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# **Creative Tax and Estate Planning Ideas for the Family Business**

by

**Robert A. Briskin**

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**CREATIVE TAX AND ESTATE PLANNING IDEAS  
FOR THE FAMILY BUSINESS**

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## **CREATIVE TAX AND ESTATE PLANNING IDEAS FOR THE FAMILY BUSINESS**

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### **INTRODUCTION**

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

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**Because each client's situation has unique facts, this article is not legal or tax advice as to any specific situation or client. If you or a client desire legal or tax advice for a particular matter, please contact Robert A. Briskin at [rbriskin@rablegal.com](mailto:rbriskin@rablegal.com) or at (310) 201-0507.**

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; (v) recapitalization of the business; and (vi) transfer of business opportunities to younger generation levels.<sup>1</sup>

Over the past 30 years, Congress has eased the transfer tax burden on closely-held family businesses through: (i) increasing the gift tax annual exclusion (currently in 2012 it is \$13,000 per donor and indexed for inflation); (ii) providing for the unlimited marital deduction; (iii) revising the special use valuation under §2032A<sup>2</sup> for real estate used in the family business; (iv) increasing the unified credit (currently in 2012 it is \$5,120,000, but reducing to \$1,000,000 in 2013); and (v) revising the estate tax payment deferral provisions under §6166.<sup>3</sup>

## **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:

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<sup>1</sup>See a detailed discussion at paragraph 3 on how to transfer the family business to the younger generation.

<sup>2</sup>Unless otherwise stated, all Code references are to the Internal Revenue Code of 1986, as amended.

<sup>3</sup>Few estates for decedents dying in 2002 pay a federal estate tax because of the unlimited marital deduction and the 2012 \$5,120,000 per person estate tax exclusion.

- 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.<sup>4</sup> 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.<sup>5</sup>

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.

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<sup>4</sup>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.

<sup>5</sup>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 partnership will be taxed as a partnership for income tax purposes.

**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 dividends distributed.<sup>6</sup> 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 is 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.<sup>7</sup> The shareholders report at the shareholders level a pro rata share of the S corporation income, whether or not there are distributions.<sup>8</sup> 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.<sup>9</sup> Additionally, shareholders of S corporations are restricted in deducting tax losses based on corporate level

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<sup>6</sup>See §11 for corporate level tax rate. §301 imposes an income tax on dividends distributed to the shareholder.

California's current franchise tax rate on C corporation income is 8.84%. Rev. and Tax. Code §23151(e). There is an \$800 per year minimum tax. Corporations that incorporate or qualify to do business in California are not subject to this minimum tax for the first year. However, this first year tax exemption does not apply to LLCs, limited partnerships and qualified Subchapter S corporation subsidiaries.

<sup>7</sup>California imposes a 1.5% tax on S corporation earnings.

<sup>8</sup>§1366

<sup>9</sup>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."

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.

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.<sup>10</sup> 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

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<sup>10</sup>Reg. §1.1366-3(a).

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).

On the other hand, S corporations cannot have shareholders that are partnerships or LLCs.<sup>11</sup> 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.<sup>12</sup> S corporations may also not have more than 100 shareholders, which limitation can cause problems where shares of stock are left to multiple family generations producing large numbers of shareholders.<sup>13</sup> On the other hand, C corporations, partnerships, and LLCs can have an unlimited number of owners for tax purposes.

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 100 shareholders potentially wields the power to revoke an S election.

**Planning Idea:** 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.

1.4.4 **Goal to Form the Business Entity Tax Free.** A partnership, LLC or corporation can be formed tax free under

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<sup>11</sup>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.

<sup>12</sup>See §1361(b).

<sup>13</sup>See §1361(b)(1)(A).

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.

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.<sup>14</sup> 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 gain may be passed through to the shareholders. 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.

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. 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 **Goal to Increase the Entity's Assets' Tax Bases Upon the Death of the Business Owner.** At death, a decedent's stock and partnership interest tax bases are adjusted

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<sup>14</sup>See §311(a).

to their date of death (or alternate valuation date) values.<sup>15</sup> For community property, both the decedent's and the decedent's spouse's share of the community property receives a basis adjustment.<sup>16</sup> 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 no 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.

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.<sup>17</sup> Thus, when a partner dies the tax basis of the deceased partner's partnership interest is adjusted to its fair market value under §1014. 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.

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

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<sup>15</sup>§1014(a).

<sup>16</sup>See §1014(b)(6).

<sup>17</sup>See §§754 and 743.



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.

1.5.1 **Types of Valuation Discounts.** 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.

1.6 **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.

1.6.1 **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.

1.6.2 **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.

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

1.6.3 **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."

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

### **1.7.1 C Corporation.**

#### **Advantages of C corporations:**

- Limited liability protection.
- No restrictions on types of owner of stock.
- Relatively inexpensive and simple to form.

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

### **1.7.2 S Corporation.**

#### **Advantages of S corporations:**

- Limited liability protection.
- Relatively inexpensive and simple to form.
- 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%.

1.7.3 **Limited Partnership.**

**Advantages of limited partnerships:**

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

1.7.4 **Limited Liability Company.**

**Advantages of limited liability companies:**

- Members (including managing members) have liability protection.
- 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). Currently the fee is:

<u>California Fee<sup>18</sup></u>	<u>Total Income</u>
\$900	\$250,000 or more, but less than \$500,000
\$2,500	\$500,000 or more, but less than \$1,000,000
\$6,000	\$1,000,000 or more, but less than \$5,000,000
\$11,790	\$5,000,000 or more <sup>19</sup>

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

Valuation discounts are a 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:

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<sup>18</sup>Rev. and Tax. Code §§17942.

<sup>19</sup>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.

"[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."<sup>20</sup>

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.<sup>21</sup> The IRS in Revenue Ruling 59-60 specifies various factors for valuing a closely-held business interest.<sup>22</sup>

To arrive at the "fair market value" of the entire business, the appraiser will apply one or a combination of the valuation methods. After the "fair market value" of the 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.

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

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<sup>20</sup>Reg. §20.2031-1(b). The gift tax regulations have a similar definition of fair market value at Reg. §25.2512-1.

<sup>21</sup>See Reg. §20.2031-2(f).

<sup>22</sup>1959-1 CB 237.

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.<sup>23</sup>

2.1.2 **The IRS Acquiesces in Revenue Ruling 93-12 and Recognizes No Attribution of Family-Owned Interests.** In Rev. Rul. 93-12<sup>24</sup>, 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.

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

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<sup>23</sup>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).

<sup>24</sup>1993-1 CB 202.

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*,<sup>25</sup> 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.<sup>26</sup>

On the same day that the *Estate of Mellinger* decision was issued, the Tax Court issued the *Estate of Ethel S. Nowell* decision.<sup>27</sup> 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 spouse 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**

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<sup>25</sup>112 T.C. 26 (1999), acq. AOD 1999-006. In the IRS's acquiescence in *Estate of Mellinger*, the IRS pointed out that when the QTIP Trust is funded, a minority discount should be reflected in satisfying the marital bequest. The Tax Court in *Estate of Mellinger* followed the decision of the Fifth Circuit Court of Appeals in *Estate of Bonner*, 77 AFTR2d ¶96-2369 (5th Cir. 1996).

<sup>26</sup>*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.

<sup>27</sup>TC Memo 1999-15.



**Survivor's Trust upon the death of the first spouse in order to produce minority discounts.**

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

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

2.2.1.1 **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.<sup>28</sup>

2.2.1.2 **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. 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**

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<sup>28</sup>One Tax Court case supported a discount for "lack of super-majority control," where a 7.5% discount was allowed for a decedent who owned 62.96% of the stock of a corporation. Here, the shares lacked the power to compel a liquidation, a sale of all or substantially all of the assets, or a merger of the corporation, all of which required a two-thirds vote under applicable state law. See *Estate of Dunn*, TC Memo 2000-12.

gifting enough shares of stock to the client's children in order that the client is left with a minority (i.e., less than 50% of the voting rights) interest. Alternatively, the client could gift one-half of the controlling interest to each of two children (splitting the control among two children). The Tax Court and the IRS allow splitting a gift of a controlling interest among multiple donees to produce a minority discount.<sup>29</sup> The client could even gift stock to children immediately before death to reduce the client's stock ownership below 50%, thereby producing a minority discount.

2.2.2 **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).<sup>30</sup>

2.2.2.1 **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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<sup>29</sup>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 above.

<sup>30</sup>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.

The Tax Court in **Bernard Mandelbaum**<sup>31</sup> listed and analyzed various factors to be utilized to determine marketability discounts.

2.2.3 **How Much of a Combined Minority and Lack of Marketability Discount Applies to the 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. Clients cannot rely on a particular Tax Court case's percentage valuation discount amount for authority to deduct these same valuation discount percentages from their business interests' values.

Courts have found combined minority and lack of marketability discounts ranging between 30% to 65% of the fair market value of the aggregate entity. For example, in **Estate of Ethel S. Nowell**, the Tax Court allowed without comment a valuation discount of 65% on certain partnership interests.<sup>32</sup>

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<sup>31</sup>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. **Bernard Mandelbaum** listed the following factors to determine marketability discounts: (i) financial statement analysis of the entity; (ii) dividend policy of the entity; (iii) nature of the company, its history, industry position and economic outlook; (iv) the management of the entity, whether it was proven and experienced; (v) control of the transferred shares since a lack of control would indicate a greater discount; (vi) any transfer restrictions on the shares of stock; (vii) the holding period of the stock; (viii) the entity's redemption policy of its stock; and (ix) the cost of doing a public offering in order to make the stock marketable.

<sup>32</sup>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.

In *Gallagher*,<sup>33</sup> the Tax Court in valuing a closely held publishing company applied a 23% minority discount plus a 31% lack of marketability discount for a total blended discount of 46.8%. In *Estate of Bailey*,<sup>34</sup> the Tax Court valued corporate stock of a corporation owning motels, utilizing a 50% blended valuation discount.

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

**2.3 Valuation Discount for Corporate Taxes That a Corporation Might Have to Pay in the Future.** A discount is allowed for potential future income taxes on corporate built-in gains, even if the corporation is not currently liquidating.<sup>35</sup> The Second Circuit in *Irene Eisenberg*,<sup>36</sup> found that such a discount was proper under general business valuation principals. The value of a C corporation's stock must take into account the fact that the C corporation has a contingent built-in income tax liability due to the difference between the fair market value of the corporation's assets and those assets' tax bases. The appraiser should, therefore, consider what a willing buyer would pay for the corporation's stock considering this corporate

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<sup>33</sup>T.C. Memo 2011-48, as modified by T.C. Memo 2011-244.

<sup>34</sup>T.C. Memo 2002-152.

<sup>35</sup>See *Estate of Jensen*, T.C. Memo 2010-182 and *Estate of Artemus D. Davis*, 110 T.C. 530 (1998). Taxpayer's argument for a discount in the value of a C corporation for the corporate level built-in gains tax arose after the repeal of the General Utilities doctrine under the Tax Reform Act of 1986. The repeal of the General Utilities doctrine resulted in a corporate level gain when the corporation was liquidated. Taxpayers argued that this corporate level tax was a corporate liability to be taken into account in valuing the stock.

<sup>36</sup>82 AFTR2d ¶98-5757 (Ct.Ap.2d 1998) acq. AOD 1999-001. The *Irene Eisenberg* and *Estate of Artemus D. Davis* results have been acquiesced to by the IRS. The IRS's acquiescence indicates that the amount of the reduction in value of the corporate stock will be based upon the facts and circumstances of each case. The corporate built-in gains tax has also been allowed as an reduction in the value of the corporate stock in *Estate of Jameson*, TC Memo 1999-43; *Estate of Rodgers*, TC Memo 1999-129; and *Estate of Simplot*, 112 T.C. 1930 (1999). In *Estate of Dunn*, 301 F3d 339 (Ct.Ap5th 2002), the Court discounted the entire amount of the capital gains tax.

contingent income tax liability. In *Estate of Jensen*, a dollar for dollar discount for built-in gains was allowed.<sup>37</sup>

2.4 **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.<sup>38</sup>

In *Maude G. Furman*<sup>39</sup>, 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.

2.5 **Valuation Adjustments by 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.<sup>40</sup>

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<sup>37</sup>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.

<sup>38</sup>Rev. Rul. 59-60, 1959-1 CB 237.

<sup>39</sup>*Maude G. Furman*, TC Memo 1998-157.

<sup>40</sup>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.

2.6 **Parents Can Increase Valuation Discounts by "Layering" Ownership of the Business's Operations.** 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).<sup>41</sup>

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

- Taxpayers must hire a respected business appraiser. A qualified appraisal is important in defending valuation discounts before the IRS and in court.
- Case law supports minority, lack of marketability, corporate tax liability/built-in gain, and key person valuation discounts.
- When partnership interests, LLC membership interests, and corporate stock are transferred by parents to their children, there is no family aggregation or constructive ownership rules in the valuation discount area.
- It is important that taxpayers and their advisors create favorable fact patterns by gathering evidence on the date of death and the time the gifts or transfers are made to support valuation discounts.
- Despite IRS claims to the contrary, the sum of the parts do not equal the whole in the area of valuation discounts.

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

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<sup>41</sup>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.

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

2.9.1 **The Murphy Argument that the Transaction Has No Substance.** In *Estate of Elizabeth B. Murphy*, the Tax Court valued the decedent's 49.65% common stock interest in a closely-held corporation as a controlling interest because the decedent had given her children a 1.76% block of stock only eighteen (18) days before her death. The Tax Court found that nothing of "substance" changed by the stock gift and disregarded the stock gift because it was done solely to reduce taxes.<sup>42</sup> Thus, a minority valuation discount was not recognized. However, *Estate of Frank* came to an opposite conclusion than *Estate of Murphy*, under similar facts.<sup>43</sup>

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.<sup>44</sup>

2.9.2 **Refute IRS's Arguments Against Gifts Made Within a Few Years of Death By Pointing Out that the IRS Failed to Consider §2035.** Under the 1981 changes to §2035, §2035 (with some specific exceptions) no longer contains provisions causing gifts made within three years of date of death to be included in the decedent's gross estate. Thus, because of §2035's repeal, parents' gifts of stock to their children within three years of

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<sup>42</sup>TC Memo 1990-472.

<sup>43</sup>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.

<sup>44</sup>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).

date of death, arguably, cannot be brought back into the decedent's taxable estate to create control and eliminate minority valuation discounts.

2.9.3 **Refute IRS Argument of "No Business Purpose" for Gift of 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.

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

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

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

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

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



2.11.3 **Discuss the Draft of the Appraisal Report With The Appraiser Before the Final Appraisal Report is Issued.**

The appraiser should submit a draft of the appraisal report to the attorney 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.

2.11.4 **The Appraisal Report Should Discuss in Detail All Valuation Methods.** The business' 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.

2.11.5 **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 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.

2.11.6 **The Appraisal Report Should Tie Specific Valuation Discounts to Specific Fact Patterns.** The appraisal report should apply valuation studies to the specific facts of the 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.

2.11.7 **The Appraiser and Appraisal Report Should Comply With 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.<sup>45</sup> 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

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<sup>45</sup>§6501(c)(9).

the gift that conflicts with the Regulations or Revenue Rulings.<sup>46</sup>

The description of how the gifted property was valued must include, under the Regulations, a statement of all discounts, premiums and other adjustments used in the valuation, and a description of any transfer restrictions taken into account in valuing the gifted property. A statement of the value of 100% of the interest in the closely-held family corporation or partnership should be included.<sup>47</sup> 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.<sup>48</sup>

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<sup>46</sup>Reg. §301.6501(c)-1(f)(2).

<sup>47</sup>See these and other disclosure requirements at Reg. §301.6501(c)-1(f)(2)(iv).

<sup>48</sup>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).

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

2.12.1 **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.

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

The "tax practitioner privilege" under §7525 does not apply in all cases. That privilege as applied to accountants is only limited to non-criminal tax matters before the Internal Revenue Service or noncriminal proceedings in Court brought by or against the United States, and does not apply to promoting a tax shelter.

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

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

less of the "correct" value.<sup>49</sup> 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."<sup>50</sup>

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

### 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

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<sup>49</sup>§6662(h)(2)(C).

<sup>50</sup>§6664(c)(1).

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 \$13,000 per spouse per donee (\$26,000 for husband and wife)<sup>51</sup>, the parents can gift a total of \$416,000 each year gift tax free to their children and grandchildren (16 issue multiplied times \$26,000). 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 \$416,000 per year gift tax free under the annual exclusion means that the 49% interest can be gifted gift tax free in seven years.<sup>52</sup>

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<sup>51</sup>The current \$13,000 per donee gift tax annual exclusion amount will increase in the future for inflation under §2503(b)(2).

<sup>52</sup>There is the practical issue of having to get an appraisal of the stock each year to value the stock for the annual gift tax 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 above. If the IRS questions these gift values and discounts on audit at a later date, final appraisals can then be obtained for each of these prior year gifts. This author's experience is that the IRS on field audits has accepted this "rough solution" method for valuing annual gifts using the annual exclusion amounts.

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

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 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 \$13,000 annual gift tax exclusion, can make further tax free gifts to their issue by utilizing the parents' unified credit amount (currently in 2012 \$5,120,000 per donor or \$10,240,000 for a husband and wife, but is scheduled to reduce to \$1,000,000 on January 1, 2013 per donor parent or \$2,000,000 for both

parents in 2013).<sup>53</sup> There is also portability of a deceased spouse's unused exclusion amount to the surviving spouse for those surviving spouses dying before 2013. Thus, the surviving spouse during 2012 can use a deceased spouse's unused exclusion to make gifts during 2012 (where the first spouse died after 2010).

**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 discounted for lack of marketability or other factors.

**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

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<sup>53</sup>The unified credit amount has increased over the years as follows:

<u>In the Case of Decedent's Dying and Gifts Made During</u>	<u>The Applicable Exclusion Amount (or Credit equivalent)</u>
2000 and 2001	\$675,000
2002 and 2003	\$1,000,000
2004	\$1,500,000
2005	\$1,500,000
2006 to 2008	\$2,000,000 (but gift tax exemption at \$1,000,000)
2009	\$3,500,000 (but gift tax exemption at \$1,000,000)
2010 to 2011	\$5,000,000 (both gift and estate taxes)
2012	\$5,120,000 (both gift and estate taxes)
2013	\$1,000,000 (both gift and estate taxes)



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).<sup>54</sup>

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

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<sup>54</sup>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 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.

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*.<sup>55</sup> 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 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

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<sup>55</sup>74 T.C. 1239 (1980), acq. in result 1981-1 CB 2. However, if the facts show that the SCIN was not a bona fide promissory note then the note will not be recognized for tax purposes. *Estate of Musgrove*, 33 Fed. Cl 1657 (1995)

with a younger seller.<sup>56</sup> 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).<sup>57</sup>

**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, recapitalization of corporations with preferred stock have fallen out of favor in family-held corporate planning.<sup>58</sup>

**3.6 Using a Grantor Trust to Transfer the Family Business to Children.** Parents can sell limited partnership, stock or LLC interests to a grantor trust (formerly known as a defective income trust) benefitting their children. This trust is

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<sup>56</sup>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).

<sup>57</sup>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.

<sup>58</sup>Section 2701 results in an increase in the value of the common stock given to the younger generation, thereby increasing the gift tax cost. Section 2701 values the common stock by subtracting the preferred stock value from the value of the parents' total stock holdings. Section 2701 reduces the value of the preferred stock where the corporation has discretionary powers to issue dividends.

classified for income tax purposes as a "grantor trust." Under a grantor 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 (since the trust is irrevocable). 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).<sup>59</sup> 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.

The parents still pay the income taxes on all of the grantor trust's income, which further increases the trust's worth at no estate or gift tax cost to the children or grandchildren trust beneficiaries under Rev. Rul. 2004-64.

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

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<sup>59</sup>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.

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

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

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 2.7%<sup>60</sup> and is payable and amortized over 10 years (promissory note payments of \$36,122 per month by the trust to the parents).<sup>61</sup> Thus the trust receives \$46,000 per month from the S corporation (in dividends), and pays \$36,122 per month to the parents on the promissory note, netting the trust \$9,878 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 \$36,122 amount received under the installment note. At the end of 10 years, the defective income trust (which benefits the children) owns 69% of the stock and any appreciation thereon gift tax-free,

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<sup>60</sup>The interest rate should be at least equal the applicable federal rate ("AFR") under §1272. Note that recent long term AFR rates (for notes longer than 9 years) is 2.68% for April 2012, where paid monthly.

<sup>61</sup>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).

while the parents receive \$3,795,000 of principal payments (plus interest) over 10 years on the installment note.<sup>62</sup>

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

Example: 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 California). The father assists the children's

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<sup>62</sup>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.

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.<sup>63</sup> 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?<sup>64</sup> 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.<sup>65</sup> 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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<sup>63</sup>See §§704(e) and 1366(e).

<sup>64</sup>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.

<sup>65</sup>See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7th ed., Warren, Gorham & Lamont (2006), at ¶8.05.

arguably, not a taxable gift.<sup>66</sup> In Rev. Rul. 81-54<sup>67</sup>, 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.

#### 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 controlled 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 controlled corporation stock transferred where the parents retain the stock's voting rights, unless the parents make the transfer for full and adequate consideration. The rules of §2036(b) only apply to controlled corporations. Taxpayers can fall into §2036(b)'s tax trap by retaining voting

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<sup>66</sup>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.

<sup>67</sup>1981-1 CB 476.



rights through written shareholders' agreements, voting trusts, grantor trusts, or other arrangements.<sup>68</sup>

**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<sup>69</sup> the IRS held that if a transferor owns both voting and non-voting stock, the transferor can give away non-voting stock and retain the voting stock without §2036(b) applying.<sup>70</sup>

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).

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<sup>68</sup>In a Private Letter Ruling, the IRS applied §2036(b) to include corporate stock attributable to a limited partnership interest in the parents' estate where the parents transferred the corporate stock into a family limited partnership in which the parents were general partners and the children were given limited partnership interests. See PLR 199938005.

<sup>69</sup>1981-1 CB 457.

<sup>70</sup>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 by a parent's gift of some or all of the non-voting stock to the children.

- 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 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 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).

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 an 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.<sup>71</sup> 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 (assuming no valuation discounts) to the non-working child over seven years, payable monthly (i.e. 84 payments), at 5% interest per annum, or required monthly payments of \$56,638 (which equals \$643,658 per year).<sup>72</sup> It must be verified that the corporation will have enough cash flow to afford this annual \$643,658 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

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<sup>71</sup>A C corporation's alternative minimum taxable income is increased by 75% of the difference between its adjusted current earnings and its adjusted minimum taxable income.

<sup>72</sup>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.

control and compensation could be restricted under a shareholder's agreement to protect the nonworking child.

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.<sup>73</sup>

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 is that the shareholder's agreement require the estate of the deceased family shareholder to sell its shares to the corporation for a price established by an independent appraisal. An independent appraisal would, arguably, meet the arm's-length test of §2703. On the other hand, this alternative does not freeze the estate tax value of the stock on the date of the shareholders' agreements' signing. In another alternative, the shareholder's agreement has a formula price which establishes the value of the deceased family member's stock. Section 2703 requires that

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<sup>73</sup>See Reg. §25.2703-1(b)(3).

this formula price, be an arm's-length negotiated formula.

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

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

In 1936, all of the stock in the Ford Motor Company was privately owned by Henry Ford I and his only child, Edsel. The Ford family wanted to avoid estate taxes (which in 1936 subjected most of the Ford estate to the top estate tax bracket of a 70% tax rate) and at the same time retain control of Ford Motor Company within the Ford family.<sup>74</sup> 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 all of the voting power. The Class A non-voting stock which 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.<sup>75</sup> When the corporation's stock went public in the 1950s, because of New York Stock Exchange and

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<sup>74</sup>Unexpectedly, the son Edsel Ford died first in 1943, four years before his father Henry Ford I's death in 1947.

<sup>75</sup>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.

SEC requirements, the Class A shares owned by the public had to be modified to carry a certain amount of voting rights.<sup>76</sup> 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 a substantial part of 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.<sup>77</sup> Today the Ford family only owns 1.86% of the company's stock in the form of Class B shares, but still exercises 40% of the company's voting rights. Thus, the Ford family, through the use of a family voting trust and two classes of stock, has retained control of Ford Motor Company for over 100 years.

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

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<sup>76</sup>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.

<sup>77</sup>See SEC Form 14A dated April 1, 2011 and Form 10-K dated February 21, 2012, filed with the Securities and Exchange Commission. Each B share has enough votes per share to give the B shares in the aggregate 40% of the voting rights. For various reasons, not all of the B shares are in the Ford family voting trust.

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.<sup>78</sup>

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 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 owned and run by the Hearst Family Trust, which today consists of a 13-member board of trustees, many of whom are family members and others are non-family management who work for the Hearst Corporation.<sup>79</sup>

## 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

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<sup>78</sup>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.

<sup>79</sup>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.



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 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 father's 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.

## 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 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.

**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 "productive" and issue dividends.<sup>80</sup> Paying corporate

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<sup>80</sup>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.

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.
- 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 no-contest clause included in the Will and trust documents.
- The working parent should sit down and talk to his/her second spouse and children. The working parent can use the explanatory letter (see form at **Appendix A**). However, must be careful that this type of letter is consistent with parent's Will and trust documents, and does not have unexpected legal effects.
- 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 the family business. Giving up control has the estate tax advantage of producing a minority valuation discount upon the deaths of the parents.
- Have the parents keep control of the business. On the death of the first parent, split the parents' stock (or other family business interests) between a QTIP Trust, Survivor's Trust and Unified Credit Trust to produce valuation discounts for estate tax purposes. The surviving parent can be the sole income and principal beneficiary of all three trusts. See discussion of the ***Mellinger*** case at Section 2.
- The parents could keep control over the main core business and have portions of the business owned by 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.

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 Section 4).
- 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.
- 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 A**).
- Use a no contest cause in the parents' Wills and trust.

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

Some solutions to this problem are:

- Do a split-up of the 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.<sup>81</sup>
- 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.

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<sup>81</sup>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 (2006), at Chapter 11.

- Utilize family letter at **Appendix A** instructing the working siblings of the parent's wishes.
- Utilize a no contest clause in the parents' Wills and trust.
- Include a provision in 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 **What if There Are No Children to Run the Family Business?** With today's educational and job opportunities, none of the client's children may elect to work in the family 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. The disadvantage of selling during lifetime is do not receive a step up in income tax basis.
- 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 Section 4). The business could also hire outside officers and employees to run the business.
- Use an Employee Stock Ownership Plan ("ESOP") and have some of the business stock owned by employees.

5.8 **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).

**Example:** 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.

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:

- 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.

## **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.

## **7. SPECIAL INTERNAL REVENUE CODE PROVISIONS FOR THE PAYMENT OF FEDERAL ESTATE TAXES.**

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 Redeeming Stock From the Family Business Under Section 303.** Section 303 allows the payment of federal and state death taxes and expenses by permitting the income tax free withdrawals of monies from the 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<sup>82</sup>, the stock's tax basis will equal the redemption amount for the stock, thus producing no gain to be taxed to the deceased shareholder's estate.

**7.1.1 What Are the Ownership Percentage Requirements of §303?** The benefits of §303 are limited to a distribution by a corporation whose stock of all classes included in the decedent's gross estate exceeds 35% of the excess of: (i) the value of the decedent's gross estate over (ii) the sum of the amounts allowable (not actually allowed) as

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<sup>82</sup>See §1014.

a deduction under §§2053 or 2054 (which are funeral and administrative expenses, claims and tax losses).<sup>83</sup>

**Example:** Decedent's gross estate has a value of \$1,000,000, funeral and administration expenses of \$275,000, and a charitable gift at death of \$25,000. Therefore, the decedent's taxable estate is \$700,000 (\$1,000,000 less \$275,000 less \$25,000). 35% multiplied times \$725,000 (the gross estate) equals \$253,750. Thus, the corporation's stock of all classes must exceed \$253,750 in value for the estate to receive §303 tax treatment.

If the decedent owns stock in two or more corporations, of which 20% or 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.<sup>84</sup>

#### 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

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<sup>83</sup>§303(b)(2)(A).

<sup>84</sup>§303(b)(2)(B).

\$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.<sup>85</sup>

7.1.3 **The Shareholder Whose Stock is Being Redeemed Must Actually Bear the Economic Burden of the Taxes and Administration Expenses in Order for Such Shareholder's Stock Redemption to Qualify Under §303.** Section 303 requires that the shareholder whose stock is being redeemed have their stock interest directly reduced (or have a binding obligation to contribute to the estate) by the payment of the estate taxes or allowable §2053 funeral and administration expenses.<sup>86</sup> 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.<sup>87</sup>

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 pay only the interest due on the estate taxes for the first four years. Then, beginning in year five, the estate must pay all accumulated interest and 10% of the deferred estate tax each year (thus, extending the time to pay the estate taxes to 14 years).

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<sup>85</sup>Reg. §1.303-2(g)(2).

<sup>86</sup>§303(b)(3).

<sup>87</sup>§303(b)(1).

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 "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%<sup>88</sup>, and for a reduced interest rate (equal to 45% of normal interest rates) 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.<sup>89</sup> "Adjusted gross estate" means the decedent's gross estate value less the sum of amounts allowable as a §2053 or 2054 deduction.<sup>90</sup> 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.<sup>91</sup>

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

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<sup>88</sup>§6601(j).

<sup>89</sup>§§6166(a)(1) and 6166(b)(6).

<sup>90</sup>§6166(b)(6).

<sup>91</sup>See §2035(d)(4).

tax (reduced by the credit against such tax) as the decedent's estate's closely-held business amount bears to the amount of the decedent's adjusted gross estate.<sup>92</sup>

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."<sup>93</sup> 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.<sup>94</sup> 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.<sup>95</sup> For decedents dying in 2011, the tax attributable to the first \$1,360,000 in value of the closely-held business in excess of the unified credit exemption is subject to an interest rate of 2%.<sup>96</sup> A favorable interest rate also applies to the remaining amount of the estate tax qualifying for §6166 treatment that exceeds the \$1,360,000 amount. Interest on the deferred tax that exceeds the 2%

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<sup>92</sup>§6166(a)(2).

<sup>93</sup>See Reg. §20.6166-1(e)(2).

<sup>94</sup>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.

<sup>95</sup>This lower 2% interest rate applies to estates of decedents dying after 1997.

<sup>96</sup>The \$1,000,000 portion which accrues at 2% interest on unpaid estate taxes is adjusted for inflation.

portion is payable at a low interest rate equal to 45% of the annual underpayment rate established under §6621.<sup>97</sup>

Because of the §6166 reduced interest rates, interest on federal estate taxes deferred under §6166 may not be deducted, either for estate tax purposes under §2053 or for income tax purposes under §163.<sup>98</sup>

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

Section 6166 is only intended to apply to active "businesses". There is a body of IRS rulings and case law interpreting what a "business" is for purposes of §6166. Section 6166 does not apply to "passive assets" held by an entity, such as rental real estate where the landlord has no duties or services.<sup>99</sup>

The IRS held in Rev. Rul. 2006-34 that there was a "business" for §6166 purposes where the decedent was actively participating in the management and operation of commercial rental properties owned by the decedent. In a private letter ruling, there was a business where the decedent's employees

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<sup>97</sup>This means, for example, that if the underpayment rate is 3%, the effective interest rate is 1.35% (45% of 3%).

<sup>98</sup>See §§163(k) and 2503(c)(1)(D).

<sup>99</sup>Where a decedent owned stock in a corporation, and individually (through a grantor trust) owned the real estate in which the business was conducted outside of the corporation, the IRS allowed the decedent's interest in the corporation and the real estate to be aggregated into one single closely-held business for purposes of the applying the 35% test of §6166. See PLR 200006034. The IRS held that the real estate was not a "passive investment" because it was an active business asset used in the business's operations and was essential to the decedent's business.

provided significant repair, maintenance, and janitorial services to the commercial tenants.<sup>100</sup>

On the other hand, in a private letter ruling, the IRS held that a corporation was not carrying on a trade or business, and the decedent did not receive §6166 treatment, where the decedent's corporation owned a 70-unit motel which was leased to a third-party operator. Here the tenant (and not the decedent) made all repairs, did all maintenance, and paid all insurance.<sup>101</sup>

**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.<sup>102</sup>

**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.

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 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

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<sup>100</sup>PLR 9832009.

<sup>101</sup>PLR 8352086.

<sup>102</sup>See §6166(d) and Reg. §20.6166-1(a).



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.<sup>103</sup>

**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.<sup>104</sup>

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

### **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 in mind the ownership percentage limitations of §§303 and 6166. Although in certain cases it may be more tax effective to make the gifts and sales of business interests to younger generations, if ownership is reduced below these "threshold" percentages then the benefits of §§303 and 6166 could be lost.

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<sup>103</sup>§6166(g)(1)(A).

<sup>104</sup>§6166(g)(1)(B).

## **8. 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.<sup>105</sup>

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 for a number of reasons. First, there are the highly technical pre-death and post-death requirements of the statute. Second, real property generally constitutes a small percentage of a closely-held business's assets, as compared to a farm or ranch. Third, once the §2032A election is made, the income tax basis of the real property is reduced to its special use valuation amount. Finally, once the election is made, there is concern about the recapture at a later date of the estate taxes in the event that the family members cease to materially participate in the qualified use of the property.

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

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

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<sup>105</sup>§2032A(e)(8).

**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.

8.2 **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.<sup>106</sup> Thus, the §2032A limitation is increased to \$1,020,000 for estates of decedents dying in 2011.<sup>107</sup>

8.3 **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 immediately preceding the decedent's death, was owned by the decedent or a member of the decedent's family and used for a

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<sup>106</sup>§2032A(a)(3).

<sup>107</sup>Rev. Proc. 2010-40.

qualified use generally involving material participation by the decedent or a member of the decedent's family.<sup>108</sup>

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.<sup>109</sup>

8.4 **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.<sup>110</sup> The recapture is imposed by an "additional tax." The "additional tax" is imposed if within 10 years<sup>111</sup> 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.

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<sup>108</sup>§2032A(b)(1).

<sup>109</sup>§2032A(b)(1).

<sup>110</sup>§2032A(c)(1).

<sup>111</sup>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).

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

[SAMPLE LETTER FROM FATHER TO HIS THREE CHILDREN  
AND SECOND SPOUSE, TO BE OPENED AFTER FATHER'S DEATH]

\_\_\_\_\_, 2012

Jack Smith  
Jane Smith  
Steve Smith  
Mary Smith

Dear Jack, Jane, Steve and Mary:

I am writing this letter to the four of you in order to express my desires upon my death. This letter shall have no legal effect, and I specifically intend that this letter not be a legally-binding document, nor shall it affect the interpretation of my Will or the Smith Revocable Trust. Rather, this letter is intended as an expression of my hopes and desires for each of you and the ways to handle the affairs of Smith Manufacturing Co. after my death.

Smith Manufacturing Co. has been an important part of my life. The company has been a manufacturer of plumbing fixtures here in California for over 70 years. The company was given to me by my father 40 years ago. I have expanded the business considerably during my lifetime. I intend for Jane and Jack to continue to work in the business. I realize that Steve, who is a doctor, will not be working for Smith Manufacturing, but instead will have his career in medicine. Thus, Jane and Jack will have the responsibility to continue to operate Smith Manufacturing Co.

I have appointed Perfect Bank and Trust Co. as my trustee and executor. I have requested that Perfect Bank, and the four of you consult with my long-time accountant, Bill Notachs, and my long-time attorney, Yule Solvit. I request that you seek their advice as to any issues regarding Smith Manufacturing Co. or my affairs.

I am leaving under my trust all of my stock in Smith Manufacturing Co. to Jane and Jack in equal shares. Steve is receiving no stock at my death. I have included a provision in my trust to leave to Steve certain other assets. Even though the amount of these other assets which Steve receives may not equal the amount of the stock which Jane and Jack are receiving,

this is my desire. In other words, Steve should not feel slighted by the fact that I may have left him less than Jane and Jack. My love for all three of you is equal.

I have left in a QTIP Trust for Mary's benefit \$10,000,000 of publicly-held stocks and bonds, along with my house, plus I am leaving Mary \$500,000 of liquid assets outside of the trust. Mary and I previously executed an antenuptial agreement under which all of my assets, including Smith Manufacturing and my wages therefrom, were to remain my separate property.

One important point is that I have previously gifted to Jane, Jack and Steve shares of stock in Smith Manufacturing Co. Even though Steve will not be receiving any further stock on my death, he still owns 20% of the Smith Manufacturing Co. stock as a result of my prior gifts. As you recall, Jack, Jane and Steve have executed a shareholders' agreement which provides, among other things, that Steve's shares will be redeemed by Smith Manufacturing Co. at my death. Unfortunately, I could not obtain life insurance to fund this redemption since I was uninsurable due to the cancer. I intend that this shareholders' agreement be carried out even though it initially will use up some of the corporation's available excess cash for the down payment to Steve for his stock's redemption, and will require cash outlays each year to make payments on Steve's promissory note.

I recognize that there have been disagreements over the years among Jack and Jane regarding the operation of Smith Manufacturing Co. After my death, Jane and Jack will have equal control of Smith Manufacturing Co. Jane is currently serving as president of the corporation, while Jack has been in charge of sales. My father left me Smith Manufacturing Co. and I have built it up over the years. I would hope that Jane and Jack can amicably work together and to carry on the Smith family tradition of building the best plumbing fixtures in the country.

My goal is that there always be an amicable relationship among the four of you, and especially among Jane and Jack in running Smith Manufacturing Co. Nothing would hurt me more than to know that there was any tension or friction between any of you.

With love,

Dad