controlling interest.

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[45]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).

[46]1993-1 CB 202.

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2.1.3 ***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 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***,[47] Judge Mary Ann Cohen, the then Chief Judge of 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.[48]

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[47] 112 T.C. No. 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).

[48] ***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.

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On the same day that the ***Estate of Mellinger*** decision was issued, the Tax Court issued the ***Estate of Ethel S. Nowell*** decision.[49] 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 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 family business interests between a QTIP Trust and a Survivor's Trust upon the death of the first spouse in order to produce minority discounts.**

2.2 **Recent Proposed Tax Legislation to Limit Valuation Discounts Would Not Have Affected Operating Family Businesses**. Because the IRS failed to have the courts limit valuation discounts for family-owned entities, the IRS approached Congress and the President to enact new tax legislation to limit valuation discounts. The last two Clinton Administration budget proposals included provisions (which were never enacted into law) to eliminate valuation discounts for entities owning investment assets.[50] These recent legislative proposals to limit valuation discounts, even if enacted, would only apply to family entities owning investment assets (such as marketable stocks and bonds, and rental real estate) and would not have applied to family-owned operating business entities.

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

2.3.1 ***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."

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[49] TC Memo 1999-15.

[50] Under President Clinton's recent budget proposals, interests in family-owned business entities would be required to be valued at a proportionate share of the entity's net asset value to the extent that the entity holds "non-business assets" (such as cash, stock and securities traded on a national exchange, real property, royalty producing property, and art or collectibles) at the time of the gift or at death. This legislative proposal was not enacted into law.

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2.3.1.1 ***What Does Lack of Control Mean***? The elements of "control" which the interest holder does not 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.[51]

2.3.1.2 ***How to Calculate Minority Discounts***. 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, but such approach is based upon comparable controlling interest transactions, then those comparable controlling interests must be discounted if the interest being valued is a minority interest.[52] It is common for appraisers to value a minority interest by first valuing what a willing buyer would pay for a controlling interest of an entity (such as where the entire business is purchased). The minority discount is then applied to this controlling interest.

> **Planning Idea: If a client owns a controlling interest in the stock of the family 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**

[51]One recent 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***, TC Memo 2000-12.

[52]Pratt, Reilly & Schweihs, ***Valuing a Business: The Analysis and Appraisal of Closely-Held Companies*** (3d ed. 1996).

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a minority discount.[53] 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 under *Estate of Frank* (but see opposite result arrived at in *Estate of Murphy*, discussed at paragraph 2.11.1).

2.3.2 ***Lack of Marketability Discount***. 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, 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).[54]

2.3.2.1 ***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.

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[53]See ***Estate of Mario E. Bosca***, TC 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 at paragraph 2.1.2.

[54]See, for example, the case of ***Estate of Sidney Friedberg***, TC 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.

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Tax Court Judge David Laro in ***Bernard Mandelbaum***[55] listed and analyzed various factors to be utilized to determine marketability discounts.

2.3.2.2 ***Applying Lack of Marketability Discounts to Family Limited Partnerships***. In the case of a family limited partnership, both limited and general partnership interests receive a lack of marketability discount since no market normally exists for the sale of these partnership interests. Limited partnerships generally are composed of few partners, and people do not regularly purchase limited partnership interests. Furthermore, there are often provisions contained in the partnership's agreement which restrict transferability of interests, and give the general partner control over partnership distributions.

2.3.3 ***How Much of a Combined Minority and Lack of Marketability Discount Applies to the Family Business***? Clients often ask: "How much of a valuation discount can I get for gifts of my business to my children (or at my death)?" Only a qualified appraisal taking into account the specific facts and circumstances of the client's business 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 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. See paragraph 2.13 for items to include in the appraisal report. Clients cannot rely on a particular Tax Court case's percentage valuation discount amount (such as those percentages listed at

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[55]TC Memo 1995-255, aff'd 78 AFTR2d ¶96-5159 (3d Cir. 1996). The ***Bernard Mandelbaum*** case is only a Tax Court memorandum, and not a published decision. In ***Bernard Mandelbaum***, Judge Laro 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.

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paragraph 2.9) for authority to deduct these same valuation discount percentages from their business interests' values.

Recently, courts have found combined minority and lack of marketability discounts ranging between 30% to 65% (and even higher) of the fair market value of the aggregate entity. For example, in ***Estate of Ethel S. Nowell***, the Tax Court allowed without comment a valuation discount of 65% on certain partnership interests.[56] The IRS has conceded the fact that there are valuation discounts in IRS appeals training procedures.[57] See paragraph 2.9 for recent sample valuation discount cases.

2.4 **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.[58] The Second Circuit in ***Irene Eisenberg***,[59] found that such a

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[56]See also ***Estate of Helen J. Smith***, TC 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% discount.

[57]See IRS Course Book on *Valuation Training for Appeals Officers (Part III, revised May 1997)* which specifically directs IRS appeals officers on how to determine the percentage of minority and marketability discounts. Additionally, the IRS stated that taxpayers electing special use valuations under §2032A may also take into account minority interest discounts (see IRS Action on Decision 1998-006) where the IRS acquiesced to the case of ***Estate of Hoover***, 76 AFTR2d ¶95-7305 (10th Circ. 1995)).

[58]***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 argued that this corporate level tax was a corporate liability to be taken into account in valuing the stock.

[59]82 AFTR2d ¶98-5757 (Ct.Ap.2d 1998). 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***, TC Memo 1999-43; ***Estate of Rodgers***, TC Memo 1999-129; and ***Estate of Simplot***, 112 T.C. 1930 (1999). In ***Estate of Dunn***, TC Memo 2000-12, the Tax Court found the likelihood of a corporate liquidation low

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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 this corporate contingent income tax liability. In ***Irene Eisenberg***, the Court of Appeals held that the amount of the discount will not be the full amount of the built-in corporate income tax, but instead will equal what a potential buyer in the marketplace would pay for the stock of a C corporation having this contingent income tax liability.[60]

2.5 **Key Person Valuation Discount**. 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.[61]

In ***Maude G. Furman***[62], 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 plus 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.

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for a heavy equipment rental company and, therefore, only allowed a discount of 5% of the corporate built-in gains.

[60]See footnotes 15 and 16 of ***Irene Eisenberg*** decision. 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.

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

[62]***Maude G. Furman***, TC Memo 1998-157.

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2.6 **Valuation Adjustments Which Increase the Value of the Business Interest**.

2.6.1 ***Increased Valuation for a "Swing Vote" Interest***. 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.[63]

2.6.2 ***Valuation Premiums Where There is Both Voting and Non-voting Stock***. What happens where a corporation has issued both voting and non-voting stock, and the donor/parent owns a minority amount of the voting stock? How should the donor's/parent's (or parent's estate) minority number of shares of voting stock be valued? The Tax Court in a published decision provided guidance in ***Estate of Richard R. Simplot***[64].

In ***Estate of Richard R. Simplot***, the corporation had issued only 76.4 shares of voting stock, versus 141,288.584 shares of non-voting stock. Thus, the ratio of voting shares to non-voting shares was 1 to 1,848. The decedent owned 23.5% of the issued voting stock and 2.79% of the non-voting stock. The remaining voting stock was owned by the decedent's three siblings. The Tax Court adopted the valuation methodology of the IRS's appraiser, and held that the voting privileges of the voting stock and the collective premium for those voting privileges should be expressed in terms of a percentage of equity value of the corporation. Judge Jacobs, writing for the Tax Court, rejected the estate's appraiser's position that the premium to be attached to the voting stock should be calculated as a percentage of the value of the non-voting stock. The Court said that the Court was not valuing a premium for controlling voting power, but only a premium for voting rights for the voting shares. The Court said that a premium for controlling

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[63]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***, TC Memo 1997-53, rejected the IRS's swing vote argument.

[64]112 T.C. 130 (1999). The ***Simplot*** case is currently on appeal to the Ninth Circuit, No. 00-70013.

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voting power would be substantially greater. The Court applied a 3% premium of the total corporation's equity value to establish the premium for the voting stock. Thus, because there were only a small number of voting shares (76.4 shares), the premium for the voting shares was spread among these small number of shares, producing a voting premium per voting share of $325,724. The Tax Court, after applying this voting premium, went on to agree with the IRS's appraiser to provide a lack of marketability discount of 35% for the voting shares and a 40% discount for the non-voting shares.[65]

2.7 **<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).[66] Can parents keep increasing the number of discounts by adding on additional layers of entities?

2.8 **<u>Summary of Recent Court Case Principles on Valuation Discounts</u>**. The following principles should be gleaned from recent 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.

- When partnership interests, LLC membership interests, and corporate stock are transferred by parents to their children, there is <u>no</u> family aggregation or

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[65]Some commentators have criticized the ***Simplot*** decision based upon the fact that even a controlling shareholder's interest should not have a value greater than the amount which that shareholder would receive on the corporation's liquidation. See S. Akers, ***An Overview of Post-Mortem Tax Planning Strategies***, 34th Ann. U. Miami Philip E. Heckerling Inst. on Est. Plan. ¶1209.3 (2000).

[66]In ***Roy Martin, Jr.***, TC 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.

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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.

2.9 **Recent Sample Valuation Discount Cases of Closely-held Businesses**. Some recent valuation discount cases are listed below.

Case	Interest Being Valued	Amount of Discount
Estate of Charles A. Borgatello, TC Memo 2000-264	Estate owned 82.76% of stock of real estate holding corporation.	33% lack of marketability discount
Estate of Emily F. Klauss, TC Memo 2000-191	Estate owned minority number of shares of closely held corporation.	30% lack of marketability discount.
Estate of Ann H. Brookshire, TC Memo 1998-365	Estate owned 9.79% of shares of stock of closely-held corporation.	Combined 40% minority and lack of marketability discount.
Maude G. Furman, TC Memo 1998-157	Gifts of closely-held stock.	Combined 40% minority and lack of marketability discount; plus a 10% key-man discount even though the transferee was the key-person.
Louise B. Barnes, TC Memo 1998-413	Gifts of minority stock in two closely-held corporations.	Combined minority and lack of marketability discount of 40% for one corporation and 45% for the other corporation.

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Charles C. Dockery, TC Memo 1998-114	Gifts of minority stock of a closely-held corporation.	Combined 40% discount for minority and lack of marketability discount.

2.10 **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. Otherwise, the taxpayer generally has the burden of proof in Tax Court under Tax Court Rule 142(a).

2.11 **How to Refute Certain IRS Arguments Against Valuation Discounts**. The latest series of IRS attacks on valuation discounts have concentrated in the family investment partnership area by the so-called "Sham TAMs."[67] The Sham TAMs do not focus on operating family businesses, but rather on family partnerships owning liquid investment assets. However, in recent IRS gift and estate tax field audits of family held businesses, field auditors have raised these same Sham TAM arguments to attack the valuation discounts of the family business interests.

Below are discussed some recent IRS arguments against valuation discounts raised on audit and ways to refute these IRS arguments.

2.11.1 ***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.[68] Thus, a minority valuation discount was not recognized. However, ***Estate***

[67] See, for example, TAMs 9719006; 9736004; 9735003; 9725002; 9723009; 9842003; 9802004 and 9804001.

[68] TC Memo 1990-472.

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of Frank came to an opposite conclusion than ***Estate of Murphy***, under similar facts.[69]

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.[70]

2.11.2 ***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.

2.11.3 ***Refute IRS Argument of "No Business Purpose" for Gift of Family 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 discounts, parents should stress the need to have their children manage the family's business. Shifting management of the business's control to children should be a sufficient business purpose.

2.12 **Tax Court Has Become More Critical of Appraisers**. Hiring a qualified and respected appraiser is essential to substantiate valuation discounts. Some Tax Court judges have

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[69]In ***Estate of Frank***, TC 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.

[70]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).

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recently criticized taxpayer's and IRS's appraisal reports. 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.

2.12.1 ***Estate of Alice Friedlander Kaufman***[71]. Judge David Laro criticized the taxpayer's appraiser in ***Estate of Alice Friedlander Kaufman***, alleging that the appraiser failed to value the company by the "net asset" value method, relied on unverified representations of management, did not analyze certain corporate documents and did not properly apply the discounted cash-flow method. Judge Laro went on to state that the appraiser failed to explain the appraiser's choice of comparable companies and failed to demonstrate that the comparable companies which the appraiser utilized were identified by the same industry. Judge Laro also criticized the IRS' appraiser by pointing out that the IRS' appraiser was biased because he was a full-time employee of the IRS. Judge Laro concluded that where both the taxpayer's and the government's appraiser fell short of the "standard," the Tax Court will hold against the party who had the burden of proof (in this case, the taxpayer). Thus, the IRS' determination of fair market value was sustained.

2.12.2 ***Estate of Eldon L. Auker***[72]. In ***Estate of Eldon L. Auker***, Judge David Laro again criticized the taxpayer's appraiser, accusing the taxpayer's appraiser of having a preconceived bias in favor of the estate.

2.12.3 ***Estate of Walter L. Gross, Jr.***[73] In ***Estate of Walter L. Gross, Jr.***, Judge James S. Halperin criticized the taxpayer's efforts to exclude the IRS's appraiser's testimony. The Tax Court pointed out that the IRS's appraiser's use of the "discounted cash flow" analysis to be a reliable tool to determine the present value and called the estate's arguments "nonsensical." The Court criticized the taxpayer's appraiser in failing to consider that there was no corporate level tax since this was an S corporation, and for failing to consider the fact that the corporation made regular annual cash distributions.

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[71]TC Memo 1999-119.

[72]TC Memo 1998-185.

[73]TC Memo 1999-254 (July 29, 1999).

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Thus, in determining the lack of marketability discount, the Tax Court found the IRS's appraiser was more "thorough and more persuasive than the taxpayer's appraiser."

2.12.4 ***Summary of the Tax Court's Observations on Business Valuations Appraisers***. **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 specific facts of a business to the appraisal and not just apply general valuation principals. **Finally**, the appraiser should not become an "advocate" and appear biased.[74]

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

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

2.13.2 ***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.

2.13.3 ***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 and accountant for their review. The attorney and accountant 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.

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[74]In ***Louis H. Mooneyham***, TC Memo 1991-178, the appraiser's credibility was questioned when the appraiser appeared to be an advocate for the taxpayer. The Tax Court similarly criticized the appraiser in ***Estate of Trenchard***, TC Memo 1995-121, at footnote 17.

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2.13.4 ***The Appraisal Report Should Discuss in Detail All Valuation Methods***. In ***Estate of Alice Friedlander Kaufman***, Judge Laro provided a critique on what items the appraisal report should contain. The Tax Court criticized the taxpayer's appraisal report for failing to include the "net asset" method. Accordingly, the 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, 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 closely-held business is determined by presently valuing future benefits derived from the business. The anticipated return from the 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 liability amounts. Sometimes it is difficult to apply solely the cost method to an operating business because this method fails to take into account goodwill.

2.13.5 ***The Appraisal Report Should Discuss Any Recent Sales of Similar Interests of the Particular 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 arms-length sale of the same stock, partnership or LLC interest (for example, the same closely-held business 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 "arms-length" such as by evidencing any

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potential family conflicts. The appraisal report should discuss how the buyer in a prior comparable stock or partnership interest sale analyzed their purchase to arrive at the sales price, and how the seller of the comparable stock or interest maximized his/her profit from the sale.

2.13.6 ***The Appraisal Report Must Tie Specific Valuation Discounts to Specific Fact Patterns***. The appraisal report should apply valuation studies to the specific facts of the family business being valued. The report should not just be summary in nature regarding methods of valuation or the amount of valuation discounts. Rather, the report should be analytical and lay out in detail the methods and calculations of how a business's value and any discounts were arrived at.[75]

2.13.7 ***The Appraiser and Appraisal Report Should Comply With the Recent Gift Tax Return Regulations***. The statute of limitations on assessing a gift tax deficiency will only commence running if a gift tax return adequately disclosing the gift is filed. When such a return is filed with the IRS, the IRS cannot then revalue such gift for either gift or estate tax purposes after the period for assessing a gift tax deficiency expires.[76] 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.[77]

The description of how the gifted property was valued must include, under the Regulations, a statement of all discounts,

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[75]See ***Estate of James J. Renier***, TC Memo 2000-298, where the Tax Court criticized the taxpayer's appraiser for being summary in his conclusions.

[76]§6501(c)(9).

[77]Reg. §301.6501(c)-1(f)(2).

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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 closely-held family corporation or partnership should be included.[78] These gift tax return disclosures may be separately explained on the gift tax return, or by attaching a copy of the appraisal to the return. If an appraisal is used, the Regulations require that the appraisal report be prepared by an appraiser who meets specific requirements.[79]

2.14 Have Client Memos and Correspondence Prepared to Help Support Valuation Discounts for Lifetime Gifts and Bequests at Death.

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

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

[79]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).

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2.14.2 ***<u>Preserve the Attorney-Client Privilege</u>***. 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" which was enacted as part of the Internal Revenue Restructuring Act of 1998 under §7525 does not apply in all cases. That privilege as applied to accountants is only limited to non-criminal tax matters <u>before</u> the Internal Revenue Service or noncriminal <u>proceedings in Court</u> brought by or against the United States.

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.

2.15 **<u>When Using Valuation Discounts Must Keep in Mind Potential Tax Penalties</u>**. 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 from 50% to over 25% 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 25% or less of the "correct" value.[80] 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."[81] One example of reasonable cause cited in the cases is the valuation is supported by an appraisal by a qualified independent appraiser.[82]

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[80]§6662(h)(2)(C).

[81]§6664(c)(1).

[82]See Tax Court case of ***Bernard Mandelbaum, supra***.

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2.16 **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.

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3. **DIFFERENT WAYS TO TRANSFER THE FAMILY 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? (See discussion at Section 4.)

- Should restrictions be placed on family members conveying their family business interests to persons outside of the family? (See discussion of shareholders' agreements at paragraph 4.2.)

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

- Consider protecting any S corporation or other special tax status (see discussion at paragraph 1.4.3).

3.1 **Annual Gifts to Transfer the Family Business to the Younger Generation**. Probably the simplest way to transfer ownership of the family business is to gift interests (such as 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 $10,000,000) to their children and grandchildren. Using the gift tax annual exclusion of $10,000 per spouse per donee ($20,000 for husband and wife)[83], the parents can gift a total of $320,000 each**

[83] The current $10,000 per donee gift tax annual exclusion amount will increase in the future for inflation under §2503(b)(2).

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year gift tax free to their children and grandchildren (16 issue multiplied times $20,000). 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 $2,695,000 (49% of $10,000,000 less a 45% discount). Thus, being able to gift $320,000 per year gift tax free under the annual exclusion means that the 49% interest can be gifted gift tax free in nine years.[84]

3.1.1 ***Lifetime Gifts Can Produce Greater Valuation Discounts then 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

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[84]There is the practical issue of having to get an appraisal of the stock each year to value the stock for the annual exclusion gift. Such appraisal is necessary for among other reasons 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 from the initial appraisal year) and other financial factors. The gift tax return must include the disclosures as described in paragraph 2.13.7. 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 field audits has accepted this "rough solution" method for valuing annual gifts using the annual exclusion amounts.

With respect to taxable gifts in years ending after August 5, 1997, 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). After such a gift tax return is filed, the IRS cannot then revalue the gift for either gift or estate tax purposes after the period for assessing a gift tax deficiency has expired. The Treasury Regulations describe what amounts to adequate "disclosure." See Reg. §301.6501(c)-1(f)(2). Thus, gift tax returns should be filed, even for transactions for which the annual gift tax exclusion eliminates any gift tax, because the statute of limitations on assessing the gift tax deficiencies and revaluing the transfer for estate tax purposes will not otherwise begin to run. The Regulations require that taxpayers make the adequate disclosures required by the Regulations or to obtain an appraisal that meets the requirements of the Regulations. See Reg. §301.6501(c)-1(f)(2)(iv). Thus, if a formal appraisal is not used with an annual gift tax exclusion, adequate disclosures must be made on the filed gift tax return.

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the above example the parents made no gifts 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 Credit to Make Lifetime Gifts*.** Parents, in addition to making annual gifts using the annual gift tax exclusion, can make further tax free gifts to their issue by utilizing the parents' unified credit amount (currently $675,000 per donor, but rising to $1,000,000 by 2006 per donor or $2,000,000 for both parents in 2006).[85]

3.2 **Parents Can Sell Their 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 note can be paid by the younger generation from the corporation's earnings. If the parents receive back an installment note and own this promissory note on their deaths, then the value of this note can possibly be

[85]The unified credit amount is increased by the following table under §2010(c):

In the Case of Decedent's Dying and Gifts Made During	The Applicable Exclusion Amount or Unified Credit
2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
2006 or thereafter	$1,000,000

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discounted for lack of marketability or other factors (see discussion at paragraph 2.3.2).

3.3 **Using an Installment Note Combined with Regular Annual Forgiveness of the Note's Installments**. 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 the note's annual installment payment as that payment becomes due, or in the alternative the parents could make annual cash gifts to their children to enable their children to pay the note's annual installment payment. The parents have taxable income on the installment sale of the stock under §453.

> **Example: Parents desire to gift to their two children stock worth $100,000 with a $0 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 note payments. In either alternative the parents have $100,000 of capital gains tax (spread over the 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 tax basis).**

In the above example, the parents should not have any correspondence or agreements indicating that the parents intend to forgive the installments 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 annual installment forgiveness).[86]

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[86]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 installments at the time of the sale. Thus, the IRS

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3.4 **Using Self-Canceling Installment Notes Known as "SCINs."** If in the above example the parents still held the unpaid installment note on the date of death, 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 note's then obligations are canceled upon the last to die parent's death, then the installment note on date of death is worth $0. This self-canceling promissory note is referred to as a "SCIN." SCINs can be used to sell stock and other family business interests.

A SCIN is based upon the Tax Court case of ***Estate of Moss***.[87] 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 ***Moss*** there was evidence of an arms'-length negotiation that the amount of the note considered the fact that the note would terminate on Mr. Moss's death.

Similar to a regular installment note, a SCIN freezes the value of the stock in the children, 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 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

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disregarded the installment sale form of the transaction and 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.

[87]74 T.C. 1239 (1980), acq. in result 1981-1 CB 2.

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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.[88] 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 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).[89]

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 company 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,

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[88]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).

[89]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. With the revised Treasury actuarial tables issued in April 1999, it is now more favorable from a transfer tax standpoint to use SCINs. These revised actuarial tables reflect that the chances of the seller dying before the expiration of the SCIN/promissory note's term are now reduced. Since the chances of the seller/parent dying are reduced under these revised tables, the amount of "premium" that has to be added to the SCIN (whether interest or principal) is reduced.

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recapitalization of corporations with preferred stock have fallen out of favor in family-held corporate planning.[90]

3.6 **<u>Using a Defective Income Trust to Transfer the Family Business to Children</u>**. Parents can sell limited partnership, stock or LLC interests to a defective income trust benefitting their children. This defective income trust is classified for income tax purposes as a grantor trust. Under a defective income trust, the parents recognize no taxable gain on the sale, and all of the income and deductions pass through the trust and are taxed to the parents (and not the children). However, the trust's family business interests passes gift and estate tax-free to the children. The parents are taxed on the trust's income because the trust contains certain provisions causing the trust's deductions and income to be taxed to the parents (thus, the trust is a grantor trust for income tax purposes).[91] The trust is irrevocable for gift tax purposes and the trust's assets are not included in the parent's estate for federal estate tax purposes. The parents then sell their discounted partnership, stock or LLC interests to this 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.

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[90]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.

[91]There are a number of techniques which practitioners utilize to create a grantor trust for income tax purposes, but which do not cause inclusion of the 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 power has been held in a fiduciary capacity (which might 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, and that the holder of the power may decide for any reason, or for no reason, to exercise or to not exercise the power.

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 <u>not</u> limited by any reasonable definite standard set forth in the trust instrument. Again, be sure that the trust instrument specifies that the non-adverse party's powers are not limited to any fiduciary standard. §674(a).

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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 defective income trust 69% of the total stock, all of which is nonvoting stock. Assume that the family business has a $10,000,000 value, and the 69% sold stock is reduced in value 45% for "minority," "lack of marketability" and "key man" discounts, or a total discounted value of $3,795,000 (69% of $10,000,000 less a 45% discount). Assume that 69% of the stock 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 an installment note payable to the client in the amount of $3,795,000, which note bears interest at the rate of 7.5%[92] and is payable and amortized over 10 years (promissory note payments of $45,047 per month by the trust to the parents).[93] Thus the trust receives $46,000 per month from the S corporation (in dividends), and pays $45,047 per month to the parents on the promissory note, netting the trust $953 per month. Because this is a defective income trust, the parents pay all of the income taxes on the $46,000 per month amount received by the trust and pays no tax on the $45,047 amount received under the installment note. At the end of 10 years, the defective income

[92]The interest rate should equal the applicable federal rate under §1272.

[93]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 not 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 not 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 not be charged to the trust property. In order to satisfy this test, commentators have suggested that the trust contain 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).

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trust (which benefits the children) owns 69% of the stock and any appreciation thereon gift tax-free, while the parents receive $3,795,000 of principal payments (plus interest) over 10 years on the installment note.[94]

3.7 **<u>Transfer the Family Business By Transferring Business Opportunities to Children</u>**. 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 <u>do not</u> 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), or introduce the children's entity to a business opportunity.

<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, "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

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[94]It is preferable from a tax standpoint if the promissory note is 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 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 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 argue that a taxable sale occurred on the parent's death, which produced taxable gain to the parent's estate. See M. Mulligan, at ¶1509, ***<u>id.</u>***

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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.

3.7.1 ***Income Tax Issues***. 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.[95] 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.

3.7.2 ***Be Careful Not to Make a Constructive Dividend Distribution to the Parent***. If a corporate benefit is distributed to a shareholder, can a constructive dividend be imputed by the IRS?[96] 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.[97] Thus, in the above example, the IRS should not 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.

3.7.3 ***Gift Tax Issues***. The federal gift tax is imposed on the transfer of property, and a gift of "advice" is,

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[95]See §§704(e) and 1366(e) discussed at paragraph 1.4.2.

[96]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.

[97]See B. Bittker & J. Eustice, ***Federal Income Taxation of Corporations and Shareholders***, 7th ed., Warren, Gorham & Lamont (2000), at ¶8.22[1].

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arguably, not a taxable gift.[98] In Rev. Rul. 81-54[99], 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 arms'-length transaction.

3.8 **Using the Marital Deduction to Assist Transferring the Family Business to 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 and second spouse's death) upon the death of the second spouse.

[98]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.

[99]1981-1 CB 476.

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4. **HOW PARENTS CAN RETAIN CONTROL OF THE FAMILY BUSINESS AND STILL TRANSFER THE BUSINESS TO THEIR CHILDREN**.

4.1 **Parents Retaining Voting Rights in the Family Corporation Must Avoid the Tax Trap of §2036(b)**. Many parents gifting corporate stock to their children and grandchildren desire to retain the 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 closely-held 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.[100]

> **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 at such time when the shares are worth $20,000. At the parent's death, the 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[101] the IRS held that if a transferor owns both voting and non-voting stock, the transferor

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[100]In a recent 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.

[101]1981-1 CB 457.

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can give away non-voting stock and retain the voting stock without §2036(b) applying.[102]

4.2 **Using Shareholders' Agreements to Retain Control**. Shareholders' agreements can accomplish the following goals:

- Prevent the transfer of the family 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.

There are two basic forms of buyout provisions included in a shareholders' agreement. **The first form** is called a "redemption agreement" whereby the corporation purchases the stock of the deceased or retired shareholder. **The second form** is called a "cross-purchase agreement" whereby the other shareholders purchase the stock of the retired or deceased shareholder. Hybrid forms of redemption and cross-purchase agreements can be created. For example, one common hybrid form gives the corporation a first right to redeem a shareholder's shares, and if the corporation fails to do so, then the other shareholders may purchase such shares.

4.2.1 ***Provisions to Include in a Shareholders' Agreement***. The shareholders' agreement, in addition to having a provision to buy out family members, can include other provisions to protect the family shareholders. Examples of such provisions are:

- Give the corporation an option to purchase a shareholder's shares upon the shareholder's creditors

[102] 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.

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liening their 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 shareholders' agreement should specify the security for payment of the promissory note. Such security could be to have the remaining shareholders personally guaranty the payment of the promissory note, or to secure the note by a UCC-1 lien on the corporation's assets. UCC-1s are normally not 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.

- If a family member's stock is redeemed then any corporate debts, bank loans, or other obligations of the family business which the redeemed family member guaranteed should be released by the corporation's creditor or bank. If the corporation's creditor or bank refuses to release the redeemed family member's guaranty, then that family member should be indemnified and held harmless by those family members who remain as shareholders.

- If a family member is bought out of the business and other family members continue the business but sell out within a short period of time thereafter for a "premium price," the shareholders' agreement could provide that the selling shareholder is paid a portion of this premium.

4.2.2 ***Receiving Sale or Exchange Income Tax Treatment Under a Shareholders' Agreement***. The shareholders' agreement should be structured in order to produce sale or exchange income tax treatment to the selling shareholder. In the case of a deceased shareholder, the deceased shareholder's estate receives an adjustment in their stock basis to its fair market value under §1014, resulting in little or no taxable gain on the estate's sale or redemption of the stock. The requirements of §302 or §303 (see paragraph 7.1) must be satisfied in a shareholder's buyout in order to not have the proceeds received by the redeemed shareholder from a stock redemption treated as a dividend and taxed as ordinary income (rather than being treated as a sale or exchange with little or no income tax cost).

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Section 302 specifies several alternative method 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).

4.2.3 ***Avoiding the Alternative Minimum Tax***. Life insurance can produce a income tax issue in funding a redemption form of shareholder's agreement. For C corporations, the alternative minimum tax may apply because life insurance proceeds increases the corporation's "adjusted current earnings" under §56(g), thereby potentially producing a corporate level alternative minimum tax. One solution to this alternative minimum tax issue is not to use a redemption agreement, and instead to use a cross purchase agreement.

4.2.4 ***How to Fund the Shareholders' Agreement in Order to Pay the Departing Family Member for Their Stock***. Will the corporation have the 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 promissory note. However, the corporation must have enough future cash flow to pay the promissory note's debt service. Another alternative to pay the deceased shareholder's estate is to have life insurance insure the shareholder's life for all or a portion of the redemption amount.

> **Example: 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 non-working child over seven years, payable monthly (i.e. 84 payments), at 9% interest per annum, or required monthly payments of $80,445 (which equals $965,345 per**

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year).[103] It must be verified that the corporation will have enough cash flow to afford this annual $965,345 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 shareholder's agreement.

4.2.5 ***Estate Tax Issues of Shareholders' Agreements***. In order for the shareholders' agreement to establish the estate tax value of the stock, §2703 require 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. The Regulations under §2703 provide examples of safe harbors to meet the statute's requirements.[104]

Planning Idea: In order for the shareholders' 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

[103]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.

[104]See Reg. §25.2703-1(b)(3).

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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. <u>In another alternative</u>, the shareholder's agreement has 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.

4.3 **<u>How to Retain the Family Business in the Same Family's Control for Multiple Generations</u>**. 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 <u>should</u> <u>never</u> be a reason for nonsurvival. Successful businesses use various planning methods to keep the family's control of the business for multiple generations.

<u>Example</u>: The Ford Motor Company has been under the control of the Ford family for four generations, 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 70%) and at the same time retain control of Ford Motor Company within the Ford family.[105] Thus, 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 <u>all of the voting power</u>. The Class A non-voting stock which

[105]Unexpectedly, the son Edsel Ford died first in 1943, four years before his father Henry Ford I's death in 1947.

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represented 95% of the company's value (under the tax laws at that time) was transferred to the Ford Foundation which Henry Ford I and Edsel Ford set up in 1936 as a private foundation and tax-exempt charity.[106] When the corporation'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.[107] However, the Ford family retained voting control in the Class B stock which kept 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.

The Ford family today continues to preserve its 40% voting stake by its ownership of Class B stock. Furthermore the Ford family has their Class B shares governed by a voting trust in order that the widely-disbursed Ford family votes their B shares as one voting block.[108] Today the Ford family only owns 4.5% of the company's stock in the form of Class B shares, but still exercises 40% of the company's voting

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[106]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.

[107]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 some of its shares in an initial public offering.

[108]See ***Fancy Financial Puzzle***, Newsweek, July 31, 2000, at 42. Also see SEC Form 8-A filed July 7, 2000 with the Securities and Exchange Commission. Each B share has 10.67 votes per share, and each A share has one vote per share, which gives the B shares 40% of the voting rights. For various reasons, not all of the B shares are in the voting trust.

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rights.[109] 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 65 years.

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.

4.3.2 ***Use of 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.[110]

4.3.3 ***Use of Board of Directors 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 the family business. Thus, a board of directors or board of trustees can be established to administer the business. Outside experts and active employees could serve on these boards. Ultimate voting control could

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[109]Recently, in April 2000 the Ford Motor Company went through another recapitalization in which all shareholders (including the Ford family) had the option of taking additional shares of Class A stock. This gave the Ford family additional shares of Class A stock which these family members can then use at a later date to have redeemed to pay potential federal estate taxes on a Ford family member's death. Thus, a deceased Ford member's family can sell Class A shares without touching their Class B stock, which preserves the Ford family's 40% voting control. See ***Ford Motor to Pay $10 Billion Dividend and Insure Family Control***, New York Times, April 15, 2000.

[110]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. In California, 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.

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still be left within the family unit under any such board-run entity.

Example: The Hearst Corporation, since the death of William Randolph Hearst in 1951, has been run by the Hearst Family Trust, which today consists of a 13-member board of trustees, five of whom are family members and eight are non-family management who work for the Hearst Corporation.[111]

[111]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. See D. Nasaw, ***The Chief, the Life of William Randolph Hearst***, Houghton Mifflin Company, at 606, 2000.

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5. **HOW TO AVOID CONFLICTS AMONG FAMILY MEMBERS**.

In structuring the ownership of the family business, consideration must be given to prevent conflicts among the family members. Examples where conflicts can arise include: (i) a working parent with 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; (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 not wanting 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.
- 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 family

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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 support. Accordingly, many parents choose not to transfer the family business to their children upon the death of the first spouse since this would cut off cash flow to the surviving spouse.

> **Example: George Getty, the founder of the Getty oil interests, 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 his fathers death, J. Paul Getty was a minority shareholder of George F. Getty Oil, but served as the company's president. After George Getty's death the mother, Sarah Getty, concerned about her son's 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. The Sarah C. Getty Trust 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 J. Getty Trust amount (approximately $4.1 billion) was distributed to J. Paul's children (her 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 discussion of non-dividend paying stock in a QTIP Trust at paragraph 5.3.

5.2 **Planning for the Senior Family Member's Retirement**. When a senior family member retires from the family business, they may still require the business's cash flow to support

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themselves. This desire for continuing cash flow is one reason senior family members desire to retain control over the business.

Solutions to providing cash flow to the retiring family member are:

- Provide consulting agreement to retiring family member.

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

- Provide rental stream to the retiring family member from the business's real estate retained by the retiring family member.

- Provide license agreement to make royalty payments to the retiring family member for technology, name, logo or other intellectual property rights that the retiring family member retains.

- The retiring family member could sell the business to the working children in exchange for an installment promissory note.[112]

5.3 **Planning the Succession of the Family Business Where There is a Second Spouse and Children By the First 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.

Some suggested solutions are:

- Leave second spouse a QTIP interest for all or a portion of the family business. One problem with this solution is that most family businesses are owned in corporate form and are not income producing (i.e. are not dividend paying). Because of estate tax law requirements for the marital deduction and trust accounting principles, the surviving spouse may be able to demand that the family business become

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[112]See discussion of use of installment notes at paragraphs 3.2, 3.3 and 3.4.

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"productive" and issue dividends.[113] 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.

- Be sure that the working parent who owns the family business as their separate property has a property agreement (preferably antenuptial) to protect against the surviving second spouse claiming a "community interest" or other claim in the business. Such an agreement provides certainty as to who owns the family business and avoids future conflicts between the second spouse and children by the first marriage.[114]

- Consider having the surviving second spouse not be involved or own an interest in the business, and only have the working children involved in the business.

- Have a strong no-contest clause included in the Will and trust documents.[115]

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[113]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 property.

[114]See the recent California Supreme Court case ***In Re the Marriage of Susann Margreth Bonds and Barry Lamar Bonds***, 2000 Daily Jrnl D.A.R. 9250 (August 21, 2000), for a decision upholding the enforceability of an antenuptial agreement. In ***Bonds*** the wife was not represented by counsel in the preparation of an antenuptial agreement. despite this lack of legal representation, the Supreme Court upheld the trial court's determination that the antenuptial agreement was voluntarily entered into. The fact that one of the parties was not represented by independent counsel is only one of several factors that must be considered in determining whether an antenuptial agreement was voluntarily entered into.

[115]See Prob. Code §21300 **et. seq.** for enforceability of no-contest clauses in California.

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- 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 B**). 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.

- On the death of the working parent who owns the family business, have assets other than the family business 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 family business) to the surviving second spouse 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 the various 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."

5.4 **"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 family business. Additionally, parents may have the perception that a child or the child's spouse is a spendthrift. In such cases the parents may not want to give their children control of the family 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 family 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

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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 paragraph 2.1.3.

- The parents could keep control over the main core business and have portions of the business owned by the working children in a separate 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. See, however, the ***Simplot*** case discussed at paragraph 2.6 where the Tax Court attached a extraordinarily high valuation premium to voting stock.

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

- Provide for the buyout of the non-working children's interests in the family business. The non-working children may have received from their parents gifts of stock in the family business or the non-working children may receive stock upon the deaths of their parents. Utilize a shareholders' agreement to purchase the non-working children's interests in the family business (see discussion of shareholders' agreements at paragraph 4.2).

- 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 family business.

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- If at the parents' deaths there is a specific gift of the family business to the working children where the family business interests are discounted, then the parents may effectively be leaving "more assets" to the working children who receive the family 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 family business interests.

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

- Use a strong 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 family business stock (which 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 additionally $1,000,000 in the family business stock (before considering valuation discounts).

5.6 **<u>How to Prevent the Working Siblings From Fighting Among Themselves</u>**. 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:

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- Do a split-up of the family business among the quarreling working siblings. The split-up could consist of dividing the different divisions of the family business among the siblings. Where the family business may be composed of two or more distinct businesses, then could split these distinct businesses among the siblings.[116]

- 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 B** instructing the working siblings of the parent's wishes.

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

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

5.7 **<u>What if There Are No Children to Run the Family Business</u>**? With today's educational and job opportunities, none of the client's children may elect to work in the family business. What happens when the parents have a closely-held family business in which none of their children wish to work?

- Could sell the family 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.

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[116]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., Warren, Gorham & Lamont (2000), at Chapter 11.

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

- Have the family business continue after the parents' deaths with the non-working children (or trust for their benefit) own the business. A board of directors, with family members acting as the directors, could govern the business (see example of the Hearst family at paragraph 4.3.3.). 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 **Prepare the Family Business for the Unexpected Death**. Family businesses should not be lulled into expecting that events will occur in their natural order. Children may die before their parents (see, for example, the Ford Motor Company at paragraph 4.3, where the son, Edsel Ford, died before his father, Henry Ford I). 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 business die unexpectedly together).[117] Divorces and death can occur in a family at any time. People experience bankruptcies and other financial crises, or a family member may suffer a severe disability.

Some potential solutions are:

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[117]The fate of the Dodge Brothers Motor Car Company in the 1920s is a good example of not planning for the survival of the family business in the event of the unexpected deaths of both owners. There, two brothers, Horace Dodge and John Dodge, each owned 50% of the corporation's stock. John Dodge died unexpectedly at age 56, leaving his stock to his family. A few months later Horace Dodge died, also leaving his 50% stock interest to his family in trust. The wives and children were inexperienced, and in many cases spendthrifts. Furthermore, there were no contingency plans on how to run Dodge 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.

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- Have a shareholders’ agreement which contains triggering events for a buyout such as on a family member’s death, disability, retirement, or termination of employment (see a discussion of shareholders’ agreements at paragraph 4.2).

- Each family member should provide in his/her Will or revocable living trust for the disposition of their family business interest on their death. To avoid 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 shareholders’ agreement for the buyout of the family business interest if an interest passes to a child’s spouse upon death or divorce. Have the non-family member spouse execute a "spousal consent" to the shareholders’ agreement.

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6. **USES OF LIFE INSURANCE WITH THE FAMILY OWNED BUSINESS**.

Life insurance can be purchased on the lives of family members: (i) to provide for the payment of death taxes due upon the death of a family member; (ii) to hire additional employees to replace deceased working family members; (iii) to provide for a distribution of assets to a non-working spouse or non-working child; and (iv) to pay the business's debts upon the death of a family member. See paragraph 4.2 for the use of life insurance to buy out the interests of a deceased family member.

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7. **<u>SPECIAL INTERNAL REVENUE CODE PROVISIONS FOR THE PAYMENT OF FEDERAL ESTATE TAXES</u>**.

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

7.1 **<u>Redeeming Stock From the Family Business Under Section 303</u>**. Section 303 allows the payment of federal and state death taxes and expenses by permitting the income tax free withdrawals of monies from the family-owned corporation. Without §303, an estate (and its beneficiaries) could have distributions from the family-held corporation taxed to them as a dividend and ordinary income. If §303's requirements are satisfied, corporate distributions in exchange for stock used to pay estate taxes and funeral and administration expenses deductible under §2053, are treated as distributions in "exchange" for the redeemed stock. Since the decedent's stock is adjusted to its fair market value on date of death[118], the stock's tax basis will equal the redemption amount for the stock, thus producing no gain to the deceased shareholder's estate.

7.1.1 ***<u>What Are the Ownership Percentage Requirements of §303?</u>*** 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 <u>over</u> (ii) the sum of the amounts allowable (not actually allowed) as a deduction under §§2053 or 2054.[119]

> **<u>Example</u>: 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 <u>less</u> $275,000 <u>less</u> $25,000). 35% multiplied times $725,000 (the gross estate) equals $253,750. Thus, the corporation's stock of all**

[118]See §1014.

[119]§303(b)(2)(A).

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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.[120]

7.1.2 ***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.[121]

7.1.3 ***The Shareholder Whose Stock is Being Redeemed Must Actually Bear the Economic Burden of the Taxes and***

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[120]§303(b)(2)(B).

[121]Reg. §1.303-2(g)(2).

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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.[122] Thus, the redeemed shareholder must actually bear the economic burden of the death taxes and administration expenses.

7.1.4 ***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 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.[123]

7.2 **Deferring the Payment of Estate Taxes Under §6166**. 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 only pay interest due on the 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.[124]

7.2.1 ***Paying Estate Taxes in Installments Under the Alternate Provision of §6161***. 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

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[122]§303(b)(3).

[123]§303(b)(1).

[124]California law conforms to federal law regarding the interest rate on unpaid California estate taxes. Rev. and Tax. Code §13550. Under Rev. and Tax. Code §13534, estates may defer the California estate taxes attributable to a closely-held business in the same way that the federal estate tax may be deferred under §6166 and may accrue interest on the same basis as the federal estate tax.

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"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, 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.

7.2.2 ***Summary of §6166's Operation***. 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%[125], and for a reduced interest rate on the remaining estate tax due.

7.2.3 ***Requirements to Qualify Under §6166***. 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.[126] "Adjusted gross estate" means the decedent's gross estate value less the sum of amounts allowable as a §2053 or 2054 deduction.[127] Thus, to determine the adjusted gross estate, §2053 funeral expenses, administration expenses, claims against the estate, unpaid mortgages, etc. 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.[128]

7.2.4 ***What Are the Limitations on the Amount of Estate Taxes That Can be Paid in Installments***? 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

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[125]§6601(j).

[126]§§6166(a)(1) and 6166(b)(6).

[127]§6166(b)(6).

[128]See §2035(d)(4).

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estate's closely-held business amount bears to the amount of the decedent's adjusted gross estate.[129]

7.2.5 ***How Many Estate Tax Installments Can Be Paid Under §6166***? 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."[130] 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.[131] 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.

7.2.6 ***What Interest Rates Apply to the Unpaid Estate Taxes Under §6166*?** 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 taxable value of a closely-held business.[132] For decedents dying in 2000, the tax attributable to the first $1,030,000 in value of the closely-held business in excess of the unified credit exemption is subject to an interest rate of 2%.[133] A favorable interest rate also applies to the remaining amount of the estate tax qualifying for §6166 treatment that exceeds the $1,030,000 amount. Interest on the deferred tax that exceeds the 2%

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[129]§6166(a)(2).

[130]See Reg. §20.6166-1(e)(2).

[131]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 first five years, only interest needs to be paid.

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

[133]The $1,000,000 portion which accrues at 2% interest on unpaid estate taxes is adjusted for inflation. Accordingly, in 1999 this "2% portion" became $1,010,000, and in 2000 it became $1,030,000. Rev. Proc. 99-42, 1999-46 IRB.

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portion is payable at a rate equal to 45% of the annual underpayment rate established under §6621.[134]

> **<u>Example</u>: Mr. Smith dies in 1999 owning stock in a closely-held family business that qualifies under §2057 for deduction for "qualified family-owned business interests." Mr. Smith's business, Smith Manufacturing Co., is valued at $6,000,000 for federal estate tax purposes (after considering all valuation discounts). The first $1,300,000 in value is not subject to estate tax because of the unified credit/exclusion and the §2057 deduction. After application of the unified credit and the §2057 deduction, Mr. Smith's estate has business interests of $4,700,000 in taxable value (its only assets). Mr. Smith's executor makes a §6166 election to pay the estate taxes in installments. Interest on the tax attributable to the inclusion of $1,010,000 of value of Smith Manufacturing Co. in the estate is payable at the 2% rate. The deferred estate tax attributable to the remaining $3,690,000 is payable with interest at 45% of the underpayment interest rate. The interest is <u>not</u> deductible on the estate tax return or the estate's 1041 fiduciary income tax return.**[135]

Because of the §6166 reduced interest rates, Congress no longer permits interest on federal estate taxes deferred under §6166 to be deducted, either for estate tax purposes under §2053 or for income tax purposes under §163.[136]

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[134]This means, for example, that if the underpayment rate is 10%, the effective interest rate is 4.5%. The §6621(a)(2) interest rate has ranged between 7% and 10% since 1992. California estate tax payments are based upon the same interest rates. See Rev. and Tax. Code §13534.

[135]See C. Stoneman and W. Dingemans, ***Estate Planning for Owners of Closely-Held Business Interests***, BNA Tax Management Portfolio, No. 809, 1994.

[136]The California estate tax payable in installments also accrues at the lower interest rate. Rev. and Tax. Code §13534. On the face of the Internal Revenue Code at §§163(k) and 2503(c)(1)(D), the estate <u>also</u> can deduct for federal tax purposes the California interest.

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7.2.7 ***<u>What Qualifies as a "Closely-Held Business" Under §6166</u>***? 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 15 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 15 or fewer shareholders.

Section 6166 is only intended to apply to "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.[137]

The IRS held in a private letter ruling 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. Here the decedent's employees provided significant repair, maintenance, and janitorial services to the commercial tenants.[138]

In a published ruling, the IRS held that a corporation was carrying on a trade or business for §6166 treatment where the corporation built homes on land owned and developed by the decedent.[139] 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,

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[137]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, <u>the IRS allowed</u> 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.

[138]PLR 9832009.

[139]See Rev. Rul. 75-367, 1975-2 CB 472.

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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.[140]

Planning Idea: 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.

7.2.8 ***How to Make a §6166 Election***. 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.[141]

Planning Idea: 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. See the form for a §6166 election at Appendix C.

7.2.9 ***Acceleration of Payments Due Under §6166***. 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

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[140]PLR 8352086.

[141]See §6166(d) and Reg. §20.6166-1(a). Although Rev. and Tax. Code §13534 is not clear on how to make the California election for installment payments of the California estate tax, a recommended method is to separately include an election when the estate files the Form ET-1 with the State of California stating that the estate elects to pay the estate tax in installments.

If the estate is paying in installments under §6166, Rev. Rul. 86-38, 1986-1 CB 296 states that an estate that pays estate taxes over a deferred period may claim a §2011 credit for additional state estate taxes as such taxes are paid.

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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.[142]

Example: 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 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.[143]

If a §6166 is in effect clients must proceed cautiously in reorganizing or changing the corporate structure. In many cases, if a transaction is being contemplated that potentially could accelerate §6166, the estate should obtain an IRS private letter ruling as to whether the §6166(g) acceleration provisions will apply.

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

Planning Idea: In gifting and selling shares of stock in the family business to younger family members, keep

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[142]§6166(g)(1)(A).

[143]§6166(g)(1)(B).

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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 the benefits of §§303 and 6166 are lost.

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8. **SECTION 2057 SPECIAL ESTATE TAX DEDUCTION FOR CLOSELY-HELD BUSINESSES**.

Because of Congress's concern to protect family-held businesses from the federal estate tax, there is a special estate tax deduction for qualified family-owned business interests ("QFOBI"). The QFOBI deduction does not apply for gift or generation-skipping transfer taxes.

Section 2057 allows the exclusion of the excess of $1,300,000 of value of the QFOBI over the amount of the applicable exclusion amount.[144] Thus, for persons dying in 2000, the maximum amount excludable by reason of §2057 will be $625,000 ($1,300,000 minus the 2000 applicable exclusion amount of $675,000). By 2006, the maximum exclusion under §2057 will only be $300,000 because the applicable exclusion amount will then be $1,000,000. Although §2057 may be of minimal benefit to many family businesses, it does provide tax benefits in certain cases.

8.1 **Requirements to Qualify Under §2057**. In order to qualify under §2057, the following requirements must be satisfied: (i) the decedent must be a U.S. citizen or U.S. resident; (ii) the executor must elect for the treatment of all persons who have an interest in the property, and they must submit an agreement with the IRS for §2057 treatment; (iii) the value of the business plus certain gifts made by the decedent must exceed 50% of the decedent's adjusted gross estate as that estate is increased by certain gifts; (iv) the business must be an active trade or business; (v) the trade or business must be a proprietorship or another form with certain restrictive percentage ownerships by the decedent, and the decedent's family; (vi) the business must be in the United States; (vii) no stock or debt of the business could have been publicly traded within three years of the decedent's death; (viii) not more than 35% of the adjusted ordinary gross income of the trade or business may be personal holding company income; (ix) the business must have been operated for five of the past eight

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[144] Proposed Treasury Regulations under §2057 are scheduled to be issued by the end of 2000, but the IRS has told this author that the issuance of these regulations could be delayed until 2001. Because of these pending regulations, the IRS has stated that it will not issue rulings in the §2057 area.

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years by the decedent or a member of the decedent's family and there must have been a material participation within the meaning of §2057 by the decedent or family member; (x) the business interest must pass to a qualified heir within the meaning of §2057; and (xi) the qualified heir who receives the property must be a citizen of the United States or the property can qualify only if it is held in a qualified trust similar to a qualified domestic trust under §2056A.

8.2 **Use of QFOBI with the Marital Deduction**. The QFOBI deduction of the first to die spouse is basically wasted if the entire business is left to a surviving spouse because the marital deduction would exclude the value of the business in any event. Thus, the deductible QFOBI amount should be added to the unified credit trust (assuming that the beneficiaries are qualified heirs) to take advantage of the QFOBI deduction in the first-to-die spouse's estate and, thus, cause the QFOBI amount to be excluded from the surviving spouse's gross estate.

8.3 **Recapture of QFOBI Deduction**. If the QFOBI deduction is allowed and any of the following events occur within ten years after the decedent's death and before the death of the qualified heir, then an additional estate tax is imposed (i.e., the QFOBI deduction is recaptured): (i) the material participation requirements are no longer met; (ii) the qualified heir disposes of any portion of the qualified family-owned business interest, other than a disposition to a member of the qualified heir's family or through a qualified conservation contribution; (iii) the qualified heir loses U.S. citizenship; or (iv) the principal place of business of the qualified family-owned business ceases to be located in the U.S. The amount of the additional estate tax imposed because of the recapture is based upon the percentage of time that has lapsed since the decedent's death, plus interest on the amount at the §6621 underpayment rate from the time that the estate tax liability was due and ending on the date that the additional recapture of estate tax is due.[145] The recapture percentage, for example, for year 1 through 6 is 100%, while in year 10 it is 20%.[146] Each qualified heir is personally liable for the portion of the

[145]See §2057(f)(2)(A).

[146]See §2057(f)(2)(B).

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recapture estate tax that is imposed with respect to such qualified heir’s interest in the qualified family-owned business.

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9. **SECTION 2032A REDUCTION IN 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.[147]

Section 2032A is commonly used in the farm and ranching area, but can apply to real property used in closely-held family 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.

As a practical matter, §2032A is not regularly used in the closely-held business area. 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**

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[147] §2032A(e)(8).

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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.[148] Thus, the §2032A limitation is increased to $760,000 for estates of decedents dying in 1999, and $770,000 for decedents dying in the year 2000.[149]

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;

(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

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[148]§2032A(a)(3).

[149]Rev. Proc. 99-42, 1999-46 IRB.

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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.[150]

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.[151]

9.4 **Recapture**. 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.[152] The recapture is imposed by an "additional tax." The "additional tax" is imposed if within 10 years[153] 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.

> **Planning Idea: If §2032A is utilized and the decedent's Will or trust does not allocate the §2032A**

[150]§2032A(b)(1).

[151]§2032A(b)(1).

[152]§2032A(c)(1).

[153]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).

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savings to the heirs receiving the special valuation use property, then the beneficiaries should enter into an agreement among themselves under which those beneficiaries receiving the §2032A special valuation use property agree to bear the burden of any recapture of estate tax.

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10. **ETHICAL PROBLEMS IN REPRESENTING FAMILY BUSINESSES**.

Attorneys commonly end up being the "family lawyer" representing multiple family members along with the family business. The same attorney may prepare estate planning documents for different family members, as well as serve as corporate counsel to the family business. Such multiple attorney representations can produce conflicts of interest and run afoul of the California Rules of Professional Conduct.[154] These attorney conflicts in may cases evolve slowly over many years.

> **Example: In 1980, attorney Yule Solvit is retained by father to provide business representation for Smith Manufacturing Company. Additionally, the father has Mr. Solvit prepare the father's Will and revocable living trust (father is divorced). Father remarries in 1983, and Mr. Solvit prepares and represents the father in preparing father's prenuptial agreement (the father's second wife is represented by her own attorney). In 1990, the second wife, feeling comfortable with Mr. Solvit, who is a family friend and who socializes with father and wife, asks Mr. Solvit to prepare her own Will. Mr. Solvit prepares the wife's Will in 1990. The father's two children from his first marriage, Jane and Jack, work in the business, and Mr. Solvit also prepares their estate planning documents, along with shareholders' agreements between the father and his children in 1996. Father dies in 2000. Thus, Yule Solvit has represented father, wife by the second marriage, the**

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[154] California Rules of Professional Conduct 3-310(C) states:

"A member shall not, without the informed written consent of each client: (i) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or (ii) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict; or (iii) Represent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter."

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children by the first marriage, and the family's corporation.

The attorney's representation in the above example becomes even more complicated as the children retain this same attorney for the children's own business ventures. California Rules of Professional Conduct 3-310(C)(1) imposes an ethical duty on attorneys not to represent multiple clients whose interests are "potentially" adverse without receiving everyone's informed written consent.

10.1 **Obtaining Written Informed Consents from Clients**. Ideally, the attorney should obtain an informed written consent from each family member where there is a potential conflict of interest. Thus, a detailed engagement letter to the family member outlining the terms of the engagement, the various family member clients that the attorney represents, and requests for a written waiver of the conflict would be appropriate. The attorney should receive similar informed waivers from all family members. See form of waiver of conflict at **Appendix D**, which is used in connection with the family business's shareholders' agreement.

10.2 **Attorney's Duty of Confidentiality Among Family Members**. In addition to the conflict rules discussed above, the attorney also has a duty of confidentiality in representing multiple family members owning a business.[155] To address the confidentiality issue, the attorney in their engagement letter with family members should state that the attorney cannot, and is not expected by the fact that the attorney is representing multiple family members, to keep information that is told to the attorney by one family member confidential from the other family members. The engagement letter should further state that the

[155]California Bus. and Prof. Code §6068(e) states:

"It is the duty of an attorney...(e) [t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." Additionally, California Rule of Professional Conduct 3-110 states in part "a member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment."

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attorney has the right (but not the duty) to disclose information that the attorney receives from one family member to another family member. As a practical matter, sometimes a family member will want the attorney to hold in confidence certain information from other family members. Does the attorney have a duty to disclose this information to other family members represented by the attorney? Preferably, family members should waive any duty for the attorney to disclose confidential information that is disclosed to the attorney.[156] However, is such a waiver enforceable?

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[156]For an excellent discussion of an attorney's duty to avoid conflicts of interest and duties regarding confidentiality in the estate planning area, see ***Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel***, State Bar of California, Estate Planning, Trust and Probate Law Section, edited by Susan T. House and Bruce S. Ross, 1997.

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