

2008

## Transitioning the Family Business

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## TRANSITIONING THE FAMILY BUSINESS

Dwight Drake\*

*Abstract:* By any measure, family-dominated businesses are the backbone of the American economy. Although a large majority of family businesses are managed by senior family members who are older than age 55 and more than 80 percent of such senior family members claim that they want the business to remain in the family, less than 30 percent of such businesses have tackled the challenge of developing a plan for transitioning the business to the next generation. For over 90 percent of such families, this planning challenge is aggravated by the fact that they have no diversified wealth: the family's wealth is the business.

This article examines the technical challenges of designing such a transition plan that meets the specific objectives of the family, including the family's tolerance for complexity. Through the use of a simple case study, this article reviews essential elements that should be carefully evaluated in the design of any transition plan and explains numerous technical traps that must be avoided in the plan design. These elements and the related traps include timing considerations, valuation discounts, marital deduction planning, life insurance structuring, entity limitation and conversion options, compensation opportunities, and co-shareholder planning. The comparative benefits and inherent limitations of alternative transition strategies and business restructuring options are also illustrated, including the complexities and unique challenges of incorporating advanced estate planning strategies into the plan design. The article explains and illustrates why certain popular estate tax savings strategies, including the grantor retained annuity trust, the intentionally defective grantor trust installment sale, the self-canceling installment note, and the family partnership, often become problematic, inadvisable, or merely supplemental when the bulk of the family's wealth is tied up in a valuable family business. The tax benefits, challenges, and risks of each of these strategies and others are explained, along with the practical problems that surface with a family business. The article also explores alternative strategies for anticipating and resolving conflicting interests between children who work in the business and children who have no career ties to the business.

The purpose of the article is help professionals better understand the importance, magnitude, and difficulty of the intergenerational transition challenges of family-dominated businesses. As the article demonstrates, these are not challenges that can be met with stock solutions or quick fixes. Each situation requires a custom, strategic plan that, when implemented wisely over an appropriate period of time, addresses the core objectives of the family and avoids destructive traps and useless complexities. The ultimate goal is to design a plan that effectively incorporates a mix of strategies that accomplish the highest priority objectives at a level of complexity that works for the family.

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## I. INTRODUCTION—MOUNTAIN OR MARBLES

Mom and Dad have labored a lifetime building a profitable business that services a market niche and regularly delivers a paycheck to two hundred hard-working employees. On paper, most would consider them rich, but they fully appreciate that the bulk of their wealth is tied up in a business operation that could be derailed by changing market conditions, a breakthrough technology, a new tenacious competitor, sloppy management, or a host of other factors. They have witnessed the demise of other businesses that were all considered “rock solid” at some point in their existence. The time has come for Mom and Dad to slow down, turn over the reins, and enjoy their retirement. One child is immersed in the business, fully prepared and anxious to run the show, and two other children are off pursuing other careers. The family wants a plan that will ensure the parents’ financial security, treat all children fairly, protect the business, promote family harmony, and minimize all tax bites. It’s a tall order.

Family business transition planning is big business. Oft-quoted statistics say it all. Family-dominated businesses comprise more than 80

percent of U.S. enterprises, employ more than 50 percent of the nation's workforce, and account for the bulk (some estimate as much as 64 percent) of America's gross domestic product.<sup>1</sup> According to a recent 2007 survey of family businesses with annual gross sales of at least \$5 million, 60 percent of the majority shareholders in family businesses are 55 or older, and 30 percent are at least age 65.<sup>2</sup> And although more than 80 percent of the senior family owners claim that they want the business to stay in the family, less than 30 percent acknowledge having a transition plan.<sup>3</sup> The result is that most family businesses do remain in the family, but at a dear cost. Best estimates are that less than 30 percent of family-dominated businesses survive a second generation, and the survival rate is even uglier for those businesses that make it to generation three.<sup>4</sup>

Strategic transition planning takes time, energy, and a willingness to grapple with tough family, tax, and financial issues. It cannot make a weak business strong or provide any guarantees of survival. But it can trigger an analytical process that prompts a frank assessment of available options, facilitates better long-term decision making, and saves taxes.

Although many successful family business owners enjoy a net worth that rivals or exceeds that of other well-heeled clients, the planning dynamics usually are much different when a family business takes center stage. For many clients, wealth transition planning focuses on a potpourri of investment and business assets, packaged into a medley of partnerships, trusts, limited liability companies (LLCs), and corporate entities. The challenge is to analyze, reposition where necessary, and ultimately transition the various marbles in the most tax efficient manner possible, consistent with the family objectives of the owners. With a family business, it's usually not about rearranging marbles; it's about trying to move a mountain. In the recent survey referenced above, a

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1. See generally M. F. R. Kets de Vries, "The Dynamics of Family Controlled Firms: The Good News and the Bad News," ORGANIZATIONAL DYNAMICS, Winter 1993, at 59-71; P.L. ROSENBLATT ET AL., THE FAMILY IN BUSINESS (1985); W.G. DYER, CULTURAL CHANGE IN FAMILY FIRMS (1986) 59-71; Arthur Anderson/Mass Mutual, American Family Business Survey, 2002.

2. LAIRD NORTON TYEE, FAMILY TO FAMILY: LAIRD NORTON TYEE FAMILY BUSINESS SURVEY 5 (2007), [http://familybusinesssurvey.com/pdfs/LNT\\_FamilyBusinessSurvey\\_2007.pdf](http://familybusinesssurvey.com/pdfs/LNT_FamilyBusinessSurvey_2007.pdf).

3. *Id.* The survey also indicated that (1) only 56 percent of the respondents have a written strategic plan; (2) nearly 64 percent do not require that family members entering the business have any qualifications or business experience; and (3) 25 percent do not believe that the next generation is competent to move into leadership roles. *Id.* at 5.

4. See J.I. WARD, KEEPING THE FAMILY BUSINESS HEALTHY XXIV, 12, 247-50 (1987). This book suggests the survival rate to generation three is less than 15 percent. *Id.*

startling 93 percent of the senior business owners acknowledged that the business is their primary source of income and security.<sup>5</sup> With little or no diversification, everything gets tougher. Strategies that easily accommodate marble shifting often become more challenging, sometimes impossible, when applied to a sliver of the mountain. And, more often than not, the process is further complicated by strong emotional ties to the mountain and historical perceptions regarding essential bonds between the family and the mountain.

The initial challenge in the planning process is the threshold “Keep vs. Sell” question: Should the business be sold or kept in the family? Often, the parents automatically assume that the business is going to be transitioned to the next generation; no thought of selling has seriously crossed their minds. Some even regard the issue as a taboo subject that is not to be discussed. The advisor needs to be discerning in such a situation and assess the risks of saying nothing. A little artful devil’s advocacy may open minds and jumpstart the analytical process. Priorities, objectives, biases, family dynamics, and business risk factors continually evolve and change over time. So too, the answer to the keep-sell decision may change with time. The patriarch who would never consider selling out at age 55 may have a very different perspective by age 70, particularly if he or she has been subjected to many enlightened discussions over the years that have focused on a number of key factors that impact the analysis and the ultimate decision.<sup>6</sup>

This paper discusses the challenge of developing a transition plan once the decision has been made to keep the business in the family. The focus here is not “whether,” but “how.” A simple case study is used to explain essential plan elements and related planning traps and to illustrate and contrast strategic options for moving the mountain. The facts of the case study, summarized in Part II, are common to many successful family businesses: parents preparing to slow down; a successful business that represents the bulk of the parents’ estate; children inside and outside the business; looming estate tax problems;

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5. See TYEE, *supra* note 2.

6. Many factors can and often should impact the analysis, including the family’s emotional ties to the business, evolving external business risks, children who have committed their careers to the business, qualified heir challenges, the availability of viable sellout options, and key business indicators (i.e., strategic- vs. relationship-based, institutionalization potential, margin tolerances, asset composition, low-tech vs. high-tech, barriers to entry, and capital structure). For a discussion of the “Keep vs. Sell” decision, see DWIGHT DRAKE, *BUSINESS PLANNING: CLOSELY HELD ENTERPRISES* ch. 16 (2006).

and a compelling need to prepare for the future. Part III of the paper discusses seven key elements and related traps that should be carefully considered up front in the design of any transition plan. These are essential building blocks of the plan. They include: timing transition decisions to meet the objectives of the specific family; the smart use of valuation experts and precious valuation discounts; entity limitations and conversion options; coordinated life insurance planning and related structural traps that can compromise the entire liquidity plan; challenges of multiple family owners; marital deduction planning to defer the ultimate estate tax hit; and compensation planning opportunities. The discussion includes a review of specific traps that need to be anticipated and avoided in the plan design.

Part IV discusses, illustrates, and compares strategies for transitioning stock in a family corporation—gifting options, redemption alternatives, cross-purchase structures, and business restructuring strategies. This discussion includes an analysis of the unique challenges that family businesses often encounter in dealing with popular marble shifting strategies, such as grantor retained annuity trusts and intentionally defective grantor trusts. Part V analyzes the challenges of integrating a family partnership or family LLC into the plan design. The wise use of a family partnership or LLC may facilitate income shifting, enhanced valuation discounts, wealth scattering, asset protection, and more. In recent years, the Internal Revenue Service (IRS) has stepped up its efforts to challenge family partnership strategies that push the outer limits. As a result, existing tax limits and uncertainties must be anticipated and carefully factored into the plan design. Finally, Part VI reviews strategies for dealing with the conflicting interests between children who work in the business and children who have no career ties to the business. If not properly addressed, these conflicts can lead to bad business decisions, costly tax consequences, and intolerable family friction. In some situations, the conflicts can be eliminated by implementing a strategy that prevents the outside children from ever acquiring an interest in the business or fairly terminates any such interest that is acquired. Often, the sheer size of the business precludes this possibility: joint ownership of the business is unavoidable. The challenge then shifts to developing a strategy that will provide the inside children with the control and incentives they require while ensuring that the liquidity needs and financial interests of the outside children are satisfied.

The plan design process for each family necessarily must be detail-

oriented, strategic, and forward-focused. Care must be exercised to avoid planning traps and the temptation to tack on complicated strategies that offer little or nothing for the particular family. Each situation is unique and should be treated as such. There is no slam-dunk solution; all strategies have limitations and disadvantages that mandate careful evaluation, and some pose risks or legal uncertainties that many just cannot stomach. Above all, the specific objectives of the family must drive the planning process. The objectives, once identified, must be prioritized to facilitate an effective analysis of the trade-offs and compromises that inevitably surface in the planning process. The ultimate goal is to design a plan that effectively accomplishes the highest priority objectives over a period of time and at a level of complexity that work for the family.

## II. CASE STUDY: WILSON INCORPORATED

The Wilson family owns a business that is going to be transitioned to the next generation. The sellout option is off the table. Wilson Incorporated is a privately owned C corporation that has been in a specialized distribution business for 26 years. It has an established reputation with its customers and suppliers. Earl Wilson, age 65, is the founder and President of the company and historically has been the principal force behind the company. Earl and his wife Betty, age 60, own as community property 90 percent of the outstanding common stock of the company. Betty serves on the board but spends no serious time in the business. Jeff Wilson, Earl and Betty's oldest child, owns the remaining 10 percent of the outstanding stock. Jeff is married and has been actively involved in the business for years. Technically, Jeff is considered the second-in-command behind Earl, but all close to the company recognize that Jeff now is the driving force in the company. In addition to his strong financial background, Jeff has a proven knack for sales and marketing, is skilled in dealing with people, and is adored by key employees and valued customers. Jeff is anxious to take over the reins and wants to aggressively grow and expand the business. If Jeff's involvement in the business was terminated for any reason, the loss to the business would be substantial.

The company's growth was dynamic in the earlier years, but recently the growth has been modest. Earl has been slowing down and has been reluctant to aggressively reinvest or borrow funds to expand the operation into new markets. This has been a frustration for Jeff, who

wants to conquer new frontiers. The business has consistently generated sufficient profits and cash flow to pay generous salaries and to allow Earl and Betty to draw approximately \$400,000 from the business each year in compensation payments.

Earl and Betty have two other children—Kathy and Paul. Both are grown and married, and neither has ever worked in the business. Paul is a dentist; Kathy used to work in commercial real estate before becoming a stay-at-home mom. Earl and Betty have four grandchildren and hopes for one or two more. All family members get along with each other. Earl is recognized as the family patriarch, although all acknowledge that the continued success and future of the business rest in the hands of Jeff.

Earl estimates that the business is worth approximately \$10 million. That's the price that he believes the business could be sold for today. Earl and Betty's total estate, inclusive of their share of the business, is valued at approximately \$18 million. Their assets, all community property, include the building that houses the business. Earl and Betty own the building outside of the corporation and lease the building to the company. The building has a value of \$3 million.

Earl and Betty have various personal hobbies and interests that they have neglected in the past to accommodate the demands of the business. They are anxious to move forward; they are looking forward to retirement. They would like to develop a plan that will accomplish the following objectives.

- Earl will phase out of the business over the next year and will continue to receive payments from the business that will enable Earl and Betty to ride off into the sunset and enjoy their retirement for the rest of their lives.

- Jeff will take over the control and management of the business. Earl wants some ongoing involvement as a hedge against the boredom of retirement and to ensure that the financial integrity of the business is protected for the sake of his retirement and Betty's welfare. Earl will be freed of all day-to-day responsibilities.

- Jeff will have the freedom to diversify and expand the business. Jeff would like the plan structured so that the value of all appreciation in the future will be reflected in his estate and will not continue to build Earl and Betty's estates or the estates of other family members, specifically Kathy and Paul, neither of whom play any role in the business.

- Earl and Betty want to make sure that, at their passing, each child receives an equal share of their estates. They are particularly concerned

about Kathy and Paul, the two children who do not participate in the business. They appreciate that the business represents the bulk of their estate. They want Jeff to control and run the business, but they want to make certain that Kathy and Paul are treated fairly.

- Earl and Betty want to minimize estate taxes, consistent with their other objectives and their overriding desire to be financially secure and independent. They never want to be placed in a position of having to depend on their children, and they always want to know that their estate is sufficient to finance their lifestyle for the duration. They are willing to pay some estate taxes for this peace of mind. As a hedge against future estate taxes, they would like to start transitioning assets to other family members. They generally understand that, as of right now, their unified credits<sup>7</sup> will shelter \$4 million of their estate (\$2 million each) from any federal estate tax exposure and that the excess will be taxed at a rate of 45 percent. Given the value of their estate, the math is frightening. Their anxiety is only heightened by the reality that Congress will take some action to revise the estate tax by 2010.

- All family members want to minimize negative income tax consequences to the fullest extent possible.<sup>8</sup>

### III. ESSENTIAL PLAN ELEMENTS: STARTING POINTS AND TRAPS

The design of a business transition plan requires that certain key elements be carefully considered up front to ensure that the financial interests of the parents are protected, estate taxes are minimized and deferred, family liquidity needs are satisfied, adverse income tax hits are eliminated, and sloppy planning does not derail the effort. There are

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7. The estate tax unified credit under I.R.C. § 2010 is presently \$780,800, an amount sufficient to shelter \$2 million of property (the applicable exclusion amount) from the federal estate tax. I.R.C. § 2010 (2006). The applicable exclusion amount increases to \$3.5 million in 2009 and, absent further action by Congress, goes away in 2010, along with the one-year demise of the estate tax. After 2010, the applicable exclusion amount returns to its pre-2001 level of \$1 million along with a full restoration of the estate tax. Most expect that the one-year disappearing act will never occur because Congress will be forced to take action before 2010. Depending on their state of residency, the Wilsons may also have a state inheritance tax burden.

8. The Wilson family's situation mirrors that of most successful family-owned businesses in America. According to the 2007 Laird Norton Tyee Family Business Survey, 60 percent of the responding family companies had a CEO over age 55, 71 percent had no succession plan, 97 percent had one or more additional family shareholders, 91 percent had at least one additional member employed by the company, and 74 percent had fewer than five shareholders. *See TYEE, supra* note 3, at 5-15.

various planning traps that need to be avoided.

A. *Timing to Fit the Family*

Timing is a critical element in the design of any transition plan. The temperament and anxieties of the parents can impact all timing decisions. Some are anxious to move at full steam; many need to take it slow, to walk before they run. A variety of factors can influence important timing decisions, including the stability of the business, the parents' capacity to accept and adapt to change, the demands and expectations of the children, the strength of the parents' financial base outside of the business, the age and health of the parents, and personal relationships between specific family members. Often the pace of implementing specific plan elements will accelerate as circumstances change and as the parents become more comfortable with the transition process and their new roles.

The planning process usually is helped by focusing on three timeframes: the period both parents are living, the period following the death of the first parent, and the period following the death of the surviving parent. So long as both Earl and Betty are living, top priorities must include their financial needs and security, their willingness to let go and walk away from the business, and their appetite for living with any fallout resulting from the transition of serious wealth and control to their children. From a tax perspective, all transfers during this timeframe are going to trigger either a transfer of the parents' existing stock basis (often very low)<sup>9</sup> or a recognition of taxable income predicated on such basis.

The death of the first parent often creates more flexibility, particularly in a community property state such as Washington. A double tax benefit is realized on the death of the first parent—the income tax basis in all community property is stepped-up to its fair market value,<sup>10</sup> and the marital deduction may be used to eliminate any estate taxes.<sup>11</sup> Any gifts to other family members during this timeframe now will transfer high-basis assets. Any sales will likely be income tax free. If the deceased

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9. For all gifts of property, the donee's tax basis in the transferred property equals the donor's carryover basis plus the amount of any gift taxes paid with respect to the gift, but in no event may the basis exceed the fair market value of the property at the time of the gift. I.R.C. § 1015(a), (d).

10. *Id.* § 1014(a), (b)(6). For non-community property, the basis step-up is applicable only to property acquired from the decedent. *Id.* § 1014(a).

11. *Id.* § 2056.

parent had the strongest ties to the business (as is so often the case), officially surrendering total control may no longer be an issue. In our case, for example, Betty presumably would have no interest in being involved in the business following Earl's death. Plus, if the life insurance planning correctly eyeballed the parent most likely to die first (Earl in our case), the receipt of tax-free life insurance proceeds<sup>12</sup> may substantially reduce or completely eliminate the surviving parent's financial dependence on the business. For these reasons, often a transition plan is designed as a "targeted first death plan" to shift into high gear the wealth transition process on the death of the first parent.

Of course, the death of the surviving parent triggers the moment of truth for the two big consequences that have been the focus of the planning from the outset: (1) the ultimate transition of the business and the parents' other assets, and (2) the estate tax bill. As regards the first, the goal is to ensure that the parents' objectives for the family are satisfied without compromising the strength and survival prospects of the business. The objective for the second is to keep the bill as small as possible while ensuring a mechanism for payment that won't unduly strain the business.

If substantial death taxes are expected on the death of the surviving parent, it may be very important to structure the timing of various asset transitions to ensure that at least 35 percent of the surviving parent's adjusted taxable estate consists of the company's stock. Two valuable benefits may be triggered if this threshold is met. First, a corporate redemption of the stock held by the estate may qualify for exchange treatment under section 303 to the extent the redemption proceeds do not exceed the estate's liability for death taxes (both federal and state) and funeral and administrative expenses.<sup>13</sup> The result is that the redemption proceeds are income tax free to the estate because of the basis step-up in the stock at death. Absent this section 303 benefit, and to the extent any redemption proceeds exceed the 303 limits, the redemption proceeds likely will constitute taxable dividends to the estate under section 302

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12. *Id.* § 101(a)(1).

13. *Id.* § 303(a), (b)(2)(A). The 35-percent threshold may be satisfied by aggregating stock owned by the decedent's estate in two or more corporations if at least 20 percent of the outstanding stock value of each corporation is included in the decedent's gross estate. Solely for purposes of satisfying the requisite 20 percent ownership for an included corporation, the interest of the decedent's surviving spouse in stock held as community property, joint tenants, tenants by the entirety, and tenants in common may be considered property included in the decedent's gross estate. *Id.* § 303(b)(2)(B).

because all stock owned by beneficiaries of the estate and their family members will be attributed to the estate.<sup>14</sup> When corporate funds are needed to fund the estate's tax burden, as is so often the case, this section 303 benefit becomes very important. Second, if the 35 percent threshold is met, the estate may elect under section 6166 to fund the federal estate tax burden over a period of up to 14 years at very favorable interest rates.<sup>15</sup> In those situations where these two tax relief values are important, the timing of the parent's stock transition program prior to death and the value of the parent's non-stock assets must be carefully monitored to ensure that the 35 percent threshold will be met at death.

### *B. Valuation: Expert Disappearing Acts*

An interest in a business must be valued for tax purposes before it can be transferred. The standard is "fair market value"—the price a willing buyer would pay a willing seller with neither being under any compulsion to deal and both having reasonable knowledge of the relevant facts.<sup>16</sup> Although the standard has been around forever and the Service nearly a half century ago provided guidance on how it should be applied in valuing closely held business interests,<sup>17</sup> serious valuation tax

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14. The family and estate ownership attribution rules of section 318 usually make it impossible for the transaction to qualify as a redemption that is not essentially equivalent to a dividend under 302(b)(1), that is a substantially disproportionate redemption under 302(b)(2), or that is a complete redemption of the estate's stock under section 302(b)(3). *Id.* §§ 302(a), 302(b), 318(a)(1), (a)(3)(A). As a result, any redemption proceeds not protected by section 303 are taxed as dividends under section 301. *Id.* §§ 302(d), 301.

15. The interest rate is two percent on the "2 percent portion," a number adjusted annually, and 45 percent of the normal section underpayment rate for any amounts over the "2 percent portion." *Id.* § 6601(j). For 2008, the "2 percent portion" is \$1,280,000. Rev. Proc., 2007-66, 2007-45 I.R.B. 970. The favorable rate comes with a cost; the interest under section 6601 is not deductible for estate or income tax purposes. I.R.C. §§ 163(k), 2053(c)(1)(D). In *Estate of Roski v. Commissioner*, 128 T.C. 113 (2007), the Tax Court held that the Internal Revenue Service ("I.R.S.") had abused its discretion by requiring that all estates who elect the installment option of section 6166 provide a bond or security in the form of an extended tax lien. *Roski*, 128 T.C. at 115. In Notice 2007-90, 2007-46 I.R.B. 1003, the Service announced that it had changed its policy and the requirement for security would be determined on a case-by-case basis.

16. Treas. Regs. §§ 20.2031-1(b), 25.2512-1 (2006).

17. In 1959, the Service issued Revenue Ruling 59-60, 1959-1 C.B. 237, which set forth guidelines to be used in valuing the stock of a closely held corporation. The ruling did not use a mathematical formula. It discussed factors that should be considered in arriving at a fair market value. It recognized that the size of the block of stock was a relevant valuation factor in a closely held corporation, specifically noting that a minority interest would be more difficult to sell. Years later in Revenue Ruling 68-609, 1968-2 C.B. 327, the Service stated that the valuation principles of

disputes regarding family business interests routinely erupt.

These disputes teach three important lessons. First, secure the services of a professional appraiser. Valuing a closely held business interest requires judgment calls that must be made by a professional. Second, get the best appraiser available. If a dispute breaks out, the quality, reputation, and competence of the appraiser may be the ultimate deciding factor. The Tax Court has consistently refused to accept an appraisal on its face; it has followed a practice of carefully examining the underlying details and assumptions and the quality of the appraiser's analysis.<sup>18</sup> A quality appraisal by a competent appraiser may shift the ultimate burden of proof to the government<sup>19</sup> or result in a complete victory. In a celebrated case decided in 1980,<sup>20</sup> the Tax Court refused to "split the difference" in a valuation dispute, opting instead to declare a winner based on a comparative assessment of the credibility of the experts on each side. With full knowledge of this winner-take-all approach, which has been followed in other key cases,<sup>21</sup> an IRS agent must carefully size up the company's appraiser in assessing the value of starting any fight.<sup>22</sup> Finally, never get too aggressive on value; it can put

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59-60 also would apply to partnership interests.

18. *See, e.g.*, Estate of Kaufman v. Comm'r, 77 T.C.M. (CCH) 1779, 1784 (1999) (declining to accept petitioner's valuation of stock and conducting own two-step inquiry into value); Rabenhorst v. Comm'r, 71 T.C.M. (CCH) 2271, 2276 (1996) (holding that a party's valuation cannot be accepted on its face without a consideration of its potential shortcomings).

19. I.R.C. § 7491 (providing that in any court proceeding, the burden of proof with respect to any factual issue relevant to ascertaining the liability of the taxpayer shall shift to the Secretary [the IRS] if the taxpayer introduces credible evidence with respect to the issue). In 2007, the Second Circuit refused to hold for the taxpayer even though credible evidence had been submitted to shift the burden of proof under section 7491 and the IRS had failed to submit a competent appraisal. Thompson v. Comm'r, 499 F.3d 129, 133 (2d Cir. 2007), vacating T.C. Memo 2004-174. The Court stated, "[Section 7491] does not require the Tax Court to adopt the taxpayer's valuation, however erroneous, whenever the Court rejects the Commissioner's proposed value; the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation." *Id.* at 133.

20. Buffalo Tool & Die Mfg. Co. v. Comm'r, 74 T.C. 441, 452 (1980), acq. 1982-2 C.B. 1. ("[E]ach of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach.").

21. *See, e.g.*, Spruill Estate v. Comm'r, 88 T.C. 1197 (1987), Estate of Gallo v. Comm'r, 50 T.C. 470 (1985), Estate of Daily v. Comm'r, 82 T.C. Memo 710 (2001), Estate of Strangi v. Comm'r, 115 T.C. 478 (2000), Smith v. Comm'r, 78 T.C. 745 (1999), Estate of Furman v. Comm'r, 75 T.C.M. (CCH) 2206 (1998); Kohler v. Comm'r, T.C. Memo 2006-152.

22. Of course, in some cases the court weighs the competing appraisals and makes its own determination. *See, e.g.*, Estate of Lauder v. Comm'r, 68 T.C.M. (CCH) 985, 1001 (1994) (court's

in play a costly 20 percent penalty (computed on the tax understatement) if the value used by the client is 65 percent or less than the ultimate determined value.<sup>23</sup> The penalty jumps to 40 percent if the client's number falls to 40 percent or less.<sup>24</sup>

In every situation involving a closely held business, valuation discounts become the name of the game and play an essential role in the plan design. In a very real sense, they are the ultimate disappearing act because big transfer taxes are saved as the values plummet. Usually, there is a dual focus in planning the valuation discounts. First, all stock transfers by the parents during life should be structured to qualify for the largest possible discounts. Discounts reduce the value of the stock transferred, which in turn reduces gift taxes or permits a greater leveraging of the gift tax annual exclusion<sup>25</sup> and unified credit.<sup>26</sup> In our case, for example, Earl and Betty will be able transition to Jeff, over time and gift tax free, a larger percentage of the company's stock if the value of the shares transferred is heavily discounted. Second, the stock transition program should be designed to ensure that any stock remaining in a parent's estate at death qualifies for the maximum discounts to minimize any estate tax burden attributable to the stock.

The two most significant discounts associated with an interest in a

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value nearly average of values asserted by respective parties); *Estate of Fleming v. Comm'r*, 74 T.C.M. (CCH) 1049, 1051-55 (1997) (court valued company at \$875,000, with Service arguing for value of \$1.1 million and taxpayer asserting value of \$604,000); and *Estate of Wright v. Comm'r*, 73 T.C.M. (CCH) 1863 (1997) (court valued stock at \$45 a share, with Service's appraisal at \$50 a share and taxpayer's appraisal at \$38 a share). In select instances, the Tax Court has rejected the appraisals submitted by both the Service and the taxpayer on the grounds that the appraisals were defective or unreliable. *See Rabenhorst*, 71 T.C.M. (CCH) at 2276; *Estate of Kaufman*, 77 T.C.M. (CCH) at 1784. When both appraisals are rejected, the Service prevails because the burden of proof ultimately is on the taxpayer. All the cases confirm the importance of having a quality appraisal from a reputable firm.

23. I.R.C. § 6662(a), (g).

24. *Id.* § 6662(h). Section 6664(c)(1) provides that a taxpayer may avoid the penalties by proving reasonable cause and good faith. Reliance on a professional appraisal alone will not do the job. Treas. Reg. § 1.6664-4(b)(1) (2006). The taxpayer must show that the appraiser was a competent professional who had sufficient expertise to justify reliance, that the taxpayer provided the appraiser with all necessary and accurate information, and that the taxpayer relied in good faith on the appraisal. *Declene v. Comm'r*, 115 T.C. 457 (2000). *See also* *Thompson v. Comm'r*, 499 F.3d 129, 135-36 (2007), *vacating* T.C. Memo 2004-174 (holding that the penalty is mandatory absent proof from the taxpayer of good faith reliance).

25. The annual gift tax annual exclusion is presently \$12,000. I.R.C. § 2503(b)(1). *See infra* Section IV.A.

26. The gift tax unified credit is presently \$345,800, an amount sufficient to shelter \$1 million of value (the applicable exclusion amount) from gift taxes. I.R.C. § 2505(a). *See infra* Section IV.A.

closely held business enterprise are the minority interest (lack of control) discount and the lack of marketability discount. The minority interest discount recognizes that a willing buyer will not pay as much for a minority interest: there is no control. The lack of marketability discount reflects the reality that a willing buyer will pay less for an interest in a closely held business if there is no ready market of future buyers for the interest. Usually both discounts are applied in valuing the transferred interest.<sup>27</sup> The size of the discounts is determined by appraisal. The average lack of marketability discount applied by the Tax Court over the last forty years is 24 percent.<sup>28</sup> Often the two discounts total 35 to 40 percent.<sup>29</sup> These discounts can have a powerful impact in leveraging the use of annual gift tax exclusions and unified credits to transfer business interests to family members. In this regard (and this is real good news), there is no family attribution in applying the discounts.<sup>30</sup> The fact that all the business interests stay in the family will not eliminate or reduce the discounts. Even the separate community property interests of spouses are not aggregated for valuation purposes.<sup>31</sup> In one case where a 100 percent business owner transferred his entire ownership to 11 different family members, the Service recognized that each gift would qualify for minority interest and lack of marketability discounts.<sup>32</sup> Absent such discounts, each family member would have received a business interest valued at more than nine percent of the total value (100/11 = something more than 9). Simply by breaking the ownership interest into minority

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27. See generally *Dailey v. Comm'r*, 82 T.C.M. 710 (2001); *Janda v. Comm'r*, 81 T.C.M. 1100 (2001); *Barnes v. Comm'r*, 76 T.C.M. 881 (1998).

28. See *Janda*, 81 T.C.M. at 1104 (“Mr. Schneider [IRS’s expert appraiser] then listed various studies made on marketability discounts which are cited by Shannon Pratt in his book *Valuing a Business: The Analysis and Appraisal of Closely-Held Companies* (2d ed. 1989). The studies, which deal with marketability discounts in the context of restricted, unregistered securities subsequently available in public equity markets, demonstrate mean discounts ranging from 23 percent to 45 percent. Mr. Schneider also cited several U.S. Tax Court cases that established marketability discounts ranging from 26 percent to 35 percent. Finally, Mr. Schneider stated in his report that he had consulted a study prepared by Melanie Earles and Edward Miliam which asserted that marketability discounts allowed by the Court over the past 36 years averaged 24 percent.”).

29. See, e.g., *Dailey*, 82 T.C.M. at 711 (holding that the applicable discount rate was 40 percent); *Janda*, 81 T.C.M. at 1105 (applying a discount rate of 40 percent both for lack of control and marketability to prediscout fair market value); *Barnes*, 76 T.C.M. at 889 (applying discount rates of 40 percent and 45 percent).

30. Rev. Rul. 93-12, 1993-1 CB 202; *Mooneyham v. Comm'r*, 61 T.C.M. 2445, 2447 (1991); *Ward v. Comm'r*, 87 T.C. 78, 107-08 (1986).

31. See *Estate of Bright v. United States*, 658 F.2d 999, 1005 (5th Cir. 1981).

32. I.R.S. Tech. Adv. Mem. 94-49-001 (March 11, 1984).

pieces, the discounts reduced the value of each gift to less than six percent of the total.<sup>33</sup> For tax valuation purposes, the math can be exciting:  $100/11 =$  something less than 6.

In the planning process, care must be taken to avoid the step transaction doctrine in structuring transactions to qualify for minority and lack of marketability discounts. If, for example, Earl and Betty transfer a minority stock interest in the corporation to Jeff and then have the corporation redeem the balance of their stock, the step transaction doctrine will kick in to deny any valuation discounts on the transfer to Jeff.<sup>34</sup> A linking of the two transactions kills the discounts because Jeff ends up owning a controlling interest in the company.

Care is required whenever voting control is transferred to a family member. The flipside to the discount game is that a control premium, often as much as 35 percent, must be considered when voting control is transferred.<sup>35</sup> This results in a higher valuation and more taxes. The math can be just as weird, but in the wrong direction. In one case, the court sustained control premiums of 35 percent and 37.5 percent on two blocks of stock that aggregated 83 percent of the total stock.<sup>36</sup> The net result apparently was a value arguably higher than the total value of all outstanding stock. When voting control is ultimately transferred and a premium value kicks in for tax purposes, the planning challenge is to have the control premium attach to the smallest equity interest possible.

### C. *The Entity Form: Nothing Easy*

The form of entity usually has a significant impact in the plan design. Far and away, corporate entities are the preferred choice for family operating businesses. A 2002 survey of family businesses with average

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33. Courts have consistently held that, where a donor makes gifts of multiple shares of the same security to different donees at the same time, each gift is to be valued separately. *See* Estate of Bosca v. Comm'r, 76 T.C.M. (CCH) 62 (1998); *Mooneyham v. Comm'r*, 61 T.C.M. (CCH) 2445 (1991); *Ward v. Comm'r*, 87 T.C. 78 (1986); *Carr v. Comm'r*, 49 T.C.M. (CCH) 507 (1985); *see also* Rev. Rul. 93-12, 1993-1 CB 202, *revoking* Rev. Rul. 81-253, 1981 C.B. 187.

34. *See* I.R.S. Tech. Adv. Mem. 200212006 (March 22, 2002) ("It is well established that where the steps of a donative transaction have no independent significance, the courts will collapse the individual steps in determining the substance of the transaction."); *see also* *Heyen v. United States*, 945 F.2d 359, 363 (10th Cir. 1991); *Griffin v. United States*, 42 F. Supp.2d 700 (W.D. Tex. 1998); *Estate of Bies v. Comm'r*, T.C. Memo. 2000-338; *Senda v. Comm'r*, 433 F.3d 1044 (8th Cir. 2006).

35. *See* Rev. Rul. 59-60, 1959-1 C.B. 237, § 4.02(e); *Treas. Reg. 20.2031-2(f)* (2006); *Rev. Rul. 89-3*, 1989-1 C.B. 278; *Estate of Salisbury v. Commissioner*, 34 T.C.M. 1441 (1975).

36. *Lewis G. Hutchens Non-Marital Trust v. Comm'r*, 66 T.C.M. (CCH) 1993-600, 1599, 1612-14, 1620 (1993).

annual sales of \$36 million confirmed that over 89 percent were corporations, split relatively equally between C and S status.<sup>37</sup> All entity forms present planning challenges; none is easy. For C corporations, it is the double tax structure that drives up the cost of redemption and dividend strategies, the locked-in stock basis that discourages lifetime gifting and puts a premium on the basis step-up at death, and the alternative minimum tax threat that complicates corporate funding of life insurance.<sup>38</sup> For S corporations, it is the eligibility requirements that preclude partnerships, corporations and most trusts<sup>39</sup> from owning stock and prevents the use of any preferred stock. For partnership-taxed entities, including limited liability companies, it is enhanced self employment tax burdens,<sup>40</sup> the family partnership income tax rules, the

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37. Arthur Anderson/Mass Mutual, American Family Business Survey, 2002.

38. For a discussion of the relative tax advantages and disadvantages of each entity form, see DRAKE, *supra* note 8, at 33–51. Although the “choice of entity” analysis is heavily tax-driven, there are many important non-tax factors that can impact the ultimate decision. Some factors, deemed vitally important in the past, no longer impact the final outcome, and there are new issues that now must be factored into the mix. In most situations, the analytical process requires the family to predict and handicap the future and to consider and project earnings, losses, capital expansion needs, debt levels, the possibility of adding new owners, potential exit strategies, the likelihood of a sale, the estate planning needs of the owners, and a variety of other factors. The complexity of the challenge often is enhanced by the need to use multiple entities to accomplish specific family objectives, to protect assets from liability exposure, to limit or control value growth, to scatter wealth among family members, to segregate asset-based yields from operational-based risks and yields, to shift or defer income, to enhance tax benefits from recognized losses, to facilitate exit strategy planning, to satisfy liquidity needs, or to promote a structured discipline that helps ensure that all financial bases are covered. It complicates the process, but the benefits usually far outweigh any burdens of the added complexity.

39. In defining S status eligibility, trusts have received serious Congressional attention over the years. There has been a constant expansion of the trust eligibility rules. Trusts that are now eligible to qualify as S corporation shareholders include: (1) voting trusts; (2) grantor trusts; (3) testamentary trusts that receive S corporation stock via a will (but only for a two-year period of following the transfer); (4) testamentary trusts that receive S corporation stock via a former grantor trust (but only for a two-year period following the transfer); (5) a “qualified subchapter S trust” (QSST), which generally is a trust with only one current income beneficiary who is a U.S. resident or citizen to whom is distributed all income annually and who that elects to be treated as the owner of the S corporation stock for tax purposes; and (6) an “electing small business trust” (ESBT), which is a trust whose beneficiaries are qualifying S corporation shareholders who acquired their interests in the trust by gift or inheritance, not purchase. I.R.C. § 1361(c)(2), (d) (2006). An ESBT must elect to be treated as an S corporation shareholder, in which case each current beneficiary of the trust is counted as one shareholder for purposes of the maximum 100 shareholder limitation and the S corporation income is taxed to the trust at the highest individual marginal rates under the provision of section 641. *Id.* § 1361(c)(2), (e)(1)(A).

40. Section 1402(a) of the Code specifically provides that a partner’s distributive share of income from a partnership constitutes earnings from self-employment. There is a limited statutory exception for retired partners and a broader exception for limited partners. *Id.* § 1402(a)(10), (a)(13). Limited

“real partner” requirement for family transfers, potential gift tax annual exclusion problems if the operating agreement is too restrictive, and the threat of a wealth “recycling” claim that may trigger enhanced estate tax exposure under section 2036.<sup>41</sup>

Often a desire for a different entity form quickly surfaces in the planning process. The most common scenario is the family that is fed up with the double tax burdens of its C corporation and longs for the flexibility of a pass-through entity. For example, as discussed later, in Section IV.D, Wilson Incorporated may want to shed its C status in order to have more restructuring flexibility. Conversion from C status to partnership tax status via a partnership or a LLC is usually out of the question; it will trigger a prohibitively expensive double tax on the liquidation of the C corporation.<sup>42</sup> Conversion to S status is the only

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partners generally can escape self-employment taxes on partnership income that is not a guaranteed payment as remuneration for services rendered. *Id.* § 1402(a)(13). Thus, the key in a partnership structure is to fit within this limited partnership exception.

As for a limited liability company taxed as a partnership that has no limited partners and no basis for relying on historical state law distinctions between limited and general partners, the Service’s first attempt to provide some guidance on the issue came in 1994 when it published its first Proposed Regulations. They provided that a member of a limited liability company could fit within the limited partner exception if the member lacked authority to make management decisions necessary to conduct the business and the LLC could have been formed as a limited partnership in the same jurisdiction. After public comment, new Proposed Regulations were issued in 1997 that defined the scope of the limited partnership exception for all entities taxed as a partnership, without regard to state law characterizations. Prop. Treas. Reg. § 1.1402(a)-2, 62 Fed. Reg. 1702 (Jan. 13, 1997). Under the 1997 Proposed Regulations, an individual would be treated as a limited partner for purposes of the self-employment tax unless the individual was personally liable for the debts of the entity by being a partner, had authority to contract on behalf of the entity under applicable law, or worked in the business for more than 500 hours during the taxable year. *Id.* at 1704. The 1997 Proposed Regulations also drew criticism because LLC members who had authority to contract on behalf of the entity could never fit within the limited partner exception. The result was a statutory moratorium in 1997 on the issuance of any temporary or proposed regulations dealing with the limited partnership exception. Taxpayer Relief Act of 1997 § 935, Pub. L. No. 105-34, 111 Stat. 883 (need year). The legislative history confirms that Congress, not the IRS, ultimately must resolve the issue. The IRS has provided no additional guidance.

For planning purposes, this history provides some guidance. Any general partner under state law is exposed to the tax. Any limited partner under applicable state law is probably safe. As for LLC members, any member who can fit within the 1997 Proposed Regulations’ definition is justified in relying on the statutory limited partner exception. Beyond that definition, it becomes more difficult and uncertain in evaluating the facts and circumstances of each situation. The risk escalates in direct proportion to the individual’s authority to act on behalf of the entity and the scope of any services rendered.

41. I.R.C. § 2036. For a discussion of each of these issues in the context of transition planning, see *infra* Section V.B.

42. *Id.* §§ 331, 336. If, for example, the corporation is subject to a 34 percent marginal tax rate and the shareholder pays a 15 percent capital gains rate, the combined tax burden on any distributed

viable option, but it is not free of hassles.

A conversion from C status to S status creates potential tax traps that need to be carefully evaluated and monitored. If the company values its inventory under the last-in-first-out (LIFO) method, conversion to S status will trigger a recapture of the LIFO recapture amount, to be funded over a four-year period.<sup>43</sup> Accumulated earnings and profits from the company's prior C period will trigger a taxable dividend to the shareholders if shareholder distributions from the S corporation exceed earnings during the S period.<sup>44</sup> A corporate level built-in gains tax will be triggered if assets owned by the corporation at time of conversion are sold within the ten-year period following the conversion.<sup>45</sup> This will require a careful monitoring of any asset sales during the ten-year window. Finally, if the net passive income received by the S corporation exceeds 25 percent of its receipts during a period that it has undistributed earnings and profits from its C existence, a corporate level tax will be triggered and the S status could be put in jeopardy if the condition persists.<sup>46</sup>

In many family situations, conversion from C to S status will help the transition planning process by opening up more restructuring options.

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appreciation in the liquidation will be 43.9 percent  $[34 + (15 \times (1-34))]$ .

43. *Id.* § 1363(d). The LIFO recapture amount is the excess of what the inventory value would be under the first-in-first-out (FIFO) method over the LIFO valuation method used by the corporation. *Id.* § 1363(d)(3). The size of the recapture amount is a function of the historical increases in inventory costs and how fast the inventory turns.

44. *Id.* § 1368(c)(2). The taxable dividend exposure is limited by the amount of the corporation's earnings and profits from its C corporation existence and ends once the earnings and profits have been distributed. An S corporation, with the consent of all shareholders, may elect to accelerate such dividends by treating all distributions as earnings and profits distributions. *Id.* § 1368(e)(3). Such an acceleration may facilitate the use of the favorable 15 percent tax rate on dividends before its scheduled expiration in 2010.

45. *See generally id.* § 1374. The tax is imposed at the highest corporate tax rate (presently 35 percent) on the lesser of (1) the gain recognized on the sale or (2) the asset's built-in gain at the time of the S conversion. This corporate level tax is in addition to the tax that the shareholder bears as a result of the S corporation's gain being passed through and taxed to the shareholder. The only relief to this forced double tax is that the tax paid by the corporation is treated as a loss to the shareholders in the same year.

46. *See generally id.* §§ 1375, 1362(d)(3). For purposes of these provisions, the term "passive investment income" includes interest, dividends, royalties, and rents. *Id.* § 1362(d)(3)(C). If the 25 percent threshold is met, the highest corporate tax rate (presently 35 percent) applies to the excess of the net passive income over 25 percent of the total receipts. The actual calculation of the tax is complicated by factoring in any expenses directly connected to the passive income. Plus, an S corporation can lose its S status—a disaster—if it allows the condition to exist for three consecutive years. If the S election is lost, relief may be possible by timely showing that the circumstances resulting in the termination were inadvertent. *Id.* § 1362(f).

The potential tax traps described above, all of which are triggered by the conversion, prompt some to take the conversion option off the table. This is usually ill-advised. These traps should be viewed as serious nuisances that are capable of being monitored and often can be mitigated or eliminated entirely. Seldom will they justify rejecting a conversion that will provide needed planning flexibility in the given situation.

*D. Life Insurance: Structural Blunders*

The stock transition plan must be coordinated with the parents' life insurance planning. In many family businesses, life insurance provides essential liquidity to pay the death taxes, to cover the cash needs of the family, and to free the business of cash burdens that otherwise might adversely impact operations or threaten its survival.<sup>47</sup> A central challenge in the planning process is to ensure that the life insurance proceeds are not taxed in the parents' estates. Usually, but not always, the best strategy to accomplish this essential tax objective is to park the ownership of the policy in an irrevocable trust that has no legal connection to the corporation. However, in many situations, the cash-flow pressures of funding the premiums and the interests of other shareholders result in the policy having close ties to the business. In every such situation, the policy ownership and beneficiary decisions need to be carefully evaluated up front to eliminate tax problems and unintended consequences. This usually requires some basic "what if" analysis to avoid blunders that can undermine the entire effort. The following are key traps to avoid.

*1. Constructive Premium Dividend Trap*

To illustrate how this trap surfaces, assume in our case study that Earl and Betty, owners of 90 percent of the corporation's stock, enter into a cross-purchase buy-sell agreement<sup>48</sup> with Jeff, the owner of the remaining 10 percent. To ensure funding of the cross-purchase on the death of a shareholder, the parties agree that corporate resources will be

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47. In a 2002 survey of successful family business owners (average annual sales of \$36.5 million), nearly one-half (47.7%) of the responding owners listed life insurance as their primary source of funds to pay death taxes and listed life insurance trusts as the most frequently used estate planning technique. Arthur Anderson/Mass Mutual, American Family Business Survey, 2002.

48. A cross-purchase buy-sell agreement is an agreement among the shareholders of a corporation in which the shareholders contractually agree to purchase the stock of a co-shareholder under defined conditions and on specific terms that are set forth in the agreement.

used to fund life insurance policies on Earl and Jeff. Jeff, the minority shareholder, owns a \$9 million policy on Earl's life to cover the 90 percent of the stock owned by Earl and Betty, and Earl and Betty own a \$1 million policy on Jeff's life to cover the stock owned by Jeff. Absent careful planning, it is likely that the payments made by the corporation to fund the premiums on these policies owned by the shareholders will be treated as distributions with respect to stock for tax purposes. In a C corporation, these payments will trigger constructive taxable dividends—an added tax burden.<sup>49</sup> In an S corporation, it is possible that the arrangement (which produces larger distributions for the benefit of the minority shareholder Jeff) could be considered a second class of stock that would kill the S election—a bombshell.<sup>50</sup> Cash pressures often require that corporate resources be used to fund premiums on policies that are going to be owned by other parties, including life insurance trusts. Whenever this common condition exists, great care must be exercised to structure compensation and other arrangements that account for such premium payments in the most tax efficient manner possible. It adds complexity, but the complexity is essential in this situation.

## 2. *The Lopsided Cross-Purchase Disaster*

Assume the same cross-purchase scenario as described above, except the parties have eliminated the constructive dividend threat by implementing a compensation structure to account for the premium payments. Earl then dies, and Jeff uses the tax-free \$9 million death benefit that he receives to acquire Earl and Betty's stock. Soon after Jeff's acquisition of the stock, he sells the company for its \$10 million value. The income tax hit to Jeff on the sale is peanuts because of the high stock basis resulting from his purchase of the stock. Jeff walks from the sale with roughly \$9.9 million after tax.<sup>51</sup> In contrast, Earl and Betty's heirs, including Jeff, collectively net less than \$5 million from Earl and Betty's 90 percent stock interest after the estate tax hit on the

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49. See, e.g., *Johnson v. Comm'r*, 74 T.C. 1316, 1322–24 (1980); *Ashby v. Comm'r*, 50 T.C. 409, 417 (1968); *Hood v. Comm'r*, 115 T.C. 172, 179–81 (2000); Rev. Rul. 69-608, 1969-2 C.B. 42.

50. See Treas. Reg. § 1.1361-1(l)(2)(i)(vi) ex. 6 (CCH 2007). If there is a binding agreement to use corporate funds to pay the premiums, the risk of a second class of stock finding is very high and the S status may be in jeopardy. See *id.* § 1.1361-1(l)(2)(vi) ex. 6. See also *Minton v. Comm'r*, 2007 T.C.M. (RIA) 2011, 2016 (2007) (“[T]he corporation ceases to qualify as an S corporation . . . upon the creation of a second class of stock.”).

51. Jeff's only income tax cost on the sale would be the capital gains hit on the gain recognized on the 10 percent stock interest that he has historically owned.

\$9 million purchase price is absorbed.<sup>52</sup> Jeff, having shed the business, nets a monstrous benefit from the company compared to his siblings, a result Earl and Betty may have never intended. The simple lesson is to carefully factor in family dynamics before ever adopting a buy-sell or insurance structure commonly used by unrelated parties. In this situation, fundamental family objectives likely would have been immeasurably improved by having a life insurance trust own the policy on Earl's life under a structure that ensured freedom from income, estate, and generation-skipping tax consequences.

### 3. *The Majority Shareholder Trap*

Assume in the prior example that, to facilitate corporate funding of the premiums on the policy that insures Earl's life, the corporation actually owns the policy. Thus, the corporation just pays premiums on an asset that it owns. The corporation, as the policy owner, then names Jeff as the beneficiary. If Earl owns more than 50 percent of the corporation's outstanding voting stock on his death, the entire death benefit paid under the policy will be taxed in his estate because he will be deemed to have retained incidents of ownership in the policy by virtue of his majority stock position in the company.<sup>53</sup> Earl's gross taxable estate will have mushroomed even though the death benefit is paid to Jeff. This trap kicks in when the death benefit of a corporate-owned policy insuring the life of a majority stockholder is paid to a party other than the corporation.<sup>54</sup> The trap can be avoided by naming the policy's corporate owner as the policy's sole beneficiary or by making sure that the insured does not own a majority of the corporation's outstanding voting stock. As regards the stock ownership threshold, the good news in a community property state is that, for purposes of this trap, an insured will not be deemed to own his or her spouse's community property interest in any stock.<sup>55</sup>

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52. The calculation assumes that the present 45 percent marginal federal estate rate is in effect. [\$9 million x (1-.45) = \$4.95 million].

53. Treas. Reg. § 20.2042-1(c)(6).

54. *Id.*

55. See I.R.S. Priv. Ltr. Rul. 97-46-004 (Aug. 8, 1997) (ruling that the majority voting stock requirement was not met when the decedent and his spouse each owned a 36 percent community property interest in the corporation's stock).

#### 4. Corporate Ownership Traps

As previously stated, if the corporation is the named beneficiary on a corporate-owned policy that insures the life of the majority stockholder, the death benefit paid to the corporation on the death of the majority shareholder will not be included in the shareholder's estate.<sup>56</sup> But, that is not the end of the story. The corporation's ownership of the policy may trigger other burdens. First, the family usually needs to get the insurance proceeds out of the corporation to satisfy the cash objectives of the family. This often creates unpleasant dividend income tax burdens when a C corporation is involved. The same burdens exist, but not to the same degree, for an S corporation that has undistributed earnings and profits from a prior C corporation existence.<sup>57</sup> Second, the death benefit may trigger an alternative minimum tax ("AMT")<sup>58</sup> for the corporation because the amount by which the death benefit exceeds the corporation's basis in the policy will add to the corporation's adjusted current earnings for AMT purposes.<sup>59</sup> Finally, although the death benefit of an insurance

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56. Treas. Reg. § 20.2042-1(c)(2), (6).

57. The tax-free receipt of the life insurance proceeds by the S corporation does not increase the accumulated adjustment account of the S corporation. See I.R.C. §§ 101(a)(1), 1368(e)(1)(A) (West 2007); Treas. Reg. § 1.368-2. Any distributions by the S corporation in excess of its accumulated adjustment account (a likely result if life insurance proceeds are distributed) will trigger a taxable dividend to the shareholders to the extent the S corporation has any undistributed earnings and profits from its C corporation existence. See I.R.C. § 1368(c)(2).

58. The corporate alternative minimum tax is structured to ensure that a C corporation that claims various tax benefits under the "regular tax" will pay a minimum tax amount. The corporate AMT is 20 percent of the amount by which the corporation's alternative minimum taxable income exceeds the \$40,000 exemption amount, reduced by the corporation's alternative minimum foreign tax credit for the year. See I.R.C. §§ 55(a), (b)(1)(B), (b)(2), (c), (d)(2), 56.

59. See *id.* § 55(g). Not all C corporations are subject to an alternative minimum tax. There are blanket exceptions for a C corporation's first year of operation, any C corporation with average annual gross receipts of less than \$5 million during its first three years, and any C corporation with average annual gross receipts of less than \$7.5 million during any three-year period thereafter. *Id.* § 55(e). The Pension Protection Act of 2006 added section 101(j), which subjects a portion of the proceeds paid on certain employer-owned life insurance policies to income taxation. If section 101(j) is applicable to a policy, the excess of the death benefit received over the total premiums and other amounts paid for the policy will be taxable income. The section applies to an "employer-owned life insurance contract," which is generally defined to include any policy owned by and for the benefit of a business that insures the life of a person who was an employee of the business at the time the policy was issued. There are substantial exceptions that, as a practical matter, will render the provision irrelevant in most business and executive planning situations. The exceptions preserve tax-free treatment if the insured was an employee during the 12-month period before the insured's death, if the insured was a director or highly compensated employee of the business, if the proceeds were payable to the insured's estate, members of the insured's family or a trust established for their benefit, or if the proceeds were used to acquire an equity interest in the business from the insured's

policy owned by and payable to a corporation will not be included in the taxable estate of the shareholder, the value of the stock in the insured's taxable estate may be adversely impacted by the corporation's receipt of the insurance proceeds. Depending on the existence of a buy-sell agreement, its compliance with the section 2703 requirements,<sup>60</sup> and the underlying purpose of the corporation's ownership of the insurance, the valuation impact will vary, but in most cases the proceeds will not have a dollar-for-dollar impact.<sup>61</sup>

##### 5. *Transfer-for-Value Trap*

Unraveling a corporate ownership life insurance structure may trigger a transfer-for-value trap that will destroy the income tax-free receipt of the death benefit. Assume, in our case, that the corporation is both the owner and the beneficiary of the policy insuring Earl's life and that the family later determines that the AMT impacts and the tax problems created by having the death benefit paid to the corporation are intolerable. To remedy the situation, the corporation transfers ownership of the policy to Jeff as additional compensation or as part of a dividend

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estate or members of the insured's family. *Id.* §§ 101(j)(2), 414(q), 105(h)(5). The one potential trap is that an exception will apply only if the notice and consent requirements of the new provision are met before the policy is issued. These requirements mandate that, before the policy is issued, the company must provide a written notice to the insured of the company's intention to own; be the beneficiary of the policy; the insured must consent in writing to being the insured on a policy that may continue after the insured's termination of employment. *Id.* §§ 101(j)(2), 101(j)(4).

60. *Id.* § 2703. See related discussion in *infra* Section III.E.1.

61. A leading case in dealing with the valuation issue in the context of key person insurance is *Estate of Huntsman v. Commissioner*, 66 T.C. 861 (1976), acq., 1977-2 C.B. 1. In *Huntsman*, the IRS claimed that all the proceeds of the insurance policies received by the corporation on the death of the decedent would have to be added in determining the value of the stock in the decedent's estate. *Id.* at 869-70. In rejecting the IRS approach, the Tax Court held that the insurance proceeds should be given "consideration" in the valuation process. *Id.* at 874. Essentially, the court determined that, to the extent the valuation of the business was based upon the net assets of the business, the insurance proceeds should be included in the asset value calculation. *Id.* at 874-75. However, the court reasoned that, to the extent the stock valuation was based on a price/earnings multiple, the insurance proceeds may strengthen the cash position of the company, which in turn may impact the determination, but it would not be a dollar-for-dollar impact. *Id.* at 878. The most interesting aspect of the *Huntsman* case is the final result that surfaced after all the calculations were completed. In that case, the earnings multiple basis of valuation was weighted three times heavier than the net asset basis of valuation. *Id.* In addition, the court discounted the value of the decedent's stock to reflect the loss of the decedent's value to the corporation. *Id.* at 879. The bottom line was that, for the first corporation in the case, the ultimate value was increased approximately twenty-four cents for each dollar of insurance received. See *id.* For the second corporation in the case, the ultimate valuation was increased approximately thirty-three cents for each dollar of insurance received. See *id.*

distribution. This shift in ownership will trigger the transfer-for-value rule<sup>62</sup> under section 101(a)(2), effectively destroying Jeff's capacity to receive the death benefit income tax free. It's a disaster. Exceptions to this harsh result exist for transfers to the insured, gratuitous transfers from the insured, transfers to (but not from) a corporation in which the insured is a shareholder or officer, and transfers among partners.<sup>63</sup> The lesson is to carefully set the best insurance structure up front. Changes can be costly and sometimes tax prohibitive.

As stated above, often the smartest life insurance strategy is to use an irrevocable trust that has no legal ties to the corporation. The trust is both the owner and the beneficiary of the policy. The identity and rights of the trust beneficiaries need to be carefully coordinated with the entire transition plan to protect the respective interests of the inside and outside children. This structure avoids corporate ownership traps and tax burdens, ensures that a structure commonly used by unrelated business parties does not become the default option for the family, and, if done right, protects the death benefit from estate tax exposure.<sup>64</sup> The premium funding burden might still exist; careful planning may be necessary to get funds out of the corporation and into the trust to cover the premiums on the policy. Often, this will require compensation payments or S corporation distributions to the parents, followed by annual gifts to the trust that are carefully structured to be gift-tax protected by the parents' annual exclusions or unified credits.<sup>65</sup>

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62. Amounts received under a life insurance contract generally are not taxable as income under section 101(a)(1). An exception to this broad income exclusion, known as the transfer-for-value rule, is triggered whenever a life insurance contract is transferred for valuable consideration. When such a transfer occurs, the portion of the proceeds excluded from the income tax may not exceed the sum of such valuable consideration and any premiums paid by the transferee. I.R.C. § 101(a)(2).

63. *Id.* § 101(a)(2).

64. Life insurance proceeds will not be included in the insured's taxable estate if the insured owned no incidents of ownership in the policy at death and owned no such incidents during the three-year period preceding death. *Id.* §§ 2035(a)(2), 2042.

65. The challenge in many plans is to build provisions into the trust that will enable the gifts that are made to fund the premium burden to qualify for the annual gift tax exclusion. In almost all situations, this is done by including special *Crummey* withdrawal rights in the trust that convert a trust beneficiary's future interest in the gifts to a present interest, which in turn qualify the gifts for the annual gift tax exclusion. This *Crummey* withdrawal right, named after the case that made it famous, *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), is a special provision in the trust that gives each beneficiary, for a limited period of time, the right to withdraw a portion of any gift made to the trust. The existence of this right, even if it is not exercised and is allowed to "lapse," will convert a future trust interest to a present trust interest so that the contribution will qualify for the annual gift tax exclusion under section 2503(b)(1). See *Crummey*, 397 F.2d at 86, 88.

*E. Multiple Family Owners: More is Tougher*

The planning takes on a new dimension as multiple family members and trusts begin acquiring stock in the company. The rights and interests of the various shareholders need to be clarified by agreement to keep expectations in line, protect the business, and mitigate the risk of ugly confrontations. Plus, care must be exercised to avoid certain tax traps that can surface as the parents implement their stock transition plan.

A buy-sell agreement between all the shareholders becomes essential once the transition process begins. The agreement should anticipate how and when the balance of the parents' stock in the company will be transitioned. Often special provisions tailored to the unique needs of the parents and not applicable to the stock held by the children will be required. The agreement also must address the stock held by the children to ensure that all stock stays in the family and that a child has a fair exit sellout option if the child dies or needs to cash-in because of bankruptcy, divorce, disability, sibling discord, or some other compelling circumstance. This family buy-sell agreement should be carefully crafted to meet the specific needs of those family members who own, or in the future may own, stock in the company.

*1. Buy-Sell Valuation Trap*

The buy-sell valuation trap surfaces when the stock owned by a deceased family member is sold pursuant to the terms of a buy-sell agreement, but the price paid under the agreement is less than the value of the sold stock for estate tax purposes. The decedent's estate ends up paying estate taxes on a value that was never realized.

The key to avoiding this trap is to structure the buy-sell agreement so that it fixes the value of the company's stock for federal estate tax purposes. The Service perceives buy-sell agreements as potential tools to abuse the valuation process, particularly in family situations.<sup>66</sup> For this reason, section 2703 was added to the Code in 1990 to specify certain criteria that must be satisfied in order for a buy-sell agreement price to control for estate tax valuation purposes. Section 2703(b) imposes a three-part test:

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

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66. See, e.g., *St. Louis Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982); *Estate of Lauder v. Comm'r*, 64 T.C.M. (CCH) 1643 (1992); *Carpenter v. Comm'r*, 64 T.C.M. (CCH) 1274 (1992); *Seltzer v. Comm'r*, 50 T.C.M. (CCH) 1250 (1985).

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

(3) The terms of the agreement must be comparable to similar arrangements entered into by persons in an arm's-length transaction.<sup>67</sup>

Each of the three requirements must be satisfied, along with the requirements imposed by regulations that existed before the adoption of section 2703.<sup>68</sup> In most cases, the third requirement of section 2703 will prove to be the most difficult. The comparable arm's-length determination is made at the time the agreement is entered into, not when the rights under the agreement are exercised.<sup>69</sup> This third requirement will be satisfied if the agreement is comparable to the general practice of unrelated parties under negotiated agreements in the same industry.<sup>70</sup> An effort must be made to determine what others in the same industry are doing. If multiple valuation methods are used in the industry, the requirement can be satisfied by showing that the valuation mechanism in the agreement is comparable to one of the commonly used methods.<sup>71</sup> If there are no industry standards because of the unique nature of the business, standards for similar types of businesses may be used to establish the arm's-length terms of the agreement.<sup>72</sup>

Because section 2703 is targeted at abuses among family members, the regulations to section 2703 provide an exception in those situations where over fifty percent of the equity ownership interests in the business

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67. I.R.C. § 2703(b).

68. Three criteria established under applicable law before the adoption of section 2703 must be satisfied: (1) the price must be specified or readily ascertainable pursuant to terms of the agreement and the value must have been reasonable when entered into; (2) the decedent's estate must be obligated to sell at death at the specified price; and (3) the decedent must have been restricted from selling or transferring the interest during life. *See* Treas. Reg. § 20.2031-2(h) (2007). This third condition is not satisfied if the decedent had a right to transfer the interest by gift during life to a person who was not subject to the same restrictions. *Id.* As a minimum, this provision generally requires that the interest be subject to a right of first refusal at the fixed or determinable price under the agreement during the decedent's life. *Id.*

69. *Id.* § 25.2703-1(b)(4)(i); *see also* Estate of Amlic v. Comm'r, 2006 T.C.M. (RIA) 539, 539 (2006) (holding that evidence of price in other arm's-length transactions may be used to sustain the burden of proof).

70. Treas. Reg. § 25.2703-1(b)(4)(i). It is not necessary that the provisions parallel the terms of any particular agreement. *Id.* § 25.2703-1(b)(4)(ii).

71. *Id.* § 25.2703-1(b)(4)(ii).

72. *Id.*

are owned by non-family members.<sup>73</sup> In order for the exception to apply, the equity interests owned by the unrelated parties must be subject to the same restrictions and limitations as those applicable to the transferor.<sup>74</sup> If this fifty-percent test and the three pre-section 2703 basic structural requirements are met,<sup>75</sup> the requirements of section 2703 are deemed satisfied and the value determined pursuant to the agreement will govern for estate tax purposes.

## 2. Preferred Stock Traps

In many situations, the parent's desire to use preferred stock to facilitate the stock transition process to other family members. Extreme caution is required whenever preferred equity interests are considered in the plan design. The issuance of preferred stock will kill an S election, and the existence of preferred stock may make a future S election impossible if the holder of the stock is unwilling to surrender his or her preferred rights.<sup>76</sup> Of far greater concern is section 2701, the provision that assigns a zero value to a retained preferred interest that does not contain a "qualified payment" right when there is a transfer of a common equity interest to a family member.<sup>77</sup> Assume, for example, that a C corporation has outstanding common stock valued at \$3 million and non-cumulative preferred stock valued at \$2 million, all owned by the parent. If the parent sold the common stock to an unrelated party for \$3 million, the parent would simply report capital gain income on the excess of the \$3 million sale price over the parent's tax basis in the sold stock. If, however, the parent sold the common stock to a child for \$3 million, the parent also would be deemed to have made a \$2 million taxable gift to the child. This extreme result is mandated by section 2701, which requires that the preferred stock retained by the parent be valued at zero and the common stock sold to the child be assigned a value of \$5

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73. *Id.* § 25.2703-1(b)(3). Family members include the transferor's spouse, any ancestor of the transferor or the transferor's spouse, any spouse of any such ancestor, and any lineal descendant of the parents of the transferor or the transferor's spouse (but not spouses of such descendants). *Id.* §§ 25.2701-2(b)(5), 25.2703-1(b)(3). Broad entity attribution rules are used to determine ownership, with an interest being deemed a family interest if it is attributed to both a family and non-family member. *Id.* §§ 25.2701-6(a)(2)-(4), 25.2703-1(b)(3).

74. *Id.* § 25.2703-1(b)(3).

75. For a summary of the three criteria established under applicable law before the adoption of section 2703, see *supra* note 68; see also Treas. Reg. § 20.2031-2(h).

76. I.R.C. § 1361(b)(1)(D) (2006).

77. *Id.* § 2701(a)(3)(A).

million. And the parent still owns the preferred! This taxable gift can be avoided only if the parties agree that qualified dividend payments henceforth will be made to the parent on a regular basis and actually make such payments.<sup>78</sup> In that event, the retained preferred stock would be valued based on the size of the qualified payments, and the gift would be reduced accordingly. But such qualified payments can be burdensome; they trigger double-taxed dividend income to the parent, drain cash from the corporation, and pump up the parent's taxable estate. The lesson is to keep a very close eye on section 2701 whenever preferred equity interests are part of the mix.

### 3. *Voting Stock Trap*

This trap is triggered when a parent transfers stock in a controlled corporation and, through some means, “directly or indirectly” retains the right to vote the stock. When this condition exists, section 2036(b) kicks in and the stock is brought back into the parent's estate for estate tax purposes. The transfer will have done nothing to reduce the parent's future estate tax burden. A corporation will be considered a “controlled corporation” if at any time after the transfer and within three years of death, the transferring parent owned, or is deemed to have owned under the broad family and entity attribution rules of section 318,<sup>79</sup> at least 20 percent of the total combined voting power of all stock<sup>80</sup>—a condition that is easily satisfied by nearly every family corporation. The “directly or indirectly” language extends the reach of the section 2036(b) trap to many situations, including those where the parent votes transferred stock held in trust, where the parent is a general partner of a partnership that owns the transferred stock, and where the parent, through an express or implied agreement, retains the right to reacquire voting authority or has the right to influence or designate how the stock will be voted.<sup>81</sup> The safest way to avoid this trap is to transfer nonvoting stock, an option available to both C and S family corporations.<sup>82</sup> Plus, in addition to avoiding section 2036(b) threats, use of nonvoting stock usually will

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78. *Id.* § 2701(a)(3), (c)(3).

79. *See id.* § 318.

80. *Id.* § 2036(b)(2).

81. *See, e.g.*, I.R.S. Tech. Adv. Mem. 1999 (June 7, 1999) (transferor general partner of partnership); Rev. Rul. 80-346, 1980-2 C.B. 271 (oral agreement with transferor).

82. Use of nonvoting stock does not trigger the trap. *See* Rev. Rul. 81-15, 1981-1 C.B. 458; Prop. Treas. Reg. § 20.2036-2(a), 49 Fed. Reg. 35143 (Aug. 3, 1983).

buttress the application of a lack of control valuation discount. The need for nonvoting stock often requires a simple tax-free recapitalization to convert outstanding voting common stock to both voting and nonvoting stock.

The transition planning process should anticipate and avoid problems with the family buy-sell agreement and the preferred stock and voting stock traps. As other family members begin acquiring stock, the process also should address the expectations of the new shareholders and their perceptions of their new wealth. They are no longer just family members; they are now owners. Usually there is a need for education and dialogue on a broad range of basic issues, including limitations imposed by the buy-sell agreement, the rationale for using nonvoting stock, cash flow expectations, future transition plans, and more. The goal is to keep all shareholders informed and to ensure that expectations are in line with reality.

#### *F. Marital Deduction Traps*

Smart use of the marital deduction is essential in most plans. It is the tool that eliminates any estate tax bite on the death of the first spouse, deferring all taxes until the survivor's death. Although rationales are sometimes spouted for paying some taxes at the first death, they are always based on problematic assumptions and ignore the simple reality that most clients, particularly business owners, have no stomach for paying taxes any sooner than absolutely necessary. In most situations, the game plan is to transfer to a qualified terminable interest property (QTIP) trust the smallest portion of the deceased spouse's estate necessary to eliminate all taxes in the estate.<sup>83</sup> To qualify for the marital deduction, the QTIP must mandate that, during the life of the surviving spouse, all QTIP income will be currently paid to the surviving spouse and no person other than the surviving spouse may receive property distributions from the trust.<sup>84</sup> A closely held business interest that comprises the bulk of the estate can trigger problems with a QTIP.

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83. Although both a direct bequest to the surviving spouse and a bequest to a QTIP trust may qualify for the marital deduction and eliminate any estate tax liability on the death of the first spouse, the QTIP offers advantages that often make it the preferred option. With a QTIP, the first spouse to die can specify and limit the surviving spouse's access to the principal (not income) of the trust, can designate how the trust remainder will be distributed on the death of the surviving spouse, can help protect the trust estate against creditor claims of the trust beneficiaries, and can help preserve valuable discounts.

84. See I.R.C. § 2056(b)(7).

### 1. *The Minority Discount QTIP Trap*

The Minority Discount QTIP trap surfaces when a controlling interest in the business is included in the estate of the first spouse to die, but only a minority interest in the business is used to fund the QTIP. The same specific shares in the estate are given a high value for gross estate valuation purposes and a lower discounted minority interest value for marital deduction purposes. This whipsawing nets a marital deduction that is too low, and the estate of the first spouse to die ends up with an unanticipated estate tax liability.<sup>85</sup> Plus, if the underfunded marital deduction resulted in an overfunding of a credit shelter trust—a likely result in many cases—the surviving spouse may be deemed to have made a taxable gift to the credit shelter trust.<sup>86</sup> And, there is more. If the surviving spouse has an income interest in the credit shelter trust, the property that constituted the constructive gift likely will be pulled back into the taxable estate of the surviving spouse at death under section 2036.<sup>87</sup> The key to avoiding all this mess is to make certain that if the estate owns a controlling stock interest in the business, the QTIP is funded with other estate assets or with stock that represents a controlling interest.

The trap also can surface when a controlling stock interest is designated to pass directly to the surviving spouse under the will or living trust of the first spouse to die, but the surviving spouse disclaims a portion of the bequest<sup>88</sup> and, as a result, ends up receiving a minority stock interest. In calculating the estate tax on the first death, the size of the marital deduction will be predicated on the discounted minority valuation of the stock, triggered by the surviving spouse's disclaimer.<sup>89</sup> Again, the same shares are given a higher valuation for gross estate inclusion purposes than for marital deduction purposes.

There is a flipside to this trap that may produce a positive result in the right situation. If the QTIP is funded with a controlling interest in the

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85. See *Estate of DiSanto v. Comm'r*, 78 T.C.M. (CCH) 1220, 1226–27 (1999); I.R.S. Priv. Ltr. Rul. 90-50-004 (Aug. 31, 1990); I.R.S. Priv. Ltr. Rul. 91-47-065 (July 12, 1991).

86. See I.R.S. Tech. Adv. Mem. 91-16-003 (Dec. 27, 1990).

87. See I.R.C. § 2036(a); I.R.S. Tech. Adv. Mem. 91-16-003 (Dec. 27, 1990).

88. Such a disclaimer is effective for transfer tax purposes if (1) it is in writing and delivered within 9 months of the date the property interest is created, (2) the disclaiming party has not accepted the property interest or any related benefits, and (3) the property interest passes without any direction by the disclaiming party. I.R.C. § 2518.

89. See *Estate of DiSanto v. Comm'r*, 78 T.C.M. (CCH) 1220, 1226–27 (1999).

stock and the credit shelter trust is funded with a minority stock interest, the stock passing to the QTIP may qualify for a control premium for marital deduction valuation purposes. The end result is that fewer shares may need to pass to the QTIP to secure the needed marital deduction, leaving more shares for the credit shelter trust.<sup>90</sup>

## 2. *The Buy-Sell QTIP Trap*

The buy-sell QTIP trap may be triggered when the QTIP is funded with corporate stock that is subject to a buy-sell agreement. If the agreement gives other family members the right to buy the stock pursuant to a price established under the agreement and the requirements of section 2703 are not satisfied,<sup>91</sup> the price paid for the stock under the agreement will not be controlling for estate tax purposes. As a result, the value of the stock for estate tax purposes, as ultimately determined, may be greater than the price paid under the buy-sell agreement. In that event, the buyers of the stock may be deemed to have received an economic benefit from the QTIP during the life of the surviving spouse by virtue of their right to buy the stock for less than full consideration, and the entire QTIP marital deduction may be blown.<sup>92</sup> The key to avoiding this trap is to ensure compliance with the section 2703 requirements or to make certain that any stock passing to the QTIP is not subject to a buy-sell agreement.

## 3. *The Non-QTIP Trap*

Assume in our case study that, at Earl's death, his estate owns 45 percent of the stock and Betty owns 45 percent of the stock. The 45 percent owned by the estate would constitute a minority interest for estate tax purposes.<sup>93</sup> Assume that Earl's will or living trust mandates that a portion of his stock pass directly to Betty in order to secure a marital deduction to eliminate any estate tax liability. Betty would end up directly owning a controlling interest in the stock, which would be valued as such for estate tax purposes on her death. In contrast, assume

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90. See *Estate of Chenoweth v. Comm'r*, 88 T.C. 1577, 1588-90 (1987).

91. See *supra* Section III.E.1.

92. See I.R.C. § 2056(b)(7)(B)(ii)(II); *Estate of Rinaldi v. United States.*, 97-2 U.S.T.C. 60,281 (Fed. Cl. 1997); I.R.S. Tech. Adv. Mem. 91-47-065 (Aug. 30, 1991).

93. See *Estate of Bright v. United States.*, 658 F.2d 999, 1002-03 (5th Cir. 1981); see also Rev. Rul. 93-12, 1993-1 C.B. 202; *Mooneyham v. Comm'r*, 61 T.C.M. (CCH) 2445, 2447 (1991); *Ward v. Comm'r*, 87 T.C. 78, 107-09 (1986).

that Earl had left the requisite marital deduction stock to a QTIP trust to secure the marital deduction. The stock owned by the QTIP, although not owned by Betty, would be taxed in her estate. Both Betty and the QTIP would own minority stock interests that, if aggregated, would constitute a controlling interest. Even though both interests would be taxed in Betty's estate, they would be valued for estate tax purposes as two separate minority interests, not one controlling interest.<sup>94</sup> The lesson is that use of a QTIP in designing any gift or testamentary marital deduction components of the plan may preserve valuable discounts that otherwise would be lost with direct inter-spousal transfers.

#### 4. *The Permission Sale QTIP Trap*

This trap occurs when the QTIP trust is funded with stock of the family corporation and the trustee of the QTIP is restricted from selling the stock without the consent of a third party. Suppose, for example, that Earl dies and a portion of his stock is used to fund a QTIP trust that is intended to qualify for the marital deduction, and the family buy-sell agreement prohibits any family member or trust from selling stock without the consent of Jeff, the CEO. Such a consent requirement likely would destroy the QTIP trust from qualifying for the marital deduction. A key QTIP requirement is that all income of the trust must be paid to the surviving spouse at least annually.<sup>95</sup> To protect this right of the surviving spouse, regulations provide that the QTIP trust must require the trustee to convert stock into income producing property on the request of the surviving spouse.<sup>96</sup> The Service has ruled that this requirement will not be satisfied if any stock sale is conditioned on the consent of another family member.<sup>97</sup> The key to avoiding the trap is to ensure that any stock consent requirements imposed by the family buy-sell agreement are not applicable to the trustee of any QTIP trust.

The QTIP trust is an essential element of most transition plans. It bridges the gap between the deaths of the parents, eliminates estate taxes on the death of the first parent, ensures that each parent can control the ultimate disposition of his or her property, provides management and creditor protection benefits, and preserves precious valuation discounts.

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94. *Estate of Bonner v. United States.*, 84 F.3d 196, 197-98 (5th Cir. 1996); *Estate of Mellinger v. Comm'r*, 112 T.C. 26, 32-37 (1999), *action on dec.*, 1999-006 (Aug. 30, 1999).

95. See I.R.C. § 2056(b)(7)(B)(ii)(I).

96. See Treas. Reg. § 20.2056(b)-5(f)(4) (as amended in 2003).

97. See I.R.S. Priv. Ltr. Rul. 91-47-065.(July 12, 1991).

Although it adds complexity on the death of the first spouse, in most cases the QTIP will be far superior to the alternative of leaving stock directly to the surviving spouse. The challenge is to customize each spouse's QTIP to meet the parents' objectives and to avoid the technical traps that compromise the all-important marital deduction.

#### *F. Compensation Transition Opportunities*

In most situations, one or more children are key officers in the company at the time the transmission plan is put in motion. Frequently the fear is that stock passing to these children will be deemed to be taxable compensation, not gifts that are income tax-free. In our case study, for example, this could be a concern as Jeff starts receiving more stock. In fact, usually it is preferable to actually structure the stock transfers as compensation income from the corporation. Although such transfers trigger taxable income to the child,<sup>98</sup> the corporation receives an offsetting tax deduction,<sup>99</sup> and, in nearly all cases, the corporation's income tax savings will equal or exceed the child's income tax cost.<sup>100</sup> The result is a zero net income tax burden, and a simple gross-up cash bonus can be used to transfer to the child the corporation's tax savings to cover the child's income tax hit.<sup>101</sup> So from a current income tax

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98. Under section 83(a), recognition of taxable income is deferred so long as the stock is subject to a substantial risk of forfeiture unless the recipient makes an election under section 83(b) to accelerate the recognition of income. See I.R.C. § 83(a), (b).

99. See *id.* § 83(h). Note, however, that if the service provided is capital in nature, the corporation will have to capitalize the expenditure. See Treas. Reg. § 1.83-6(a)(4) (as amended in 2003).

100. This common outcome is a result of the comparative marginal tax rates applicable to C corporations and individuals. A C corporation will be subject to a marginal rate of at least 34 percent once its annual income exceeds \$75,000. I.R.C. § 11(b)(1)(C) (2006). For an individual joint-income filer in 2008, the taxable income thresholds for the 28 percent rate, the 33 percent rate, and the maximum 35 percent rate are \$131,450, \$200,300, and \$337,700, respectively.

101. The "gross up" is accomplished by the corporation agreeing to use the cash benefit from its deduction to pay the child a cash bonus to cover his or her tax hit on the stock and the cash bonus. With marginal corporate rates in the 34 to 35 percent range after the low-end brackets (brackets for the first \$75,000 of earnings) and top individual marginal rates in the 33 percent to 35 percent range, such a gross-up cash bonus often can be made with no after-tax cash cost to the corporation. The formula for calculating the gross-up bonus is as follows:

$$[\text{Stock Value} / (1 - \text{Executive Marginal Tax Rate})] - \text{Stock Value} = \text{Gross-Up Bonus}$$

Assuming the child is in a 33 percent marginal tax bracket, the formula would produce a gross-up bonus of \$49,254 on a transfer of stock valued at \$100,000  $[[100,000 / (1 - .33)] - 100,000]$ . If the corporation is subject to a 34 percent marginal rate, the cash tax savings to the corporation would be \$50,746 (34 percent of \$149,254), which more than covers the cash bonus to child. As an alternative to such a gross-up bonus, the corporation could use its tax cash savings to loan the child the funds needed to cover his or her tax hit in the year of recognition, with the understanding that the loan

perspective, the compensation structure usually is no worse than a push with the gift option. But the compensation structure offers two big advantages that could never be realized with a gift. First, unlike a gift where the child takes the parent's carryover basis in the stock,<sup>102</sup> a compensation transfer results in the child receiving a basis in the stock equal to its fair market value at time of transfer.<sup>103</sup> Second, with the compensation structure, the parent has no gift tax concerns, and there are no gift tax opportunity costs. The transaction does not consume any of the parent's gift tax annual exclusion or unified credit benefits.

Often there are opportunities to use the compensation process to dramatically accelerate the equity transition process. Suppose, for example, that in lieu of receiving more stock, or perhaps in addition to receiving additional stock, Jeff is given a contractual right to compensation that is structured to provide the same economic benefits as stock. A deferred compensation contract is used to pay benefits based on Jeff's hypothetical ownership of a designated number of common stock shares. The written contract offers a medley of economic benefits based on the "phantom" stock, including dividend equivalency payments and payments based on the value of the phantom shares (determined at the time of the event) if the company is sold or merged or if Jeff dies, becomes disabled, or otherwise terminates his employment.<sup>104</sup> The arrangement offers a number of tax benefits. First, there is no threat that Jeff will end up having to report taxable income without having received a like amount of cash, a "phantom income" condition that is often triggered when stock is transferred to an employee as compensation.<sup>105</sup> Because all amounts paid to Jeff are compensation under a contract, Jeff will not have any taxable income until he actually receives payment. Second, there are no gift tax concerns for Earl and Betty even though the rights under the contract transferred substantial value to Jeff. Third, because all amounts paid to Jeff represent compensation, the company receives a full deduction at the time of payment.<sup>106</sup> In many ways, such a contractual arrangement is one of the most efficient strategies, from a tax

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amount plus accrued interest would be repaid at some point in the future. Obviously, the child would much prefer the bonus structure.

102. See I.R.C. § 1015(a).

103. See Treas. Reg. § 1.83-4(b) (1978); I.R.C. § 1012.

104. For a discussion of the planning opportunities and traps of such arrangements, see *supra* DRAKE, *supra* note 8, at ch. 12.

105. See I.R.C. § 83(a).

106. See *id.* § 162(a).

perspective, for transferring equity value.

Are there any tax disadvantages to such an arrangement? Historically, the biggest disadvantage has been the absence of any capital gains break for the child. Because the child never receives real stock under the contract, there is no possibility of creating a capital gain at time of sale. To sweeten the deal for the child, an added bonus may be provided to produce a net after-tax yield to the child that is equal to the yield that would result if the phantom stock payment was taxed as a capital gain. Again, the company gets a full deduction for all amounts paid. Often this capital gains “make-up” bonus can be paid with the company still incurring a net after-tax cost that is less than would be incurred if it issued real stock and later had to purchase the real stock under a buy-sell agreement. For example, assume in our case that Jeff’s marginal ordinary income tax rate is 33 percent and his capital gains rate is 15 percent. Jeff would net 85 cents on every dollar of capital gain recognized on the sale of real stock to the corporation under a buy-sell agreement. Under a phantom stock contract with a capital gain gross-up bonus, the corporation would have to pay Jeff \$1.27 to net Jeff the same 85 cents after Jeff’s 33 percent marginal ordinary rate is applied. But if the corporation is subject to a marginal rate of 34 percent, the \$1.27 payment would cost the company only 84 cents on a net after-tax basis, which is 16 percent less than the after-tax cost the company would need to expend to buy real stock from Jeff under a buy-sell agreement.

With any such deferred compensation plan, great care must be taken to ensure that it avoids the reaches of new section 409A, added by the American Jobs Creation Act of 2004.<sup>107</sup> Generally, this will require (1) that any compensation deferral elections of the employee be made before the close of the taxable year preceding the taxable year in which the related services are actually rendered, (2) that the authorized events that may trigger payment of benefits under the contract (i.e. separation from service, specified time, change in control, unforeseen emergency) be specified in the contract (no elections as to timing of payments), (3) that there be no acceleration or further deferral of benefits, (4) that assets not be placed in a trust or other arrangement outside of the United States to pay benefits under the contract, and (5) that assets not be restricted to the payment of benefits under the contract based on changes in the company’s financial health.<sup>108</sup>

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107. *See id.* § 409A.

108. *See* Treas. Reg. §§ 1.409A-2(a), (b), 1.409A-3 (2007); I.R.C. § 409A(b)(1), (2).

## IV. CORPORATE TRANSITION STRATEGIES

The plan design usually includes a program for transferring stock to other family members while one or both of the parents are living. The strategic options include gifts of stock to other family members or trusts established for their benefit, sales of stock to the corporation, and sales of stock to other family members or trusts. No option is clearly superior to the others; each has disadvantages and limitations that need to be carefully evaluated. Often a combination approach is the best alternative. Plus, in some cases the need to actually transfer stock may be mitigated by business restructuring techniques that have the effect of transitioning future value without actually transferring stock.

A. *Gifting Strategies*

The gift strategy is clearly the simplest and easiest to comprehend. The parents seek to reduce their future estate tax exposure by gifting stock and other property to family members. The challenge is to structure the gifts to avoid or minimize all gift taxes on the transfers. In our case study, Earl and Betty could commence a program of gifting Wilson corporate stock to Jeff, the child involved in the business, and gifting other assets to other family members. For gift tax purposes, the value of any gifted stock may qualify for lack of marketability and minority interest discounts, which together may equal as much as 40 percent.<sup>109</sup>

Earl and Betty each have a gift tax annual exclusion that shelters from gift taxes any gifts of present property interests up to \$12,000 to a single donee in a single year.<sup>110</sup> All gifts of stock and other assets that fall within the scope of this \$12,000 annual exclusion will be removed from Earl and Betty's estates for estate tax purposes.<sup>111</sup> Earl and Betty have 10 potential donees in their immediate family—three children, three spouses of children, and four grandchildren. At \$24,000 per donee (\$12,000 for each parent), Earl and Betty's annual gift tax exclusions would enable them to collectively transfer tax-free \$240,000 of discounted value each year to immediate family members. If discounts

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109. *See, e.g.,* Rakow v. Comm'r, 77 T.C.M. (CCH) 2066, 2073 (1999); Estate of Dailey v. Comm'r, 82 T.C.M. (CCH) 710, 712 (2001); Janda v. Comm'r, 81 T.C.M. (CCH) 1100, 1101, 1104–05 (2001).

110. *See* I.R.C. § 2503(b).

111. *See id.* §§ 2001, 2503(b).

are factored in at 40 percent, this simple strategy could shift up to \$400,000 of value out of Earl and Betty's estates each year. During a ten-year period, the future value of property removed from Earl and Betty's taxable estates and transitioned tax-free with their annual gift tax exclusions could reasonably be expected to exceed \$5.8 million.<sup>112</sup> Simple 2503(c) trusts could be used for all heirs under age 21 to avoid future interest problems that would otherwise compromise the availability of the annual exclusion. If grandchildren are the trust beneficiaries, care should be taken to meet the requirements of section 2642(c)(2) to ensure an inclusion ratio of zero for generation skipping tax purposes and no generation skipping tax liability.<sup>113</sup>

In addition to their annual gift tax exclusions, Earl and Betty each have their lifetime gift tax unified credits and their generation skipping tax (GST) exemptions.<sup>114</sup> The gift tax unified credit enables each of them to make tax-free gifts of up to \$1 million that are not otherwise sheltered by the annual exclusion. The GST exemption permits each of them to make GST tax-free transfers of up to \$2 million during life or at death. If the company stock and other gifted assets are expected to grow in value (a reasonable assumption in most cases), early use of the gift tax unified credits and the GST exemptions will produce future estate and generation skipping tax benefits because all appreciation in the value of the gifted property accruing subsequent to the date of the transfers will be excluded from the parents' taxable estates.<sup>115</sup>

Gifts also have income tax consequences. As the common stock is transferred, any income rights attributable to that stock also are transferred. If, as in our case study, the corporation is a C corporation, any future dividends attributable to the gifted stock will be paid and taxed to the family members who own the stock. If the entity is an S corporation, the pass-through tax impacts attributable to the gifted stock will flow to the children and grandchildren who own the stock.

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112. This assumes that the annual gift tax exclusion continues to escalate in \$1,000 increments as it has done in the past and that the value of the business grows at a rate of 6 percent per annum.

113. The grandchild must be the sole beneficiary of the trust during life, and the trust assets must be included in grandchild's estate if the grandchild dies before the trust terminates. *See* I.R.C. § 2642(c)(2).

114. *See id.* §§ 2505, 2631.

115. Because the tentative estate tax calculated under I.R.C. § 2001(b) and (c) is based on the amount of the decedent's taxable estate and the amount of adjusted taxable gifts made by the decedent, any appreciation accruing on gifted property subsequent to the date of transfer is excluded from the calculation.

1. *Gift Taxes Now? A Hard Sell*

Many parents have an interest in the gifting strategy so long as no gift taxes need to be paid. The strategy becomes much less appealing when the possibility of paying gift taxes is factored into the mix. In our case study, should Earl and Betty consider making taxable gift transfers—transfers that exceed the limits of their annual exclusions and their gift tax unified credits—in hopes of avoiding larger estate tax burdens down the road? There are two potential benefits to such transfers. First, all future appreciation on the gifted property will be excluded from the donor's taxable estate. Second, if the gift is made at least three years before death, the gift taxes paid by the transferring parent are not subject to any transfer taxes, resulting in a larger net transfer to the donee.<sup>116</sup> For example, if Betty dies with an additional \$1 million included in her taxable estate that is subject to a 45 percent marginal estate tax rate, the net after-tax amount available to her heirs will equal \$550,000. In contrast, if Betty had expended that same \$1 million at least three years prior to her death by making a gift of \$689,000 to a child and paying gift taxes at the rate of 45 percent on such gift (\$311,000), the child would end up netting an additional \$139,000 (the taxes otherwise imposed on the gift taxes), plus any appreciation on the property occurring subsequent to the gift. If the donor parent dies within three years of the gift, section 2035(b) pulls the gift taxes paid by the parent back into the parent's taxable estate, and the tax benefit is lost.

Do these potential benefits justify writing a big gift tax check now in hopes of saving bigger estate taxes down the road? Most private business owners have little or no appetite for this potential opportunity. Their reluctance to seriously consider the possibility is bolstered by their understandable desire to defer any and all taxes as long as possible and wishful dialog they have heard regarding the potential demise of the federal estate tax. As a result, many families confine their gifts of stock to transfers that are fully tax-protected by the annual exclusion or the unified credit.

2. *Gifting Disadvantages*

Although the gifting strategy may result in a reduction of future estate taxes and a shifting of income, it has its disadvantages and limitations.

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116. Any gift taxes paid within three years of death are taxed in the decedent's estate. *See id.* § 2035(b).

For many parents, the biggest disadvantage is the one-way nature of a gift; they receive nothing in return to help fund their retirement needs and provide a hedge against an uncertain future. In our case study, for example, the strategy does nothing to address Earl and Betty's primary goal of having a secure retirement income from the business for the balance of their lives. Their insecurities may be heightened as they see their stock being gifted away over time. The receipt of life insurance on the death of the first spouse may reduce or eliminate the insecurities of the survivor, but so long as they are both living and trying to adjust to their new, less-involved life style, their financial security will be priority one. To help secure their retirement income, the company may agree to pay Earl ongoing compensation benefits for consulting services or perhaps an agreement not to compete. There are disadvantages to this compensation approach. There always is the risk that the payments will not be recognized as deductible compensation for income tax purposes, but rather will be characterized as nondeductible dividends.<sup>117</sup> Plus, compensation payments will trigger ongoing payroll taxes.<sup>118</sup>

Another option for securing a steady income for Earl and Betty is to pay dividends on the stock that they have retained. There are a number of disadvantages with the dividend alternative. First, it produces a double tax—one at the corporate level and one at the shareholder level. Although the pain of this double tax has been softened by the reduction of the C corporation dividend tax rate to 15 percent, there is still a double tax, and the 15 percent dividend break, absent future action by Congress, will expire at the end of 2010. Conversion to S status may help eliminate the double tax hit moving forward, but, as explained above, the conversion itself is not tax-hassle free.<sup>119</sup> Second, since children will be receiving stock, corresponding pro rata dividend payments will need to be made to the children. This just aggravates the double tax problem and does nothing to accomplish the parents' objectives.

Another disadvantage of the gifting strategy relates to Jeff's plan for the future. Because a gifting strategy is usually implemented in incremental steps over a lengthy period of time to maximize use of the

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117. Treas. Reg. §§ 1.162-7, 1.162-8 (2006).

118. The 2008 payroll tax burden is 15.3 percent of the first \$102,000 of compensation and 2.9 percent of the compensation paid in excess of \$102,000. SSA Pub. No. 05-10003, Jan. 2008, ICN 451385.

119. See *supra* Section III.C.

annual gift tax exclusion and to ensure that the parent's have retained at all times sufficient stock for their future needs, the plan may frustrate or at least badly dilute Jeff's goal of garnering the fruits of his future efforts for himself. If Jeff is successful in expanding and growing the business, his success will be reflected pro rata in the value of all of the common stock, including the stock retained by Earl and Betty and any common stock gifted to Kathy and Paul and other family members.

Finally, there's an income tax disadvantage to the gifting strategy. The tax basis of any stock owned by a parent at death will be stepped up to the fair market value of the stock at death.<sup>120</sup> If Earl and Betty make gifts of stock, their low basis in the stock will be carried over to their donees,<sup>121</sup> and the opportunity for the basis step-up at death is lost forever. This can be significant if a donee sells the stock down the road. In a community property state, this disadvantage is substantially eliminated for all gifts made after the death of the first spouse because all community property (even the surviving spouse's interest) receives a tax basis step-up on the death of the first spouse.<sup>122</sup>

These potential disadvantages need to be carefully evaluated in the design of any transition plan. The result in many situations is a gifting program that starts slowly, perhaps geared to the limits of the annual gift tax exclusion, then accelerates as the parents become increasingly more secure in their new "uninvolved" status, and then shifts into high gear following the death of the first spouse. In other cases, the fear of future estate taxes prompts the parents to aggressively embrace the gifting strategy and explore options for enhancing their stock gifting options. Following is a description of enhanced stock gifting strategies that are often considered.

### 3. *The GRAT—A Square Peg?*

The grantor retained annuity trust ("GRAT") is a proven darling in the estate planning world. For large estates wrapped up in the challenge of juggling many valuable marbles, its allure often is irresistible. Its value in transitioning a family business, a mountain, is far more problematic. Often, when all factors are fairly considered, the GRAT ends up being the proverbial square peg that just doesn't fit the situation.

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120. I.R.C. § 1014(a).

121. *Id.* § 1015(a).

122. *Id.* § 1014(a), (b)(6).

With a GRAT, the parent transfers property to a trust and retains an annuity, expressed as either a fixed dollar amount or a percentage of the fair market value of the property transferred, for a specified timeframe, expressed as a term of years, the life of the grantor, or the shorter of the two. The annuity must be paid at least annually, and its payment may not be contingent on the income of the trust.<sup>123</sup> That is, if necessary, annuity payments must be funded out of trust principal. The trust may not issue a “note, other debt instrument, option, or other similar arrangement” to pay the annuity.<sup>124</sup> No additional property may be contributed until the annuity term ends,<sup>125</sup> nor may payments be made to any person other than the grantor.

The contributed property is deemed to have two valuation components for gift tax purposes. The first component (Annuity Component) has a value based on the size of the designated annuity payment and the annuity tables under section 7520, which incorporate an interest rate equal to 120 percent of the applicable federal midterm rate.<sup>126</sup> The value of the second component (“Remainder Component”) is the excess of the value of the property transferred to the trust less the value of the Annuity Component. At the time the trust is created, the parent is deemed to have made a gift equal to only the value of the Remainder Component. At the end of the annuity term, all remaining property in the trust is transferred to the designated beneficiaries, usually children, with no further gift tax consequences. Plus, the property is removed from the parent’s estate for estate tax purposes.

A GRAT creates two key risks—a mortality risk and a yield risk. The mortality risk is that all tax objectives will be lost if the parent dies before the end of the designated annuity term. If the parent dies prematurely, the entire value of the property will be subject to estate taxes in the parent’s estate under section 2036(a).<sup>127</sup> The entire effort will have produced nothing. The yield risk recognizes that the GRAT

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123. Treas. Reg. § 25.2702-3(d) (2006).

124. *Id.* § 25.2702-3(b)(1)(i).

125. *Id.* § 25.2702-3(b)(5).

126. I.R.C. § 7520.

127. Section 2036(a) is triggered because the parent will possess a retained income interest at death. Although technically section 2039 would also be triggered on death because the annuity payments likely will continue after the death of the parent, the Service recently issued Proposed Regulation § 20.2036-1(c) that mandates the application of section 2036(a), not section 2039, in such a situation. Prop. Treas. Reg. § 20.2036-1(c), 72 Fed. Reg. 31487 (July 9, 2007), *available at* [http://www.irs.gov/irb/2007-28\\_IRB/ar13.html](http://www.irs.gov/irb/2007-28_IRB/ar13.html).

will not produce any net transfer tax benefit if the yield on the property held in the trust (including its growth in value) during the annuity term does not exceed the section 7520 rate used to value the Annuity Component. If the property's yield cannot beat the 7520 rate, the parent would be better off for transfer tax purposes if he or she, in lieu of the GRAT, had simply made a completed gift of property equal in value to the Remainder Component free of any mortality risk factor.<sup>128</sup> For the GRAT to pay off, the parent must beat both risks – live longer than the annuity term and have the trust property produce a yield superior to the 7520 rate.<sup>129</sup>

a. *The Real Goal—Something for Nothing*

Given the mortality and yield risks, often the GRAT is a tough sell if a substantial gift tax burden is triggered on its creation. Because the Remainder Component is a future interest, the gift tax annual exclusion is not available. The parent's unified credit is usually better spent on other transfers (e.g. life insurance dynasty trust insurance premiums) that are guaranteed to produce real transfer tax benefits; the opportunity cost of expending the credit on a risk-laden GRAT often just does not pencil. And, the thought of actually paying significant gift taxes on a transfer that might produce no estate tax benefits is rejected outright by many as absurd. So, the strategy of choice often is to structure the annuity so that the Annuity Component nearly equals the value of the contributed property, and the Remainder Component has little or no value. This “zero-out” strategy, made possible by the Tax Court's 2000 decision in *Walton v. Commissioner*,<sup>130</sup> is accomplished by structuring the annuity

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128. There are other differences that could favor a direct gift when the yield risk is a problem. A direct gift may qualify for the gift tax annual exclusion under section 2503(b); a future interest transfer to a trust has no hope of qualifying. Plus, any appreciation on property subject to a direct gift will be excluded from the donor's taxable estate; any trust property may be taxed in the donor's estate under section 2036(a) at its full date of death value. I.R.C. § 2036(a).

129. Arguments are sometimes advanced for the proposition that, in extreme situations, a GRAT may pay in the end even if it does not beat the yield risk. Examples include a situation where a large block of marketable stock subject to a blockage discount is transferred to a GRAT and then sold off in pieces or where large losses in a transferred portfolio are recognized before larger gains. *See, e.g.*, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Comparing GRATs and Installment Sales*, 41ST ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, 2-1, 2-9 (Tina Portuondo ed., 2007). Such theories, although potentially applicable to marble shifters, are of no help with a transition plan for a closely held family corporation.

130. 115 T.C. 589 (2000). In *Walton*, the Tax Court struck down old Example 5 in regulation 25.2702-3(e) by holding that an annuity payable for a term of years to a grantor or the grantor's estate is a qualified annuity for a specified term of years and can be valued as such, regardless of

to be paid to the parent or the parent's estate for the designated term and setting the annuity payments high enough to create the desired Annuity Component value. When this strategy is used, the GRAT becomes a "Heads I Win, Tails I Break Even" scenario. If either the mortality or the yield risk becomes a problem, the parent, although back to square one, has lost nothing because no gift tax costs (either real or opportunity) were incurred. If, however, both risks are avoided and any property remains in the GRAT at the end of the annuity term, that property will pass to the designated remainder beneficiaries free of all transfer taxes. It offers a clear shot at "something for nothing." With this "zero-out" strategy, even the mortality risk can be mitigated by setting a short annuity term<sup>131</sup> and mandating big annuity payments that, in large part, will be funded from trust principal. The Service does not like this zero-out strategy; it will not issue a private letter ruling on the qualification of a GRAT if the Remainder Component has a value of less than 10 percent of the contributed property.<sup>132</sup> Many are not deterred by this position of the Service and pursue the zero-out strategy on the theory that it is consistent with the regulations to section 2702 and that any future changes to the regulations likely would be applied on a prospective basis only. Others build a formula into the GRAT that would automatically adjust the retained annuity if there is a subsequent determination as to the legally required value of the Remainder Component.

*b. The GRAT and Closely Held Stock*

Stock of a closely held corporation may be used to fund a GRAT. Even stock in an S corporation will work because a grantor trust is an eligible S corporation shareholder,<sup>133</sup> and the GRAT can qualify as a grantor trust by requiring that the annuity payments first be paid out of

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whether the grantor survives the term. *Id.* at 603. The case opened the door to zero-out GRAT's because the fixed term can be used to value the Annuity Component. The result was a new Example 5 and 6, which are commonly referred to as the "Walton" Regulations. Treas. Reg. § 25.2702-3(e), exs. (5) & (6).

131. The minimum term of a GRAT is a concern of some, based on an earlier position of the IRS that it would not rule on any GRAT that had a term of less than five years. The GRAT in the famous *Walton* case, *supra* note 130, was two years; the Service did not challenge the 366 day term of a GRAT in *Kerr v. United States*, 113 T.C. 449 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002), and the Service ruled favorably on a two-year GRAT in PLR 9239015. I.R.S. Priv. Ltr. Rul. 9239015 (Sept. 25, 1992).

132. Rev. Proc. 2008-3, 2008-1 I.R.B. IRB 28-1, § 4(51). *See also* I.R.S. Tech. Adv. Mem 2003-72, 2003-44 IRB 964.

133. I.R.C. § 1361(c)(2).

trust income.<sup>134</sup> But the issue isn't whether it can be done; it's whether it makes any sense to do it. There will be situations where the company's growth and cash flow prospects are so strong that the GRAT will offer an excellent vehicle to leverage the parents' unified credits or even the payment of gift taxes. But the cash and yield demands of the GRAT may prove troublesome for many mature family businesses that are struggling to maintain market share while sustaining a modest growth curve.

Suppose, for example, that Earl forms a GRAT, names Jeff as the remainder beneficiary, transfers nonvoting Wilson common stock to the GRAT equal to 24 percent of the outstanding stock, and determines that the maximum annual cash distributions the company could afford to make to the shareholders going forward is \$500,000. An amount equal to 24 percent (\$120,000) of these annual distributions would be paid on the stock held in the GRAT to fund Earl's annuity and the balance would be paid to the other shareholders, principally Earl and Betty. The value of the transferred stock for gift tax purposes (assuming a 40 percent minority interest and lack of marketability discount) would be \$1,440,000.<sup>135</sup> If the annuity term was set at five years (remember Earl is now 65) and the 7520 rate was 5.4 percent (based on the November 2007 applicable federal rate), the Remainder component would trigger a taxable gift of \$926,160 based on an annual annuity of \$120,000.<sup>136</sup> If the mortality risk was extended to 10 years, the Remainder Component gift tax value would drop to \$531,132.<sup>137</sup>

Any person who contemplates funding a GRAT with family stock should carefully focus on following four practical questions that, if ignored or understated, may result in the family spending a great deal of effort and money on a structure that backfires in the end.

First, how is the trust going to fund the annuity payments? Many businesses may conclude that double-taxed dividends from their C corporation or single-taxed income from their S corporation will not do the job unless the annuity term is very long (thus escalating the mortality risk beyond any reasonable period) or the parent incurs substantial gift tax costs (either real or opportunity) up front against the risks inherent in the GRAT. And if a decision is made to bail out corporate earnings as

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134. *Id.* § 677(a).

135. Computation:  $\$10,000,000 \times .24 \times .60 = \$1,440,000$ .

136. Computation:  $\$1,440,000 - [\$120,000 \times 4.282 \text{ (Table B five year factor)}] = \$926,160$ . This assumes the annuity is paid annually and the Table K value is 1.

137. Computation:  $\$1,440,000 - [\$120,000 \times 7.5739 \text{ (Table B ten year factor)}] = \$531,132$ . This assumes the annuity is paid annually and the Table K value is 1.

fast as possible to help the GRAT, what impact will this bail out strategy have on other shareholders and the strength of the business? And if large sums of cash are regularly withdrawn from the business, what will be the resulting negative impacts on the value of the business which, among other things, might magnify many times the yield risk factor of the GRAT? For example, if Earl's GRAT described above has a five-year term and an annual annuity obligation of \$120,000, the company would have to distribute \$2.5 million to its shareholders over the next five years against the hope that Earl will outlive the five-year term and that the compounded annual growth of the company (even with these distributions) will still beat the 7520 rate and the resulting impact in the growth in Earl's estate resulting from his share of the distributions.

Second, does the zero-out strategy (the play that gets so many so excited) make any sense in the situation? If the GRAT is structured to have a "zero-out" Remainder Component by funding large annuity payments out of principal, the trust likely will end up transferring stock back to the parent to fund the annuity. If, for example, Earl desires to have the GRAT described above structured as a zero-out GRAT with a five-year term, the annual annuity payment would need to be \$336,291.<sup>138</sup> If funded by cash from the company, this would require annual shareholder cash distributions of \$1,401,212,<sup>139</sup> a total of more than \$7 million over five years. For most companies presently valued at \$10 million, such numbers would be impossible and certainly would make no sense if the expectation is that the company will grow in value and thereby produce transfer tax savings through the GRAT. So the only hope of zeroing out the Remainder Component is to transfer stock back to Earl to fund the huge annuity payments. This stock recycling will necessitate costly annual stock valuations that will serve conflicting objectives. For GRAT purposes, it will be desirable to have such valuations confirm high growth to beat the GRAT's yield risk, when in fact such high growth confirmations likely will create larger transfer tax problems on all other fronts, not the least of which is the future estate tax impacts of the very shares that are being transferred back to the parent in the form of annuity payments.

Third, will the need to beat the yield risks inherent in the GRAT be at cross purposes with other efforts that the family takes to facilitate

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138. Computation:  $\$1,440,000 / 4.282$  (Table B five year factor) = \$336,291. This assumes the annuity is paid annually and the Table K value is 1.

139. Computation:  $\$336,291 / .24 = \$1,401,212$ .

transition planning by holding down the stock value? Such efforts, for example, may include strategies to segregate new expansion growth opportunities and to adopt equity-based compensation structures for key children in the business.

Finally, what will the GRAT say to key inside children, such as Jeff, who are anxious to take over the reins and build the business? “We are going to expend real effort and money on a complicated trust structure that possibly may save some taxes and net you a few shares many years down the road if Dad can outlive the term of the annuity, if we can blow big money out of the corporation, and if we can still demonstrate that the value of the stock is escalating at a fast pace that may make other transfer strategies more difficult and may result in higher estate taxes when Dad dies.” The inside child might start looking for a new job.

The forgoing questions should be carefully evaluated whenever a GRAT is being considered as an element of a family business transition plan. Often, though not always, the analysis will quickly demonstrate that the GRAT serves no critical objectives of the family. For many families, it will once again confirm the reality that stock of the family business often should not be treated the same as a portfolio of publicly traded securities.

#### 4. *The Preferred Stock Freeze—A Very Rare Fit*

Another enhanced gifting strategy is the preferred stock freeze. It requires that the family corporation be recapitalized<sup>140</sup> with both preferred and common stock. All of the growth in value is reflected in the common stock that is gifted or sold to children over time. The parents retain significant voting and income rights through the preferred stock that has a fixed value. The goal is to reduce future estate taxes by

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140. The recapitalization can be accomplished as a tax-free reorganization. I.R.C. § 368(a)(1)(E) (2006). If common stock is exchanged for common and preferred stock, the shareholders will not recognize any gain under section 354, and the corporation will be entitled to nonrecognition treatment. *Id.* § 354. Each shareholder’s basis in his or her old common shares will carryover and be allocated to the new common and preferred shares based on their respective fair market values. *Id.* § 358(a), (b); Treas. Reg. § 1.358-2(a)(2) (2007). The preferred stock received in the recapitalization will be considered “Section 306 stock” if the effect of the transaction was substantially the same as the receipt of a stock dividend. I.R.C. § 306(c)(1)(B). The regulations mandate a cash substitution test for the dividend “effect” determination—if cash had been received instead of preferred stock—would it have been treated as a dividend under section 356(a)(2)? *See* Treas. Reg. § 1.306-3(d) (2007). Thus, if each shareholder receives a proportionate amount of common and preferred stock, a likely scenario in a family corporation recapitalization, the preferred stock will be section 306 stock.

transferring the future growth in the business to the children through the common stock. Note that this preferred stock strategy will not work for an S corporation because of the single class of stock eligibility requirement.<sup>141</sup>

This freeze strategy will work only if the valuation rules of section 2701 of the Code are satisfied.<sup>142</sup> Under these rules, the value of the common stock transferred to the children for gift tax purposes is based on a subtraction method of valuation, which subtracts the value of the parent's retained preferred stock and other non-transferred family equity interests from the fair market value of all family-held interests in the corporation.<sup>143</sup> If the income rights of the preferred stock retained by the parents are not "qualified payment" rights, such preferred stock will be deemed to have a zero value under section 2701.<sup>144</sup> In such event, the transferred common stock's value for gift tax purposes will be based on the value of the parents' entire equity interest—a disastrous gift tax result.

Section 2701 applies to transfers among family members.<sup>145</sup> For the preferred stock to have a value under section 2701 (and thus reduce the value of the gifted common stock), the preferred stock must mandate a "qualified payment," which is defined as a fixed rate cumulative dividend payable at least annually.<sup>146</sup> The value of the preferred stock

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141. I.R.C. § 1361(b)(1)(D).

142. *See id.* § 2701.

143. Treas. Reg. § 25.2701-1(a)(2). The subtraction method requires application of a four-step procedure. *See id.* § 25.2701-3(a)-(d).

144. I.R.C. § 2701(a)(3)(A).

145. Family members include the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and spouses of such descendants. *Id.* § 2701(e)(1).

146. *Id.* § 2701(c)(3). A fixed rate includes any rate that bears a fixed relationship to a specified market interest rate. *Id.* § 2701(c)(3)(B); Treas. Reg. § 25.2701-2(b)(6)(ii). Election options are available to treat, in whole or in part, a qualified payment right as not qualified, in which event it will be valued at zero under section 2701, or to treat a nonqualified payment right as a qualified payment, in which event it will be valued at its fair market value under section 2701. I.R.C. § 2701(c)(3)(C)(i),(ii); Treas. Reg. § 25.2701-2(c)(2)(i),(ii). The determination to elect in or out of qualified payment status depends on the certainty of the fixed payments actually being made. If the interests are valued as qualified payments and the fixed payments are not made, additional transfer taxes are imposed on a compounded amount that is calculated by assuming that the unpaid amounts were invested on the payment due date at a yield equal to the discount rate used to value the qualified payments. I.R.C. § 2701(d); Treas. Reg. § 25.2701-4. Because gift or estate taxes on unpaid qualified payments can be painful under this compounding rule, some may choose to forgo the qualified payment status and avoid the tax risks of nonpayment. Similarly, against the risk of this compounding rule kicking in for nonpayment, an election may be made to treat a nonqualified payment right (i.e. noncumulative preferred stock dividend right) as a qualified payment right and

under section 2701 is based on the fair market value of the qualified payment.<sup>147</sup> An appraisal will set the value by considering all relevant factors, including comparable rates paid on publicly traded preferred stock. Thus, as a practical matter, the preferred stock must pay a market-rate dividend in order for its value for gift tax purposes to equal the face value of the preferred. If the preferred stock is valued under section 2701 based on a “qualified payment” right, the value of the common stock transferred to the children for gift tax purposes may not be less than a special “minimum value.”<sup>148</sup> The special minimum value is the children’s pro rata value of all common stock if all the outstanding common stock had a value equal to 10 percent of all equity interests in the corporation.<sup>149</sup>

The strategy triggers two tough challenges that preclude its use except in the rarest circumstances. First, the cumulative dividend requirement on the preferred stock is an expensive burden from both a business and tax perspective. Many closely held corporations simply can’t afford the cash drain. And all cash distributed will trigger a double tax hit—first at the corporate level when the income is earned and then at the shareholder level when the dividends are paid. It is one of the most tax-expensive strategies for moving income. Second, for many mature businesses, the fair market value of the preferred stock (set by appraisal) will equal the face value of the preferred only if the fixed dividend rate on the preferred is set at a level that, as a practical matter, exceeds the projected annual growth rate of the business. So the preferred dividends paid to the parents will continue to increase the value of the parents’ taxable estate at least as fast as the status quo. The result is that the strategy may start producing an immediate double income tax hit with little or no transfer tax savings. For these reasons, the strategy, although useful in very unique fast-growth situations, does not fit most family businesses.

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value it as such under section 2701 on the assumption that it always will be paid.

147. I.R.C. § 2701(a)(3)(C). *See* Treas. Reg. § 25.2701-1(e) ex. 1. If the preferred stock that contains the qualified payment also contains a liquidation, put, call, or conversion right, the value of the preferred stock must be the lowest value based on all such rights. I.R.C. § 2701(a)(3)(B); Treas. Reg. § 25.2701-2(a)(3).

148. I.R.C. § 2701(a)(4)(A).

149. *Id.*

### 5. *The Three-Year GRIT—A Potential Add-On*

The three-year grantor retained income trust (“GRIT”) strategy may be helpful in those situations where a parent has decided to pay gift taxes now in hopes of saving bigger estate taxes in the future. If the parent makes a taxable gift and then dies within three years of the gift, all gift taxes paid by the parent will be subject to estate taxes in the parent’s estate under section 2035(b). However, the gifted property itself is not brought back into the parent’s estate and, therefore, does not receive a stepped-up tax basis under section 1014. If the parent lives for three years after the gift, the gift taxes are not pulled back into the estate and avoid all transfer taxes.<sup>150</sup>

A three-year GRIT may be used to generate a basis step-up if the parent dies within three years and the gift taxes are subject to estate taxation. It works by transferring the gifted stock to a trust that requires that “all income” of the trust be paid to the parent for three years. At the end of the three-year term, the property passes to a designated donee, presumably a child. The annuity component of the trust will have a zero value because the annuity is not specified as a fixed dollar amount or a percent of the contributed property.<sup>151</sup> So the remainder interest for gift tax purposes will equal the full value of the property.<sup>152</sup> If the parent dies during the three-year term, the property and all gift taxes paid will be taxable in the parent’s estate, the estate will receive a credit for the prior gift taxes, and the donee’s basis in the property will be stepped-up to its fair market value at the parent’s death.<sup>153</sup> If the parent outlives the three-year term, the GRIT will end, and the risk of the paid gift taxes being included in the estate will have ended.

The disadvantage of this strategy is that, if death occurs within three years of the gift, any appreciation in the value of the gifted property from the date of the gift to the date of death will generate an added estate tax burden. This disadvantage needs to be balanced against the value of the stepped-up basis to the donee. The 3-year GRIT may make sense in those rare situations where gift taxes are paid, the basis of the gifted property is very low in relation to its value, and meaningful appreciation during the three-year term is unlikely.

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150. For an illustration of this transfer tax savings, *see supra* Section IV.A.1.

151. I.R.C. § 2702(a),(b); Treas. Reg. §§ 25.2702-1-3, 25.2702-2(d) ex. 1.

152. Treas. Reg. §§ 25.2702-1(b).

153. I.R.C. § 1014.

All gifting strategies, enhanced or not, require the parents to transfer something for nothing. Many parents want or need something in return. They need a strategy that will convert their stock into cash to fund their retirement and that will stop or slow down the growth in the value of their taxable estates. A sale of stock might do the job. If the company is going to stay in the family, the potential buyers include the corporation, the children, or a trust established for the children.

*B. The Redemption Strategy—A Complete Goodbye*

A corporate redemption can be used to transition stock in a family business. It works best in those situations where other family members already own a substantial percentage of the corporation's outstanding stock, the company's cash flow is strong, the prospects of future stock value growth are high, and the parents have fully surrendered the reins to the business or are prepared to do so. It is not a viable option for many.

In our case study, the corporation would contract to purchase—to redeem—all of Earl and Betty's stock in the corporation for a price equal to the fair market value of the stock. The corporation would pay the purchase price, plus interest, over a long period of time, as much as 15 years.<sup>154</sup> Immediately following the redemption, the only outstanding stock of the corporation would be the stock owned by Jeff. Although not a party to the redemption, Jeff would end up owning 100 percent of the outstanding stock of the corporation and would be in complete control. The corporation would have a large debt that would be payable to its former shareholders, Earl and Betty.<sup>155</sup> This debt would be retired with

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154. The IRS ruling guidelines indicate that the Service will not issue a favorable ruling on a redemption if the note payment period exceeds 15 years or if the stock is held in escrow or as security for the corporation's obligation to make payments under the note. Rev. Proc. 2008-3, §§ 3.01(31), 4.01(20), 2008-1 I.R.B. 110. If the note term is too long, the risk is that the parents will be deemed to have retained an equity interest that (1) violates the "creditor only" requirement of section 302(c)(2)(A)(i), (2) precludes waiver of the family attribution rules of section 318(a)(1) and a complete termination of the parents' interest within the meaning of section 302(b)(3), and (3) results in the amounts distributed to the parents being taxed as dividends. I.R.C. §§ 302(b)(3), 302(c)(1)–(2), 302(d), 318(a)(1). The Tax Court has been more forgiving. In *Lisle v. Commissioner*, 35 T.C.M. (CCH) 627, 636–40 (1976), the court found that a valid section 302(b)(3) complete termination had occurred even though the payment term was 20 years, the shareholder retained voting rights through a security agreement, and the stock was held in escrow to secure the corporation's payment obligation.

155. In any such redemption, the applicable state corporate law must be carefully analyzed to ascertain any applicable restrictions and impacts on the parents. Often appraisals are necessary. The Model Business Corporation Act, adopted in whole or part as the corporation statute of 30 states, prohibits a "distribution" (broadly defined to include proceeds from a redemption, MCBA §

corporate earnings over an extended period of time. The interest and principal payments on the indebtedness would provide Earl and Betty with a steady stream of income during their retirement. If they die prior to a complete payout of the contract, the remaining amounts owing on the contract would become part of their estates and, together with their other assets, would be allocated to their children in equal shares.

The primary tax challenge that always exists with a corporate redemption is determining the character of the payments made by the corporation to the departing shareholders: will they be taxed as corporate dividends or as true principal and interest payments made in exchange for stock? If the payments are treated as dividends, they will be fully taxable to the extent of the corporation's earnings and profits, and there will be a tax hit at both the corporate and shareholder levels on the distributed income. Although the Bush tax cuts reduced the maximum tax rate on C corporation dividends to 15 percent through 2010,<sup>156</sup> it is anyone's guess as to what the tax rate on dividends will be after 2010. However, even with this dividend rate relief, in many situations the double tax hit will be unacceptable. And if the tax rate on dividends bounces back up to a level at or near the ordinary income rate, the dividend scenario tax burden will be intolerable for most. On the other hand, if the payments are treated as stock consideration payments, the parents will be allowed to recover their basis in the transferred stock tax-free, the interest element of each payment will be deductible by the corporation, and the gain element of each payment to the parents will be taxed as a long-term capital gain. In nearly all cases, the planning challenge is to structure the redemption to ensure that the payments qualify as consideration for stock, not dividends.

The answer to this challenge is found in Section 302(b) of the

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1.40(6) if, "after giving it effect: (1) the corporation would not be able to pay its debts as they become due in the usual course of business; or (2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution." MBCA § 6.40(c). These two tests, referred to as the "equity insolvency test" and the "balance sheet test," have been widely incorporated into state corporate statutes. *See, e.g.*, WASH. REV. CODE ANN. § 23B.06.400 (2008), which adopts both tests and provides that the balance sheet test may be based "either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances . . . ."

156. *See* I.R.C. § 1(h)(11), added by P.L. 108-27 and amended by P.L. 108-311.

Code,<sup>157</sup> which specifies the conditions that must be met in order for the redemption to qualify for exchange treatment. In a family situation, the only hope is to qualify the redemption as a complete termination of the parents' interests under section 302(b)(3). For the Wilson clan, this would essentially require that Earl and Betty (1) sell all of their stock to the company in the transaction, (2) have no further interest in the business other than as creditors, (3) not acquire any interest in the business (other than through inheritance) during the ten years following receipt of all payments made to them, (4) not have engaged in stock transactions with family members during the last 10 years with a principal purpose of avoiding income taxes, and (5) sign and file with the Secretary of the Treasury an appropriate agreement.<sup>158</sup> If all of these conditions are met (and they often are), then the family attribution rules are waived and the parents are able to treat the payments as consideration for their stock, not dividends.

Usually the most troubling condition is the requirement that the parents have no interest in the corporation other than that of creditors following the redemption.<sup>159</sup> In our case, neither Earl nor Betty could be an officer, director, employee, shareholder, or consultant of the corporation following the redemption.<sup>160</sup> It must be a complete goodbye. This requirement is often viewed as an insurmountable hurdle by a parent who is departing and turning over the reins with the hope that payments will keep coming over a long period. One of Earl's prime objectives was to stay involved enough to hedge the boredom of retirement and to ensure that the business remains strong during the payout period. To qualify for tax exchange treatment under a redemption strategy, this objective would have to be abandoned.

The redemption approach offers a number of advantages that need to

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157. I.R.C. § 302(b). The family ownership attribution rules of section 318 usually make it impossible for a family transaction to qualify as a redemption that is not essentially equivalent to a dividend under section 302(b)(1) or as a substantially disproportionate redemption under section 302(b)(2). The only hope is to qualify for a waiver of the family attribution rules and, thereby, qualify the redemption as a complete redemption of the parent's interest under section 302(b)(3). *Id.* §§ 302(a), 302(b), 318(a)(1)–(a)(3)(A).

158. These are the conditions imposed by section 302(c)(2) to secure a waiver of the family attribution rules and qualify the redemption as a complete termination under section 302(b)(3). *Id.* §§ 302(b)(3), 302(c)(2), 318(a).

159. *Id.* § 302(c)(2)(A)(i).

160. *See, e.g., Lynch v. Comm'r*, 801 F.2d 1176 (9th Cir. 1986) (holding taxpayers who provide post-redemption services, either as an employee or independent contractor, as holding prohibited interests in the corporation).

be carefully evaluated in each situation. It provides a long-term payment stream directly from the corporation to the parents. It effectively freezes the value of the business in the parents' estates, subject to the accumulation of interest income that is paid on the installment note. In our case, all future growth in the stock value would pass to Jeff, the sole shareholder. Finally, it makes it easy for the accumulated proceeds paid on the debt and the unpaid balance of the debt to be transferred to the children in equal shares at the appropriate time, thereby accomplishing the parents' objective of giving each child an equal share of their estates.

There are also some compelling disadvantages with the redemption approach that provide a strong incentive for many families to look for an alternative. First, the principal payments made to Betty and Earl on the indebtedness will need to be funded by the corporation with after-tax dollars. This may create an intolerable cash burden for the corporation in redeeming the stock. Second, even though large sums of after-tax dollars will be paid to the parents for their stock, Jeff, the sole stockholder of the corporation, gets no increase in the tax basis of his stock. Because the corporation is redeeming the stock and making the payments, there is no basis impact at the shareholder level. Third, as previously stated, Betty and Earl are precluded from having any further involvement in the management and affairs of the company if they want to meet the requirements of section 302(b)(3) and qualify for exchange tax treatment. For many family patriarchs, this complete goodbye requirement alone will kill the strategy. Fourth, the amounts payable to Betty and Earl will terminate when the note is paid off. Given the size of the payout in our case, it is unlikely that this potential disadvantage will be significant. In many smaller situations, the parents may want and need a regular cash flow that will last as long as one of them is living. Fifth, if the parents die before the contract is paid in full, the children who inherit the unpaid contract will pay income taxes on their receipt of interest and principal payments under the contract. The contract payments are treated as income in respect of a decedent for income tax purposes.<sup>161</sup> There is no step-up in basis for the children: the income tax burden survives the parents' deaths. Sixth, the company takes on a tremendous debt burden in redeeming the stock. The company may not have the cash flow to foot such a huge bill and the associated tax burdens. At a minimum, the cash burden of the debt may adversely impact Jeff's capacity to move the company forward or to secure

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161. *See* I.R.C. § 691(a).

financing that may be necessary to expand the business and accomplish his objectives for the business.

These disadvantages cause many families to reject the redemption strategy in the plan design. They prefer a strategy that can be implemented on an incremental basis over time and that will allow the parents to have a continuing, but reduced, role in the business.

*C. Cross-Purchase Strategies—Where Is the Cash?*

A cross-purchase is similar to a redemption, with one big twist: The purchasers of the parents' stock are the other shareholders, not the corporation. In our case, Earl and Betty would still be paid principal and income payments for a long term, but the payments would come from Jeff. How does a cross-purchase strategy compare with the redemption approach? The cross-purchase offers two significant benefits over the redemption. First, the section 302 dividend fear for the parents goes away because they are not receiving payments from the corporation. This means that the parents can stay involved in the business as much as, and for as long as, they want. Earl can remain on the board and keep his hands in the operation to the extent he chooses. Plus, there is no requirement that all of the parent's stock be sold in a single transaction. Piecemeal sales work. Thus, the biggest impediment to the redemption strategy—the complete goodbye—is gone. Second, Jeff's tax basis in the purchased stock will equal the purchase price he pays for the stock.<sup>162</sup> Unlike the redemption scenario, the amounts paid to Earl and Betty in a cross-purchase produce a basis increase for the other shareholders.

Apart from these benefits, the cross-purchase approach has many of the same limitations and disadvantages as the redemption approach. Principal payments on the installment note must be funded with after-tax dollars. Jeff's credit capacity may be tapped. The payouts to the parents will not extend beyond the contract term. Any basis step-up on the parents' deaths is lost. Payments under the contract received by other family members following the deaths of the parents will be taxed as income in respect of a decedent.

Plus, the cross-purchase approach presents a whole new problem. Where is Jeff going to get the cash to cover the payments for the stock? This problem, alone, eliminates the cross-purchase option in many situations. If Jeff has an independent source of income or cash that he is

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162. *See id.* § 1012.

willing to commit to the deal, this funding problem may be solved. Absent such an independent source, Jeff will be forced to turn to the corporation for the cash. The challenge then becomes getting enough corporate cash to Jeff on an ongoing basis to fund the current payments on the installment note. This can be a tough, often insurmountable, problem. The extra compensation payments to Jeff must be large enough to cover the current interest payments on the note, the after-tax principal payments on the note, and the additional income and payroll taxes that Jeff will be required to pay as a result of the increased compensation. Beyond the cash burden to the corporation, if the compensation payments to Jeff are unreasonably high, there may be a constructive dividend risk that could put the corporation's deduction in jeopardy.<sup>163</sup> An S election will help the tax situation, but there is still a cash drain on the company and the double tax risk of a constructive dividend is avoided only to the extent of earnings during the S corporation period.<sup>164</sup>

Corporate loans to Jeff might be an option, but corporate loans always present independent problems. First, the loans will need to be repaid at some point down the road with after-tax dollars. Figuring out how the repayments to the corporation will be funded may be more difficult than Jeff's current funding challenge with his parents' note. The loan approach may simply defer and magnify the problem. Second, the loans themselves need to be funded with corporate after-tax dollars. The corporation must pay current income taxes on the funds it loans. And third, there is always the risk that substantial shareholder loans may trigger an accumulated earnings tax.<sup>165</sup> That is, the corporation may be forced to unreasonably accumulate earnings to fund the loans. The bottom line is that the shareholder loan approach to solve the funding problem in a cross-purchase situation generally is not a satisfactory solution.

This funding challenge often requires a combination approach that integrates a cross-purchase with a gift or redemption strategy, or both.

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163. See Treas. Reg. §§ 1.162-8, 1.301-1(j) (2007); see, e.g., *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999); *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1243 (9th Cir. 1983); *Charles McCandless Tile Serv. v. United States*, 191 Ct. Cl. 108, 112-115 (1970).

164. Even with an S election, a taxable dividend exposure remains to the extent of the corporation's earnings and profits from its C corporation existence. I.R.C. § 1368(c)(2). The exposure ends once the earnings and profits have been distributed. An S corporation, with the consent of all affected shareholders, may elect to accelerate such dividends by treating all distributions as earnings and profits distributions. *Id.* § 1368(e)(3).

165. See generally *id.* §§ 531-537; Treas. Reg. § 1.537-2(c)(1) (2007) (loans to shareholder for shareholder's personal benefit may indicate that earnings are being unreasonably accumulated).

The parents may gift some stock and have the balance of their stock redeemed by the corporation or purchased by other family members. It is possible to structure a corporate redemption of a portion of the parents' stock and a cross-purchase of the balance of the parents' stock and still qualify the redemption for exchange treatment under section 302(b).<sup>166</sup> The benefit of a combination approach is that the disadvantages of each strategy are watered down because only a portion of the stock is subject to the strategy. For example, only the gifted shares will do nothing to provide a retirement income to the parents; only the redeemed shares will need to be funded with corporate after-tax dollars and will not increase the other shareholders' stock basis; and only the shares subject to the cross-purchase obligation will create a funding challenge for the other shareholders.

There are circumstances where the cross-purchase funding challenge is not a big deal. This may be the case, for example, if the entity is an S corporation with strong earnings, if other family members already own a substantial percentage of the outstanding stock or, as previously stated, if other family members have substantial investment assets unrelated to the company. When a cross-purchase is the strategy of choice in the plan design, two options for enhancing the strategy are often considered.<sup>167</sup> These are the intentionally defective grantor trust installment sale and the self-canceling installment note.

#### *1. The IDGT Sale—A Dream Deal?*

With the intentionally defective grantor trust installment sale strategy, the parent establishes a trust that names one or more children as beneficiaries. However, the trust is structured so that the parent is deemed to be the owner of the trust property for income tax purposes, but not for estate and gift tax purposes. The trust is an income tax nullity, but triggers real gift and estate tax consequences. The strategy requires that one have some capacity to speak out of both sides of the

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166. *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 75-447, 1975-2 C.B. 113-114.

167. The private annuity, a cross-purchase strategy that has been popular in the past, is not discussed because recent regulations proposed by the Internal Revenue Service have effectively eliminated the tax deferral benefit of the annuity and, thereby, destroyed the private annuity as a viable transition option. *See Prop. Treas. Reg. § 1.1001-1(j)* (providing that any person who sells property in exchange for any annuity contract will be deemed to have received "property in an amount equal to the fair market value of the contract, whether or not the contract is the equivalent of cash").

mouth. The entire basis of the strategy is the incongruity between the income tax grantor trust rules<sup>168</sup> and the estate tax rules applicable to grantor-retained interests.<sup>169</sup> Although there is a broad overlap between these rules, there are a few instances where a trust may be crafted to fall within the income tax rules without triggering the estate tax inclusion rules. One such instance (commonly used to achieve the desired result) is where the parent retains a non-fiduciary power to reacquire trust property by substituting other property of equivalent value. With such a power, the parent may be deemed to be the owner of the trust for income tax purposes,<sup>170</sup> but not for estate and gift tax purposes.<sup>171</sup>

The parent then sells his or her corporate stock to the trust in return for an installment note that has a principal balance equal to the fair market value of the transferred stock. The principal balance of the note, together with interest at the applicable federal rate (a rate that generally is less than the section 7520 rate applicable to annuities), is paid by the trust to the parent over the term of the note. The trust's income and any other assets owned by the trust are used to fund the amounts due to the parent under the installment note. The strategy can be used with either C or S corporation stock because a grantor trust is an eligible S corporation shareholder.<sup>172</sup>

*a. The Dream Scenario*

Here's the dream tax scenario of this strategy. Because the trust is an income tax nullity, the parent does not recognize any taxable income on the sale of the stock to the trust. For income tax purposes, the transaction is treated as a sale by a person to himself or herself—a nonevent. Under the same rationale, the interest and principal payments on the installment note from the trust to the parent trigger no income tax consequences. Any income recognized by the trust on the stock or other trust assets is taxed to the parent as the owner of the trust. Ideally, the parent's sale to the trust triggers no gift tax consequences because the trust is deemed to have paid full value for the stock in the form of the installment note. Similarly, the parent's payment of income taxes on the trust income will

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168. I.R.C. §§ 671–679.

169. *Id.* § 2036.

170. *See id.* § 675(4)(C); Treas. Reg. § 1.675-1(b)(4) (2007).

171. *Estate of Jordahl v. Comm'r*, 65 T.C. 92, 100 (1975), *acq.* 1977-2 C.B. 1; I.R.S. Priv. Ltr. Rul. 9227013 (Mar. 30, 1992).

172. *See* I.R.C. § 1361(c)(2)(A)(i).

not trigger a gift tax. When the parent dies, the stock is not included in the parent's estate under section 2036(a) because the parent is deemed to have sold the stock for full consideration. Thus, all future growth in the value of the transferred stock is removed from the parent's estate. The one disadvantage is that the parent's income tax basis in the stock (often very low) will probably transfer over to the trust and ultimately to the children. But even this negative result might be eliminated if the parent, before death, uses the retained non-fiduciary asset substitution power to trade high-basis assets (e.g., cash) for the low-basis stock at equal values, thus ensuring that the reacquired low-basis stock is included in the parent's estate at death and thereby receives a full basis step-up. The trust will still have accomplished its estate tax goal of removing the growth in the stock's value from the parent's estate because the substituted cash pulled from the estate will equal the higher stock value. And, once again, no income tax consequences will be triggered on the substitution because the parent will still be deemed the owner of the trust for income tax purposes.

*b. Key Question: Will It Work?*

There are some aspects of the strategy that seem relatively certain. First, a retained non-fiduciary power to reacquire trust assets by substituting other property of equivalent value should make the trust a grantor trust for income tax purposes.<sup>173</sup> Second, such a power, in and of itself, probably should not trigger estate tax inclusion. To remove any doubt regarding the estate inclusion issue related to this power, some recommend giving this non-fiduciary power to a party other than the grantor.<sup>174</sup> Third, no gain or loss will be recognized by the parent on the sale of appreciated property to a grantor trust in return for a promissory note that bears a rate of interest equal to the applicable federal rate.<sup>175</sup> Fourth, the stock should not be included in the parent's estate if the parent dies after the note has been fully paid.<sup>176</sup> Finally, the parents' payment of income taxes on the trust's income will not trigger a gift

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173. See I.R.C. § 675(4)(C); Treas. Reg. § 1.675-1(b)(4).

174. See I.R.S. Priv. Ltr. Rul. 92-27-013 (Mar. 30, 1992); Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975).

175. Rev. Rul. 85-13, 1985-1 C.B. 184.

176. Because the parent will not be receiving any payments at death, there is no risk of estate tax inclusion under section 2036(a).

tax.<sup>177</sup>

Beyond these relative tax certainties, there are two fundamental questions that are troubling. First, how will the promissory note be valued for gift tax purposes? Second, if the parent dies while the note is outstanding, will the parent be deemed to have retained a life estate in the stock, such that it will be taxed in the parent's estate at death? If the answer to the first question is that the note will be valued in the same manner as a retained equity interest under section 2701 (fair market value), a substantial gift tax will be triggered when the stock is transferred because the applicable federal rate will likely be far below the market rate needed to give the note a market value equal to the transferred stock. The net effect will be that the strategy will be no more effective than a preferred stock freeze under section 2701 because it will be subject to the same yield challenges. The answer to the second question turns on the potential application of section 2036(a), which requires that any property transferred by the decedent during life be taxed in the decedent's estate if the decedent owned an income interest in the property at death.<sup>178</sup> If the answer to this second question is "Yes," the whole effort will produce no estate tax savings if the parent does not outlive the note. The existing cases and rulings suggest that the answer to both questions likely will turn on whether the note will be considered real debt or rather be viewed as disguised equity.<sup>179</sup> This will be a fact question in each situation. If the only source for payment of the interest and principal on the note is income generated on the stock owned by the trust, the equity risk goes way up and the entire transaction is put in jeopardy.<sup>180</sup> For this reason, many sensibly believe that when stock in a closely held corporation is the asset sold to the trust, the parent would be

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177. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

178. See I.R.C. § 2036(a).

179. In *Sharon Karmazin*, Tax Court Docket 2127-03, the Service took the position that both 2701 and 2702 were applicable because the note was not real debt, but the case was settled. See I.R.S. Priv. Ltr. Rul. 9515039 (Jan. 17, 1995) (real debt only if trustee/obligor has other assets); I.R.S. Tech. Adv. Mem. 9251004 (section 2036 applied where closely held stock was only source of note payment and plan was to have trust retain stock for family purposes); I.R.S. Priv. Ltr. Rul. 9639012 (June 14, 1996) (no section 2036 inclusion where note would be paid off in three years from earnings on S corporation stock); *Estate of Rosen v. Comm'r*, 91 T.C. M. (CCH) 1220, 1237 (2006) (loans from partnership characterized as retained interests that trigger 2036 inclusion); *Dallas v. Comm'r*, 92 T.C.M. (CCH) 313 (2006) (notes not challenged; trust funded with other asset that exceeded 10 percent of stock purchase price).

180. See Robert S. Keebler & Peter J. Melcher, *Structuring IDGT Sales to Avoid Sections 2701, 2702, and 2036*, Estate Planning, Oct. 2005, at 19.

well advised to transfer other income-producing assets to the trust that have a value equal to at least one-ninth of the value of the stock.<sup>181</sup> Even with such a transfer of additional assets, there is no guarantee that the equity risk will be eliminated. Also, the client should understand that an unfavorable answer to one or both of these critical questions would probably result if Congress or the Service decided to attack this strategy (a justifiable fear given the blatant attempt to secure huge tax benefits by taking advantage of a technical incongruity in the Code).

If the parent dies before the note is paid off, there are a few tax questions that can only be answered with guesswork at this time. The trust will cease to be a grantor trust on the parent's death but will continue to owe the parent's estate (or its beneficiaries) payments on the note. First, will such payments be treated as income in respect of a decedent under section 691, triggering income to the recipients as paid? The payments do not fit the technical definition of income in respect of a decedent,<sup>182</sup> but logically it's difficult to justify income tax-free treatment to the parent's heirs. Second, what will be the trust's basis in the stock on the parent's death? The options are: (1) the amount of the note at time of purchase (a purchase step-up), (2) the fair market value of the stock at the parent's death (full basis step-up), or (3) the parent's transferred basis in the stock.<sup>183</sup> The best guess is the carryover basis provision of section 1015 because of its technical "transfer in trust" language and the fact that the whole strategy is predicated on the theories that there is no sale for income tax purposes (which is inconsistent with a basis step-up under section 1012) and that the stock is not part of the grantor's estate (which makes a step-up under section 1014 a real stretch). But wait, who said anything about being consistent? Maybe talking out of three sides of the mouth to get a basis step-up will work. Finally, will the parent's death before the note is paid off trigger any taxable gain to the parent's estate because the trust has ceased to be a grantor trust? Most think not.<sup>184</sup>

Often an IDGT is compared to a GRAT. In some respects, they are

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181. *See id.* at 24.

182. Because the parent never treated the sale as a taxable event under the rationale of Rev. Rul. 85-13, 1985-1 C.B. 184, the post-death payments do not fit the technical definition of "income in respect of a decedent (IRD)" under section 691.

183. I.R.C. §§ 1012, 1014, 1015.

184. *See* Laura H. Peebles, *Death of an IDIT Noteholder*, *Trusts & Estates*, Aug. 2005, at 28, 29; Jonathan G. Blattmachr, Mitchell M. Gans, & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of Grantor's Death*, 97 J. TAX'N 149, 149 (2002).

close cousins; they both involve a transfer of property to a grantor trust, followed by the trust making payments to the grantor over a defined period of time. But in no sense are they twins. There are many key differences, some of which can be compelling for a family business. First, a GRAT is specifically authorized by the Code and Regulations; an IDGT is a quasi-freak creation of an incongruity in the Code that triggers uncertainties. Thus, a GRAT may be viewed as a “legally safer” option. Second, a GRAT creates a mortality risk: the grantor must outlive the GRAT term for the GRAT to produce any transfer tax savings. No such mortality risk is mandated by an IDGT; ideally only the unpaid portion of the installment note at the grantor’s death will be taxed in the grantor’s estate. Third, although both a GRAT and an IDGT impose a yield risk, the IDGT hurdle rate is presumably easier because the applicable federal rate, required by the IDGT, is always lower than the section 7520 rate required for the GRAT. Fourth, the GRAT produces less valuation discount leveraging benefits because such benefits will be lost for any stock that is transferred back to the grantor as required annuity payments. Fifth, the risk of an inadvertent gift or estate tax is higher with an IDGT because of existing uncertainties regarding the potential application of Code sections 2701, 2702, and 2036(a). Finally, although the IDGT will require the commitment of other assets to the trust to hedge the disguised equity characterization risk of the installment note, the periodic payment burden of an IDGT often will be far less than a GRAT because the presumed lack of a mortality risk will allow the payments on the note to be stretched out over a long term.<sup>185</sup> Often when the GRAT and the IDGT are laid side by side in the planning process, the IDGT will appear the most attractive in spite of its inherent legal uncertainties and the need for other assets. The presumed absence of a mortality risk, the lower yield hurdle rate, the greater discount-leveraging benefits, and the smaller periodic payment burden will carry the day. But even if the IDGT wins its beauty contest with the GRAT, it may not be a sensible candidate for many family transition plans.

*c. Family Business Factors to Consider*

The potential benefits of the IDGT cross-purchase strategy are compelling. A few key factors should be carefully considered before

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185. See generally Blattmachr & Zeydel, *Comparing GRATs and Installment Sales*, Heckerling Institute on Estate Planning, ch. 2 (2007).

employing the strategy in a family business transition plan. First, a threshold issue is whether a cross-purchase of stock funded primarily with income from the corporation is the best strategy for the family and the business, given the other transition strategies that are available. If so, using a grantor trust as the purchaser may be justified. The key is to not let the allure of the grantor trust strategy short circuit the analysis of other options that may, in the end, do a better job of accomplishing the family's objectives. Obviously, if a grantor trust purchase is used, it will be easier with S status because the double dividend income tax hit triggered in C corporation situations is avoided.

A second factor is whether the client has the means and the gifting capacity to fund the trust with other income-producing assets equal to at least one-ninth of the value of the stock sold to the trust. If not, the gift and estate tax risks of the whole effort may just be too much. The significance of fudging on this protective measure should not be understated. For many, this requirement will be too burdensome.

Third, if the basis of the parent's stock is high (such as would occur on the first death of a spouse in a community property state<sup>186</sup>), the value of the strategy is reduced significantly. Compared to a straight cross-purchase with a child, the only real significant benefit of a grantor trust purchase in such a situation is the tax-free shift of value resulting from the parent's payment of income tax on corporate income that would otherwise be taxed to the child.<sup>187</sup> Even this potential benefit is watered down if the child's marginal income tax rate is lower than the parent's marginal rate, a likely condition in many situations. So the net benefits of the strategy will be substantially reduced in cross-purchase transactions targeted to occur after the death of the first parent.

Finally, the client's capacity to stomach tax uncertainty must be factored into the mix. The whole strategy is predicated on a technical incongruity that could be easily eliminated on a retroactive basis. A vulnerable element of the strategy is the basis of valuing the note for gift tax purposes. The argument would be that because the transaction is considered a nullity for income tax purposes, the note should not be valued against the applicable federal rate standards used to assess income tax impacts in family loan situations, but rather should be valued as a retained interest against market standards to assess the real gift tax impacts by comparing the value of the transferred asset (the stock)

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186. I.R.C. § 1014(b)(6).

187. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.

against the true value of the retained asset (the note). If this were done, the strategy would trigger a significant gift tax hit (if the rate on the note equaled the applicable federal rate) or would require that the note rate be set at a high market rate that would significantly reduce (if not entirely eliminate) the transfer tax benefits of the entire effort (ala section 2701).

The strategy offers mystery, uncertainty, and a potential dream ending. Its allure will be irresistible to some, but for many families it will demand too much and promise too little.

## 2. *The SCIN—A Bet Against Life*

The self-canceling installment note (SCIN) is a cross-purchase enhancement strategy that may produce an additional estate tax benefit if the parent dies before the note is paid off. The parent sells stock to a child or a grantor trust in return for a promissory note. The note, by its terms, provides that all amounts due under the note will be canceled if the parent dies before the note is paid. The benefit to the obligor on the note (child or trust) is that the obligation ends on the parent's death. From the parent's perspective, no residual note balance will be included in the parent's taxable estate,<sup>188</sup> nor will any taxable income in respect of the decedent be paid to the parent's estate or heirs.

The key to the SCIN is valuing the self-canceling feature. The determination of this amount (the Premium) requires an actuarial calculation that is impacted by the parent's age, the length of the note term, and the size of the periodic payments.<sup>189</sup> The value of the Premium must reflect the economic reality of the given situation if, for example, the parent has a short life expectancy due to poor health.<sup>190</sup> If the note itself is not adjusted for the Premium, the parent will be deemed to have made a taxable gift equal to the amount of the Premium. This gift tax impact can be eliminated by increasing either the interest rate or the principal balance of the note, or both, so that the value of the Premium is reflected in the terms of the note. If the parent dies before the note is fully paid, the note is canceled, but the basis in the stock is not

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188. See *Estate of Moss v. Comm'r*, 74 T.C. 1239, 1247 (1980), *acq.* 1981-2 C.B. 1; Rev. Rul. 86-72, 1986-1 C.B. 253; *Estate of Frane v. Comm'r*, 98 T.C. 341 (1992), *aff'd* in part, *rev'd* in part *sub nom.* *Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993).

189. Presumably, the Premium calculation could be based on Table H in the Alpha Volume of the IRS actuarial tables or Table 90CM of such tables.

190. See, e.g., *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 658 (1995).

reduced.<sup>191</sup> However, any unrealized gain in the note must be included in the first income tax return of the parent's estate as income recognized on the cancellation of an installment obligation under section 453B(f).<sup>192</sup>

There are some potential disadvantages with a SCIN. If the parent outlives the note, the strategy will have produced no benefits but will have triggered added tax costs—the parent's taxable income and taxable estate will have been increased by the amount of the Premium or the parent will be deemed to have made a taxable gift equal to the Premium. Plus, if the note is adjusted to incorporate the Premium, the purchaser will have paid more and will have received no tangible economic benefit in return. Finally, in situations where multiple children are beneficiaries of the estate, a self-canceling note in favor of only one child may conflict with the parents' overriding objective to give each child an equal share of the estate.

The forgoing discussion of gifting, redemption and cross purchase strategies assumes a need for the parents to rid themselves of their stock. Often this is necessary and desirable to reduce future estate tax burdens, to provide a secure retirement income stream to the parents, and to provide the children with the necessary incentives to carry the business forward. But there are circumstances where the business can be restructured to facilitate these essential family objectives without the parents having to aggressively sell stock. Such a restructuring may allow the parents to phase-out without selling out.

#### *D. Business Restructuring—Phase-Out Options*

Often some simple business restructuring can help immensely in the design of a family transition plan. Suppose, for example, that Wilson Incorporated is restructured to take advantage of two basic realities. First, the distribution of S corporation earnings presents no double tax issues.<sup>193</sup> Second, Jeff's desire to expand into new markets and to garner all of the benefits of expansion for himself can be accomplished by having him form and operate a new business that finances the expansion,

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191. *Estate of Frane v. Comm'r*, 98 T.C. 341 (1992), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

192. I.R.C §§ 453B(f), 691(a)(5)(A)(iii) (2006); *Estate of Frane*, 98 T.C. 341.

193. I.R.C. § 1368(c)(1). If the distributions exceed the S corporation's accumulated adjustment account, a taxable dividend exposure remains to the extent of the corporation's earnings and profits from its C corporation existence. *Id.* § 1368(c)(2). The exposure ends once the earnings and profits have been distributed.

takes the risks of expansion, and realizes all of the benefits. The restructuring may be implemented as follows:

- Wilson Inc. would make an S election. The stockholders of the company would remain the same, at least for the time being. Earl and Betty would keep their stock for now. Earl would make plans to retire and ride off with Betty.

- The company would either employ Jeff as its CEO, or it would contract with the new company to be formed by Jeff (described below) to provide top-level management for the company. The compensation structure would be designed to provide attractive bonus incentives to Jeff if the income of the company is improved under the new management. It may include deferred compensation tied to increases in the value of the company's stock.

- Jeff would form a new company. This new company would be structured to finance and manage the growth and expansion of the business. It would take the risks; it would reap the benefits. Appropriate provisions would be drawn to ensure that the new company does not adversely effect Wilson Inc.'s present operation, but that it has the latitude to enhance the existing markets and expand into new markets. Preferably, the new company would be a pass-through entity—an S corporation or a limited liability company. Jeff would select the entity form that works best for him.

- Earl and Betty would structure a gifting program to transfer to their children Wilson S corporation stock and possibly other assets if and when they determine that they have sufficient assets and income to meet their future needs. These gifts, when made, would be planned to maximize use of their annual gift tax exclusions and the unused gift tax unified credits of Earl and Betty.

- Earl and Betty's wills or living trust would be structured to leave each child an equal share of their estate. Jeff would have a preferred claim to the Wilson S stock, and Kathy and Paul would have a priority claim to the other assets in the estate. If it becomes necessary to pass some of the Wilson stock to Kathy and Paul to equalize the values, the will or living trust would include buy-sell provisions that would give Jeff the right to buy the Wilson stock passing to Kathy and Paul under stated terms and conditions. Jeff's management rights would remain protected by the existing employment or management contracts.

This simple restructuring would offer a number of potential benefits. First, because Earl and Betty would retain their stock, they would have an income for life, and, if that income grew beyond their needs, they

would have the flexibility to begin transferring stock (and the related income) to their children and grandchildren as they chose. Because the cash distributions would be stock-related distributions, the unreasonable compensation risk would be eliminated, as would any payroll tax burdens. Second, by virtue of the S election, the income distributed to Earl and Betty each year would be pre-tax earnings, free of any threat of double taxation. As long as the corporation had sufficient current earnings, this income would be taxed only once. No longer would a party be forced to make payments with after-tax dollars to another family member. Third, Jeff's management and control rights would be protected by the employment and management agreements. Earl could play as much or as little of a role in the business as he chose. The parties could sculpt their control and management agreement in any manner that they chose, free of any tax restrictions or limitations. Fourth, Jeff would be the primary beneficiary of the future growth in the business through the new business entity. The operating lines between the old company and the new company would need to be clearly defined. The goal would be to preserve the existing business operation for the old company and its shareholders (principally Earl and Betty) and to allow any new operations and opportunities to grow in the company that would be owned, financed, and operated by Jeff. Fifth, stock owned by Earl and Betty at their deaths would receive a full step-up in income tax basis.<sup>194</sup> Sixth, future increases in the value of Earl and Betty's estate could be limited and controlled by (1) the incentive employment and management contracts with Jeff; (2) the new company owned, financed, and operated by Jeff; and (3) a controlled gifting program implemented by Earl and Betty. Finally, hopefully the income stream for Earl and Betty would be insulated from some or all of the financing risks taken by Jeff to expand into new markets. These financing risks would be in the new company, not the old company.

There are limitations and potential disadvantages with such a restructuring approach that would need to be carefully evaluated and may require some creative solutions. First, Jeff may need the operating and asset base of Wilson Inc. to finance the expansion efforts. Various factors may influence this issue, including historical success patterns, the likelihood of future success, Jeff's track record and expertise, and other assets owned by Jeff. If this condition exists, it may significantly complicate the situation. Workable alternatives usually are available,

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194. *Id.* § 1014(a)(1).

depending on the flexibility of the lenders and Earl and Betty's willingness to take some risk to help with the financing. But clearly this can be a troubling complication.

The second potential disadvantage is the possibility that the value of Earl and Betty's common stock in the old company may continue to grow, with a corresponding increase in their estate tax exposure. There would be no automatic governor on the stock's future growth in value. Hopefully, this growth fear could be mitigated or entirely eliminated with a carefully implemented gifting program, the operation of Jeff's new company, and special incentives under the employment or management agreements.

A third potential disadvantage is that the employment or management contracts for Jeff would be subject to a special provision in Section 1366(e) of the Code that requires that a family member who renders services to an S corporation be paid reasonable compensation for those services.<sup>195</sup> Presumably, this requirement would not be a problem because the goal would be to adequately compensate Jeff and to provide him with attractive economic incentives to preserve the existing operations for the security of Earl and Betty.

Fourth, conversion to S corporation status likely would create additional tax challenges that usually are regarded as serious nuisances, not reasons for rejecting the strategy. These challenges are discussed in Section III.C. above. An immediate tax hit will be triggered if the company values its inventory under the LIFO method.<sup>196</sup> Additional taxes may be incurred in the future if shareholder distributions from the S corporation exceed earnings during the S period,<sup>197</sup> if assets owned by the S corporation at time of conversion are sold within the 10-year period following the conversion,<sup>198</sup> or if the net passive income received by the S corporation exceeds 25 percent of its receipts during a period that it has accumulated earnings and profits from its C existence.<sup>199</sup> Usually, these tax risks of conversion can be reduced to acceptable levels or eliminated entirely with careful monitoring and planning.

The plan design process should include an evaluation of business restructuring options that address specific family objectives. This may

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195. *Id.* § 1366(e).

196. *Id.* § 1363(d).

197. *Id.* § 1368(c)(2).

198. *See generally id.* § 1374.

199. *See generally id.* §§ 1375, 1362(d)(3).

allow the parents to rethink or slow down their stock transitions or to target the transitions to occur at key times, such as the death of the first parent. Although the tax challenges of a stock redemption require a complete disposition of the parents' stock, gifting and cross-purchase options may be implemented on a piecemeal basis to complement the business restructuring and to flexibly accommodate changed circumstances.

#### V. THE FAMILY PARTNERSHIP OR LLC—A COMPANION PLAY

Many family business owners want financial and estate plans that protect assets, preserve control, and save taxes. Perhaps no planning tools historically have been more effective in meeting these basic family objectives than the family partnership and the family limited liability company ("LLC"). These are flexible tools that can be crafted to accomplish specific, targeted objectives, including shifting income to other family members, maximizing wealth scattering gifting opportunities, protecting assets from creditors, and (the one that really drives the Service crazy) creating valuation discounts in the parents' estate by repackaging investment assets into discounted limited partnership interests. The wise use of a family partnership often can boost the performance of other planning tools, such as children and grandchildren trusts, dynasty trusts, and structured gifting programs.

If the family business is operated in corporate form, as most are, the family partnership or LLC usually will not be a vehicle for directly transitioning the stock of the corporation. A partnership or LLC may not own stock of an S corporation. And although stock of a closely held family C corporation could be contributed to a partnership or LLC, the benefits of doing so are highly questionable. There are three compelling tax problems. First, any earnings of the C corporation distributed as dividends to the shareholders, including the partnership, will be subject to both a corporate level tax hit and a shareholder dividend tax hit. This double tax burden eliminates the pass-through income benefits that partnership-taxed entities typically enjoy and will increase the expense and hassle of trying to use the partnership vehicle to shift income to other family members. Second, all losses generated by the C corporation will be trapped inside the corporation and will not pass through to its shareholders. Thus, the typical loss pass-through benefits of a partnership will not exist. Third, and of far greater concern, there is a

high risk that section 2036(a) would be applied to deny the parents the benefits of any valuation discounts that they may seek to claim as a result of the partnership structure. As discussed in Section E.2. below, section 2036(a) has been the most potent weapon used by the Service in racking up a series of victories against family partnerships in cases where the family has been unable to prove a legitimate and significant non-tax reason for the partnership.<sup>200</sup> If stock of a closely held family C corporation was transferred to a partnership in hopes of securing any valuation discount benefits on the death of a parent, a compelling argument could be made that the partnership served no legitimate and significant nontax purpose because the partnership simply held stock in a closely controlled family corporation, never functioned as a business enterprise, never engaged in any meaningful business activities, did not provide any additional limited liability or significant asset protection benefits, and was nothing more than a “recycling” vehicle motivated entirely by tax considerations. This was the reasoning that the Service argued and the Tax Court adopted in *Estate of Bongard v. Commissioner*,<sup>201</sup> a 2005 case where section 2036(a) was applied to tax the decedent’s estate interests in a limited liability company that had been transferred to a family limited partnership and thereby denied any valuation discounts claimed with respect to the partnership.

The formidable obstacles of using a family partnership or LLC to transition stock in a family corporation does not preclude such partnership or LLC from being part of the transition plan in many cases. If the family business is operated in a partnership or LLC or as a sole proprietorship, use of a partnership or LLC as the primary transition vehicle is a given. But in the great bulk of cases, those where the family business is conducted in a C or S corporation, the family partnership or LLC will serve a companion or supplemental transition strategy for valuable assets held outside the corporation that are ultimately targeted for those children who do not have career ties to the business. For example, in our case study Earl and Betty could form a limited partnership and transfer the real property that houses the business to the

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200. *Estate of Rosen v. Comm’r*, 91 T.C.M. (CCH) 1220 (2006); *Estate of Rector v. Comm’r*, T.C.M. (RIA) 1955 (2007); *Estate of Erickson v. Comm’r*, T.C.M. (RIA) 757 (2007); *Estate of Bigelow v. Comm’r*, 503 F.3d 955 (9th Cir. 2007); *Strangi v. Comm’r*, 417 F.3d 468 (5th Cir. 2005); *Estate of Hillgren v. Comm’r*, T.C.M. (CCH) 1008 (2004); *Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Estate of Thompson v. Comm’r*, 382 F.3d 367 (3d Cir. 2004); *Estate of Bongard v. Comm’r*, 124 T.C. 95 (2005).

201. 124 T.C. 95 (2005).

partnership in return for limited partnership units. Kathy and Paul, the outside children, would transfer other assets to a newly formed S corporation that they would own and control. The S corporation, in turn, would transfer its newly acquired assets to the partnership in return for general partner units. The S corporation, owned by Kathy and Paul, would be the sole general partner and have complete management authority of the partnership, and Earl and Betty would start out as the sole limited partners of the partnership. With this tiered structure, all parties would have limited liability protection for the activities of the partnership. Earl and Betty, the retiring parents, would be relieved of the burden of having to manage the real estate and negotiate with Jeff on matters related to the company's use of the real estate. Kathy and Paul, the children targeted to ultimately own the real estate with their families, would directly manage and control all issues relating to the real estate.

This partnership structure may provide some valuable tax saving opportunities. Earl and Betty could maximize the use of their annual gift tax exclusions and unified credits by transferring limited partnership units each year to their children and to trusts established for their grandchildren.<sup>202</sup> Because the limited partnership units have no control rights, the units would qualify for substantial lack of marketability and minority interest discounts. Lower values would permit more units to be gifted within the dollar limitations of the annual gift tax exclusion and unified credits. The gifts would not deplete Earl and Betty's more liquid investment assets, nor would they dilute the control rights vested in Kathy and Paul. As the gifts are made, the gifted units would be removed from Earl and Betty's taxable estates, and all distribution rights and income attributable to the gifted units would be shifted and taxed to other family members. Plus, any limited partnership units remaining in Earl and Betty's estates at death also may qualify for substantial lack of marketability and minority interest discounts because those units would have no control rights.

The potential to generate these valuation discounts makes the family partnership an attractive candidate in many transition plans. In 1959, the

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202. For grandchildren under age 21, simple 2503(c) trusts can be used to avoid future interest characterizations that would otherwise compromise the availability of the annual gift tax exclusion. I.R.C. § 2503(c). Plus, care should be taken to ensure that the each grandchild's trust is structured to avoid the generation skipping tax by having an inclusion ratio of zero. *Id.* § 2642(c)(2). Generally, this will require that the grandchild be the sole beneficiary during his or her life, and that the trust assets be included in the grandchild's estate if the grandchild dies before the trust terminates.

Service issued Revenue Ruling 59-60,<sup>203</sup> which set forth guidelines to be used in valuing the stock of a closely held corporation. Years later, in Revenue Ruling 68-609,<sup>204</sup> the Service stated that the valuation principles of 59-60 also would apply to partnership interests. The two most significant discounts associated with a minority interest in a closely held business enterprise are the minority interest (lack of control) discount and the lack of marketability discount. In devising a discount strategy for a family partnership, it helps to keep in mind differences between a partnership interest and stock in a closely held corporation. Both state law and the partnership agreement govern a partner's rights in a partnership, and it is not uncommon for both of these to impose substantial transfer restrictions. However, as discussed below, in devising a discount strategy, it is advisable to consider only state law restrictions.

The powerful tax benefits of family partnerships and LLCs have made them a popular target of the Service. The heat has been turned up over the last ten years as the Service has pulled out all the stops to shut down techniques that are designed to produce extreme tax savings. Some courts, including the Tax Court, have been willing accomplices on a few occasions. Key uncertainties still loom. Unfortunately, the thrust of the fighting has made everything harder. This is not to suggest that the family partnership or LLC is doomed as a planning tool or is only suited for those who have a cast-iron stomach and the will to invite an encounter with the government. What it does confirm is the importance of careful attention to detail, reasonable expectations, and a willingness to not push the evolving limits. Below is a review of some of the key elements that should be carefully evaluated in the design of any plan that incorporates a family partnership or LLC. Although the discussion continually references a "family partnership," the issues are the same for any family LLC that is taxed as a partnership.

#### A. *The "Real Partner" Requirement*

A family member will be deemed to be a partner for income tax purposes only if that individual is determined to be a "real partner," which requires that the transaction vest the family member with dominion and control over the partnership interest.<sup>205</sup> The Service has

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203. Rev. Rul. 59-60 1959-1 C.B. 237.

204. Rev. Rul. 68-609 1968-2 C.B. 327.

205. Treas. Reg. § 1.704-1(e)(1)(iii) (2006).

established a number of guidelines for determining whether a particular family member is a “real partner.”<sup>206</sup> No single guideline will determine whether a particular partner passes or fails the test. All factors need to be considered. Usually there is not a serious problem, but care should be taken in structuring the partnership or LLC agreement to ensure that it does not contain any one of a number of weird or unusual features. Following is a brief description of certain risky provisions that should be avoided in drawing the partnership agreement:

1. The partnership agreement should never state that there will be no cash distributions or that a particular partner will not receive any cash distributions. The family member who is precluded from participating in cash distributions likely will not be considered a real partner.<sup>207</sup> Generally, it is advisable to state in the partnership agreement that all cash in excess of the operating needs of the partnership will be distributed. If there is a need for the partnership to accumulate funds for a specific purpose, that need should be carefully documented from time to time.

2. Generally, it is not advisable to preclude a general partner from participating in the management of the partnership. That individual may not be considered a “real partner.”<sup>208</sup> The use of a limited partnership to preclude any control by limited partners, in and of itself, will not create a problem.<sup>209</sup> For this reason, it is generally advisable to use the limited partnership format when there is a desire to preclude certain family members from participating in the management.

3. A family partnership agreement should not contain severe buy-sell restrictions that prevent a partner from disposing of his or her interest in the partnership. Such provisions may preclude the partner from being considered a “real owner” for tax purposes.<sup>210</sup> The buy-sell provisions in the agreement may provide that, if a partner desires to dispose of his or her interest in the partnership, the other partners will have a first right to acquire such interest and other rights associated with the disposition of such interests. The key is not to be too strict in controlling the transfer of family partnership interests.

4. It is never advisable to allow minors to directly own interests in the

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206. *Id.* § 1.704-1(e)(2).

207. *Id.* § 1.704-1(e)(2)(ii)(a).

208. *Id.* §§ 1.704-1(e)(2)(ii)(d), 1.704-1(e)(2)(ix).

209. *Id.* § 1.704-1(e)(2)(ix).

210. *Id.* § 1.704-1(e)(2)(ii)(c).

partnership. Minors usually do not have the legal business capacity to protect themselves and may not be regarded as “real partners” for tax purposes.<sup>211</sup> A minor child’s partnership interest should be held in a trust for the minor, held by a guardian, or held by a custodian under the applicable Uniform Transfer to Minors Act.

*B. Most Suitable Assets*

Families often have flexibility in selecting the assets that will be transferred to a family partnership. Following are a few key points to keep in mind in selecting the best assets in a given situation:

1. Investments that generate income based on services rendered by a family member are completely inappropriate for a family partnership. As discussed below, the family partnership rule of section 704(e) generally requires that capital, as distinguished from personal services or labor, must be a material income-producing factor in the partnership.<sup>212</sup>

2. The stock of an S corporation should never be transferred to a family partnership. A partnership is not a qualified shareholder of an S corporation.<sup>213</sup> Any such transfer to a partnership will destroy the S election for the corporation.

3. Property that is expected to depreciate in value is not a good candidate for a family limited partnership. In most situations, gift transfers of partnership units to other family members will be sheltered from the gift tax through the use of the annual gift tax exclusion or through consumption of the parents’ unified credits. If the property depreciates following the transfer, all or a portion of these gift tax benefits will have been wasted.

4. Usually, it is not advisable to transfer to a family partnership assets that are expected to generate income tax losses for a period of time. In most situations, the parents will want to retain such assets in order to enjoy the write-offs.

5. Great care should be taken in transferring to a partnership real estate and other assets that are subject to a mortgage or other indebtedness. The transfer itself may trigger creditor’s rights under a due on sale clause or require some form of special consent from the lender.

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211. *Id.* § 1.704-1(e)(2)(vii).

212. I.R.C. § 704(e)(1) (2006); Treas. Reg. § 1.704-1(e)(1)(iv).

213. I.R.C. § 1361(b)(1)(B).

### C. *Income Shifting Limitations*

When partnership units are transferred to another family member, the income allocated to those units flows to that other family member. But there is a trap that should be watched whenever a family partnership is used to shift income among family members. The trap, found in Section 704(e) of the Code, can eliminate or dilute the income shifting advantage.<sup>214</sup> Four requirements must be satisfied to avoid the trap.<sup>215</sup>

1. Capital, as distinguished from personal services, must be a material income-producing factor in the partnership.<sup>216</sup> The capital can be in the form of tangible or intangible assets. Capital is not an income-producing factor when the partnership's income consists principally of fees, commissions, or other compensation for personal services. If the income is from investment assets or a business that requires substantial inventories or substantial investments in plant, machinery, or other equipment, this requirement usually will not be an issue.<sup>217</sup>

2. The partnership must be structured so that each partner really owns his or her capital interest—has dominion and control over the interest. This is the “real partner” requirement previously discussed. A limited partnership structure itself will not cause a problem under this “real partner” requirement.<sup>218</sup> Make certain that none of the unusual or weird provisions referenced above are included in the partnership agreement.

3. The donors, usually the parents, must be adequately compensated for services that they render to the partnership. If, for example, a parent works for a business that is owned by the partnership, the parent must be paid reasonable compensation for the services actually rendered.<sup>219</sup> If the parent is not fairly compensated, the trap kicks in to deny any allocation of the parent's service-related income to the children.

4. The partnership agreement may not allocate to the donee partners

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214. The section 704(e) provisions are not exclusive and do not provide a safe harbor against general assignment of income principles that may be applied to reallocate income among family members in extreme situations. Treas. Reg. § 1.704-1(e)(i)(b). See *Woodbury v. Comm'r*, 49 T.C. 180 (1967).

215. Section 704(e) applies to all gifts, including those made to non-family members. Plus, any partnership interest acquired by purchase from a family member is considered a gift for purposes of the section 704(e) provisions. I.R.C. § 704(e)(2) (2006). Family members include one's spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

216. *Id.* § 704(e)(1).

217. Treas. Reg. § 1.704-1(e)(1)(iv).

218. *Id.* § 1.704-1(e)(2)(ix).

219. I.R.C. § 704(e)(2).

(the children or grandchildren trusts) an interest in the partnership's income that is greater than their respective interests in the partnership's capital.<sup>220</sup> This requirement prohibits the use of special allocations that have the effect of allocating disproportionately large income shares to the donee children. The partnership income allocated to any donee should be proportionate to the capital owned by the donee. Some advisors question whether this requirement precludes special allocations of deductions within a family partnership agreement (i.e. depreciation deductions) that otherwise meet the requirements of section 704(b) and that have the indirect effect of allocating a proportionately larger share of the partnership's income to the donee children.<sup>221</sup> The safest and wisest approach is to assume that this requirement prohibits any such special allocations.<sup>222</sup>

#### *D. Creditor Protection Benefits.*

A family limited partnership, if properly structured and funded, can become a nuisance for judgment creditors. In most states, a judgment creditor is limited to obtaining a charging order against the partnership units and then petitioning to have the charging order "liquidated."<sup>223</sup> The charging order gives the creditor the right to receive income from the partnership when and if the income is distributed. It does not give the creditor the right to control or gain access to the assets that are actually held by the partnership.<sup>224</sup> The liquidation enables the creditor to become the owner of the limited partnership interest, but gives the creditor no access to the partnership property, no voting control or power, and no power to compel cash distributions. The nuisance factor of the limited partnership can be enhanced by transferring partnership units to other family members or to trusts strategically organized in states that have asset protection statutes or in select foreign countries. A combination of

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220. *Id.* § 704(e)(2).

221. *See* WILLIAM S. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMORE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS § 15.05[1][c] (4th ed. 2007) (discussing the issue and concluding that the section 704(e) limitations should trump any 704(b) allocation).

222. *See* Treas. Reg. § 1.704-1(b)(1)(iii).

223. *See* REVISED UNIFORM LIMITED PARTNERSHIP ACT § 7.03 (1976).

224. The creditors' rights are those of a transferee, which are limited to the partner's right to receive distributions from the partnership. *See* section 7.02 of the Revised Uniform Limited Partnership Act. For a description of the practical impacts of a charging order and how it often yields "little or nothing," see Author's Comments 8 & 9 of Section 504 of the Revised Uniform Partnership Act.

steps can be taken to create a number of obstacles that may discourage any creditor.

There is one additional aspect of the limited partnership device that makes it an even greater nuisance for the judgment creditor. Based on Revenue Ruling 77-137,<sup>225</sup> if a creditor secures a charging order against the partnership units, there is a high probability that the creditor will be taxed on its share of the partnership income as the owner of the units. If that income is retained in the partnership, the creditor may end up having to book phantom income for tax purposes. In effect, the charging order may become a poison pill for the creditor. If the creditor becomes a limited partner by having the charging order liquidated, there is little question that the income, phantom or real, will be taxed to the creditor.

#### *E. IRS Attacks on Family Partnerships*

Since the early 1990s, the IRS has used a variety of theories to attack the tax benefits of family limited partnerships. For simplistic purposes, these theories are lumped here into three categories.

The first category is the rejected theories. In the 1990s, the Service issued a host of Technical Advice Memorandums that denied valuation discounts on the theory that a family partnership was a sham transaction.<sup>226</sup> The theory was a loser in court, and the Service threw in the towel on the theory when, after a string of losses, the tax court awarded attorneys fees to an estate that was forced to defend against the theory.<sup>227</sup> The Service also has unsuccessfully argued that section 2703 (the Chapter 14 valuation provision for transfer restrictions) requires that partnership law restrictions should be disregarded in valuing transfers of property to limited partnerships and transfers of limited partnership interests.<sup>228</sup> Finally, the Service has futilely advanced a “gift on creation” argument, based on the theory that the excess of the value of the property contributed to a limited partnership over the discounted value of the partnership interest received in return constitutes a gift from

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225. Rev. Rul. 1977-1 C.B. 178.

226. I.R.S. Tech. Adv. Mem. 97-36-004 (June 6, 1997); I.R.S. Tech. Adv. Mem. 97-35-003 (May 8, 1997); I.R.S. Tech. Adv. Mem. 97-30-004 (Apr. 3, 1997); I.R.S. Tech. Adv. Mem. 97-25-002 (Mar. 3, 1997).

227. Estate of Dailey v. Comm’r, 2002 T.C.M. (RIA) 1816, 1818 (2002). See also Estate of Thompson v. Comm’r, 246 T.C.M. (CCH) 374 (2002); Knight v. Comm’r, 115 T.C. 506 (2000).

228. See Church v. United States, 85 A.F.T.R.2d 2000-804 (W.D. Texas 2000), *aff’d*, 268 F.3d 1063 (5th Cir. 2001); Estate of Strangi v. Comm’r, 115 T.C. 478, 448-89 (2000), *aff’d*, 293 F.3d 279 (5th Cir. 2002).

the contributing partner to the other partners. This theory, like the other two, has gone nowhere in the courts.<sup>229</sup>

The second theory category is the traps. These have some substance, but can be easily avoided with some simple planning. These are traps for the uninformed. The first is the application of the valuation limitations of section 2704(a) for lapsed voting or liquidation rights in the partnership agreement.<sup>230</sup> The key is to ensure that no person has the unilateral right to dissolve the partnership, that the death of a general partner will not dissolve the partnership, and that distributions must be made in cash out of the cash flow of the partnership (no in-kind distributions). The second is the application of the valuations limitations of section 2703 (the Chapter 14 valuation provision for transfer restrictions) to deny the valuation impact of restrictions in a partnership agreement to the extent that they exceed state law restrictions. To date, one district court has bought the theory.<sup>231</sup> What this means, as a practical matter, is that the discount valuation appraisals should specifically identify discounts based solely on state law restrictions, which in most cases will do the job. Finally, if a partner makes an additional contribution to a family partnership and receives no additional partnership interests, the Service will argue (successfully) that the contribution is an indirect gift to the other partners.<sup>232</sup> The planning point is to ensure that additional partnership interests are issued to any partner who contributes property to the partnership.

The third category is the scary theories. These theories potentially have real teeth in select situations and, if sustained, can undermine the value of the entire effort. The first relates to the denial of the annual gift tax exclusion on the gift of family limited partnership interests. The second relates to the application of section 2036(a) (the retained interest estate tax provision) to bring the value of the transferred partnership property back into the taxpayer's estate. These theories need to be carefully evaluated in each situation.

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229. See *Church*, 85 A.F.T.R.2d 2000-804; *Strangi*, 115 T.C. at 490-93.

230. I.R.C. § 2704(a) (2006). Under this section, certain lapses in voting and liquidations rights are treated as transfers for gift and estate tax purposes by the persons holding the rights. The holder of the right and his or her family members must control the partnership both before and after the lapse in order for the section to apply. *Id.* § 2704(a)(1). Any interest that is held directly or indirectly may fall within the scope of section 2704. Treas. Reg. § 25.2704-1(a)(2) (2007).

231. *Smith v. Comm'r*, 94 A.F.T.R.2d 2004-5627 (W.D. Pa. 2004).

232. I.R.S. Tech. Adv. Mem. 2002-12-006 (Nov. 20, 2001); *Shepherd v. Comm'r*, 115 T.C. 376, 388-90 (2000), *aff'd*, 283 F.3d 1258 (11th Cir. 2002).

*1. Family Partnership Interests and the Annual Gift Tax Exclusion*

The gift tax annual exclusion is applicable only to transfers of a present interest, not future interest transfers.<sup>233</sup> The Service has previously ruled that the transfer of a limited partnership interest would qualify as a gift of a present interest by virtue of the general partner's fiduciary duty to the limited partners and the limited partner's right to sell or assign the interest.<sup>234</sup> In 1997, the Service denied the annual exclusion (and found no present interest) in a case where the partnership agreement gave the general partner unlimited discretion over distributions ("for any reason whatsoever") and effectively prohibited the limited partners from assigning their interests.<sup>235</sup>

This was followed in 2002 by *Hackl v. Commissioner*,<sup>236</sup> where the Tax Court and the Seventh Circuit held that no present interest was transferred on gifts to forty-one donees where, among other things, the LLC would not produce any cash flow for many years and the donor, as the manager of the LLC, had control of all cash flow distributions, had the power to appoint his successor, had approval rights over any member's withdrawal, and had consent rights in his "absolute discretion" over any member interest sales. The court held that a transfer of an interest in a business entity did not automatically qualify as a present interest. A present interest would exist, according to the Tax Court, only if the donee received "an unrestricted and noncontingent right to the immediate use, possession, or enjoyment" of the transferred property or income from the property.<sup>237</sup> Unfortunately, neither the Tax Court nor the Seventh Circuit opinions clarify much for planning purposes. Surely, there is no requirement that the property be income-producing in order for the interest to qualify as a present interest if the donee has the power to sell the interest. And will the right to assign the interest suffice if the transferee has no right to become a substitute member or partner?

For planning purposes, what is clear is that, at a minimum, care should be exercised to spell out an objective standard for cash distributions, the general partner's fiduciary duty with respect to

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233. I.R.C. § 2503(b).

234. I.R.S. Priv. Ltr. Rul. 94-15-007 (Jan. 12, 1994); I.R.S. Tech. Adv. Mem. 91-31-006 (Apr. 30, 1991).

235. I.R.S. Tech. Adv. Mem. 97-51-003 (Aug. 28, 1997).

236. 118 T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003).

237. *Id.* at 293.

distributions, and the rights of partners to transfer or assign their interests subject only to a right of first refusal. As an added precaution, some believe that a partner's transfer rights should include the absolute right of the purchaser to become a substitute partner or member. In those situations where no income will be generated for a period of time and there is no market for the interests (a common scenario), an added precaution would be to offer the donee a Crummey-type withdrawal right for a limited period of time after the gift to strengthen the present interest argument.<sup>238</sup> The entity would agree to buy back the interest for a limited period of time for its fair market value and would be authorized to borrow funds to finance any such purchase. All the normal Crummey procedures would be followed. It might make sense in select situations.

## 2. *Partnership Donor's Status Under Section 2036(a)*

Section 2036(a) requires that a decedent's estate include any property transferred by the decedent during life if the decedent retains (1) the possession or enjoyment of the property or the income from the property or (2) the right (alone or in conjunction with others) to designate the persons who would enjoy the property. There is an exception that makes the provision inapplicable if the transfer is a bona fide sale for adequate and full consideration.<sup>239</sup> This provision is now the Service's most effective weapon against "bad fact" family partnership situations. It has been used recently to string together a series of victories against taxpayers who have pushed the limits.<sup>240</sup> If section 2036(a) is deemed to apply, the property transferred to the partnership is brought back into the decedent's estate for estate tax purposes and any gift tax exclusions and credits used in connection with gifts of limited partnership interests will have been wasted.

The starting point in the analysis is the exception. For it to apply so that section 2036 is rendered moot, there must be a "bona fide sale" and "full consideration." In the context of a family limited partnership, the

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238. N. Choate, Leimberg, *Estate Planning Newsletter* (April 4, 2002). For a brief description of Crummey withdrawal rights, see *supra* note 65.

239. I.R.C. § 2036(a) (2006).

240. Estate of Rosen v. Comm'r, 91 T.C.M. (CCH) 1220 (2006); Rector Estate v. Comm'r, 2007 T.C.M. (RIA) ¶ 2007 367; Estate of Erickson v. Comm'r, 2007 T.C.M. (RIA) 2007, 107; Estate of Bigelow v. Comm'r, 503 F.3d 955 (9th Cir. 2007); Strangi v. Comm'r, 417 F.3d 468 (5th Cir. 2005); Estate of Hillgren v. Comm'r, 87 T.C.M. (CCH) 1008 (2004); Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004); Estate of Thompson v. Comm'r, 382 F.3d 367 (3d Cir. 2004); Estate of Bongard v. Comm'r, 124 T.C. 95 (2005).

Tax Court and the circuit courts that have addressed the issue have held that the “bona fide sale” condition will exist if, as an objective matter, the transfer of property to the partnership serves a “substantial business or other non tax purpose.”<sup>241</sup> Subjective intentions of the parties will not suffice. Nor will non-tax purposes that are factually implausible or not supported by objective evidence. It is a factual issue that ultimately turns on whether the partnership has a bona fide business purpose or is just a vehicle to recycle the taxpayer’s wealth in hopes of securing big tax valuation discounts. Negative factors include the taxpayer’s ongoing financial dependence on income from the partnership’s property, the transfer of substantially all the decedent’s assets to the partnership, the commingling of personal and business assets, the failure to observe partnership formalities, the failure of the partnership to conduct any business activities, the transfer of only passive investments to the partnership, and the lack of any business rationale to support a plausible hypothesis that the partnership’s operations will produce an economic benefit at least as great as the claimed value loss triggered by the contributions to the partnership.<sup>242</sup>

If the “bona fide sale” condition is satisfied, the “full consideration” condition usually will be met if all corporate formalities are respected and, in exchange for the property transfer to partnership, the taxpayer receives a proportional interest in the partnership.<sup>243</sup> Thus, as a practical matter, the presence of a legitimate non-tax business purpose is the key to both requirements. If both requirements are satisfied, the transfer of property to the partnership will not trigger the application of section 2036.

If the exception does not apply for any reason, the issue becomes whether the taxpayer retained a “substantial economic benefit” from the property within the meaning of section 2036(a)(1). This requires an express or implied agreement that the taxpayer will retain possession or enjoyment of the property transferred to the partnership.<sup>244</sup> It too is a factual issue that usually turns on whether the evidence supports the existence of an implied understanding or assurance that the partnership assets would remain available to meet the personal needs of the

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241. *See supra* note 231.

242. *Id.*; *see also* Estate of Harper v. Comm’r, 2000 T.C.M. (RIA) ¶ 2000, 202.

243. *Strangi*, 417 F.3d 468; *Kimbell.*, 371 F.3d 257.

244. Treas. Reg. § 20.2036-1(a) (2007); *United States v. Byrum*, 408 U.S. 125 (1972); *Estate of Bigelow v. Comm’r*, 503 F.3d 955 (9th Cir. 2007); *Rosen*, 91 T.C.M. (CCH) 1220; *Strangi*, 417 F.3d 468.

taxpayer. Examples of negative facts include: partnership distributions to pay personal expenses; the taxpayer's free use of partnership property (i.e. a residence); the taxpayer's inability to support himself or herself after transfers to the partnership; the commingling of personal and partnership assets; the failure to maintain partnership capital accounts or observe other formalities; the absence or waiver of fiduciary duties relating to partnership distributions; partnership decisions based on the personal needs of the taxpayer; the taxpayer's right to change a general partner who is not subject to fiduciary duties; the taxpayer's power to liquidate the partnership; the taxpayer's power to control the income flow to the partnership; the use of partnership property to secure debts of the taxpayer; disproportionate distributions to the taxpayer; and payment of excessive management fees to the taxpayer.<sup>245</sup> The bottom line is that the taxpayer must be in a position to show that the partnership operates as a business in accordance with sound business practices and not as a personal tool of the taxpayer.

Even if the taxpayer is not deemed to have retained a substantial economic benefit, there may still be a problem under section 2036 if the taxpayer is deemed to have retained the right to designate the persons who could enjoy the property within the meaning of section 2036(a)(2). The application of this provision to a family limited partnership is unclear, at best. The few cases that have considered the issue involved extreme facts where the taxpayer had broad discretion to distribute income free of any fiduciary restraints or broad powers to remove or replace general partners or liquidate the partnership.<sup>246</sup> Nevertheless, some of the dicta in these cases suggest that this provision could prove troublesome even in more vanilla scenarios where the taxpayer owns a substantial interest in the general partnership. Some (including myself) do not believe the provision should apply in such situations so long as there is an objective standard for making distributions, the taxpayer is subject to normal general partner fiduciary duties, and the taxpayer possesses no special rights to liquidate the partnership or access partnership assets. Additional precautions may include vesting distribution decisions in a general partner who is not the taxpayer or

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245. *Strangi*, 417 F.3d 468; *Estate of Hillgren*, 87 T.C.M. (CCH) 1008; *Kimbell*, 371 F.3d 257; *Thompson*, 382 F.3d 367 (3d Cir. 2004); *Bongard*, 124 T.C. 95; *Bigelow*, 503 F.3d 955; *Rosen*, 91 T.C.M. (CCH) 1220.

246. *Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd on other grounds*, 417 F.3d 468 (5th Cir. 2005); *Kimbell v. Comm'r*, 244 F. Supp. 2d 700 (N.D. Tex. 2003), *rev'd on other grounds*, 371 F.3d 257 (5th Cir. 2004).

having the taxpayer own no interest in the general partnership.<sup>247</sup>

The uncertainty associated with section 2036(a)(2) is particularly disturbing in those common scenarios where limited partnership interests are gifted. Such gifts will never fall within the “bona fide sale” exception, but generally should not present a retained economic benefit problem under section 2036(a)(1) if there is no evidence suggesting that the taxpayer retained any right to enjoy the transferred partnership interest or the partnership assets attributable to the interest. Whether the right “to designate” prohibition can be extended to snare common, non-abusive uses of the family limited partnership is yet to be determined. The Supreme Court’s interpretation of the provision’s application to trusts in the famed case of *United States v. Byrum*,<sup>248</sup> coupled with the fact that the issue has surfaced only in factually “bad fact” difficult family partnership cases that have raised all the section 2036 issues, suggest that the provision should not be applied in such a broad fashion.

#### F. *The Family Partnership “Freeze”*

Great care should be exercised in the design of any transition plan that may include a family partnership freeze transaction where fixed preferred partnership interests are retained by the parent and growth partnership interests are transferred to the children. This freeze structure is the partnership equivalent of the corporate preferred stock freeze discussed in section IV.A.4 above. The only difference is that the preferred equity interest is offered in a partnership context and thus avoids the double income tax burdens of preferred stock. Like the preferred stock freeze, the gift tax impacts of the structure are governed by section 2701. That section requires that the value of the preferred interest retained by the parents be based on the fair market value of a fixed cumulative rate of return on such preferred interest,<sup>249</sup> and that the subtraction method be used to determine the corresponding value of the growth interest for gift tax purposes.<sup>250</sup> Plus, the same 10 percent minimum value of the growth interest transferred to the children is

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247. See generally Mitchell M. Gans & Jonathan G. Blattmachr, *Strangi: A Critical Analysis and Planning Suggestions*, 100 TAX NOTES 1153 (Sept. 1, 2003); Ronald H. Jensen, *The Magic of Disappearing Wealth Revisited: Using Family Limited Partnerships to Reduce Estate and Gift Tax*, 1 PITT. TAX REV. 155 (2004).

248. 408 U.S. 125 (1972).

249. I.R.C. § 2701(a)(3)(A), (c)(3) (2006).

250. Treas. Reg. §§ 25.2701-1(a)(2), 25.2701-3 (2007).

applicable.<sup>251</sup>

The section 2701 limitations are an insurmountable barrier in many situations. Often the fair market value of the preferred interest retained by the parents (which is set by appraisal) will have a value equal its face value only if the fixed distribution rate on such preferred interest is set at a level that, as a practical matter, exceeds the projected annual growth rate of the business. In such a situation, the freeze transaction will produce no transfer tax savings benefits. For this reason, the freeze strategy should be considered only in those rare situations where there is a real expectation of extraordinarily large future asset appreciation that will balloon an existing estate tax exposure. If the qualified income interest on the preferred units retained by the parents is not properly structured, any transfer of growth interests to the children may trigger an unwelcome gift tax.

## VI. INSIDE/OUTSIDE CHILDREN—AVOIDING A WAR

Transitioning a family business usually is tougher when some children work in the business and others do not. This is a fairly common scenario. In our case study, Earl and Betty own a business that they worked their entire lifetimes to build. They have three children; Jeff is a key insider, and Kathy and Paul have careers outside the business. Like many parents in this situation, Earl and Betty view the business as an economic investment that has become part of the family culture. Since the business represents the bulk of their estate, they assume that each child will eventually inherit an interest in the business.

Problems often surface in any family business owned by inside and outside children. The problems can lead to imprudent business decisions, costly tax consequences, and conflicts that can and often do drive a permanent wedge into sibling relationships. The planning challenge is to anticipate the potential conflicts, based on an honest assessment of the specific facts, and then implement one or more strategies that may mitigate any adverse effects. Often the best strategies are those that eliminate the source of the conflict—joint ownership of the business. Each child receives a fair share of the parents' estate, but the insiders end up with sole ownership of the family business. When this is not possible, other strategies, often perceived as less attractive, may be used to mitigate adverse tax and control issues triggered by the joint

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251. I.R.C. § 2701(a)(4)(A).

ownership by inside and outside children. Following is a review of the select strategies that may be considered.

*A. The Insider Installment Sale*

The insider installment sale strategy assumes that the parents, Earl and Betty in our case, are willing to exit the business while they are living. With this strategy, the parents sell all of the stock to the company, a grantor trust, or the insiders and take back a long-term note. If the company is the purchaser, the parents should have no further role in the business.<sup>252</sup> When the parents die, the note becomes part of their estate and passes to all their children, along with the other assets of their estate.

Although often used, this strategy has some significant disadvantages. The sale will trigger an income tax burden for the parents and any children who inherit the unpaid note obligation.<sup>253</sup> The lifetime sale eliminates any basis step-up potential at death unless the sale is structured to occur on or after the death of the first parent. Plus, the purchaser (either the insiders, a trust for the insiders, or the company) must fund the principal payments on the note with after-tax dollars, and the parents have a wasting asset (the promissory note) that may not sustain them, let alone provide anything for the outside children. For these reasons and others, an insider installment sale during the life of the parents, although preferred in select situations, often is not the solution. Many parents prefer a strategy that will allow them to retain control and stay in the driver's seat, while ensuring that each child will ultimately receive a fair share of their estate.

*B. Other Asset Equalizing*

The second strategy is simple and attractive if the numbers work. The solution is to leave the outside children assets other than the family business. The family business stock owned by the parents passes to the inside children, and other assets of equal value per child pass to the outside children. Any remaining assets after this equalizing allocation are allocated among all the children in equal shares. The result is that the inside children receive all of the interests in the business, plus possibly some other assets, and the outside children do not receive any stock in

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252. I.R.C. § 302(c)(2)(A)(i). See related discussion *supra* IV.B.

253. Any remaining payments on the note that are paid to the children will be taxed to the children as income in respect of a decedent under I.R.C. § 691(a).

the family business, but end up with property having a value equal to that received by the inside children. In this situation, it is important to carefully coordinate the provisions of the parents' wills or living trust with the disposition of other assets that will pass outside such documents, such as the proceeds on life insurance policies, retirement plan benefits, and other similar assets. These other assets must be considered in determining equality among the children and in properly structuring how the business interests are to be distributed to the inside children.

There is a common obstacle to the simple strategy of giving the business to the inside children and other assets of equal value to outside children. In many situations, the business constitutes the bulk of the parents' estate. There are not enough other assets to cover the outside children. In Earl and Betty's situation, the business, valued at \$10 million, represents more than 55 percent of their \$18 million estate and they have three children. The math does not work. In situations like this, often the preferred solution is to provide in the parents' wills or living trust that the estate of the parents will be divided among the children equally and that, in making the division, the inside children will first be allocated equity interests in the family business. To the extent that the value of total business equity interests owned by the estate exceeds the value of the equity shares allocated to the inside children, the inside children are given the option to purchase the additional business interests from the estate, before the final distributions are made to all children. This enables the inside children to acquire all of the equity business interests owned by the estate, while at the same time passing an equal date-of-death value to each child.

In creating the option, the two most critical elements are the price of the business interests to be acquired by the inside children and the terms of payment. The price may be set at the value finally determined for federal estate tax purposes. If there is no federal estate tax return required, or if the parents want a more specific basis for determining the purchase price, they may specify a valuation formula or an appraisal procedure, similar to what is often included in a buy-sell agreement among co-owners. The key is to make sure that there is either a value established or a method for determining the value so that there is little or no basis for a dispute over price. In rare cases, the parents may choose to name a non-child as the personal representative of the estate and allow that "independent" personal representative to determine the price, using whatever assistance he or she deems appropriate. In determining the

method of payment for the option price, care should be taken to make sure that the required cash flow payments do not jeopardize the ongoing success of the business. For many businesses, the death of the owner may create a significant disruption in cash flow, apart from the need to make large cash payments to the outside children. One obvious solution is to provide for a long-term installment payout of the price, securing the payment obligation with the pledge of the stock being purchased. Since the inside children will be purchasing only a portion of the equity business interests owned by the estate, often the installment payment method will fit within the cash flow parameters of the business.

In some cases, it may be prudent to fund the buy-out price in whole or in part with life insurance on the parents. The inside child, Jeff in our case, owns the policies and uses the proceeds collected on the parents' deaths to buy the equity business interests from the estates. Often, the inside children do not have enough surplus cash flow to fund the premiums on the life insurance policies. So in many cases, the company bonuses the inside children sufficient amounts to cover the premiums and any tax hit on the bonuses. Some parents view this insider insurance funding bonus mechanism as a deviation from the overall objective to treat all children equally even though it ultimately provides the outside children with cash instead of an installment note from the insiders. If the parents share this view, the parents' wills or living trust may be structured to equalize such insurance bonuses among the children by requiring that, for allocation purposes only, all bonus insurance payments to the insiders must be added to the total estate value and be treated as payments already credited to the inside children.

The parents may prefer to have the company itself fund the insurance premiums, own the policy, collect the death benefit, and use the proceeds to redeem from the estate the business interests that exceed the equal shares of the estate allocable to the inside children. This approach has a few significant disadvantages. It eliminates the ability of the inside children to benefit from the stepped-up basis in the stock that would result if they purchased the stock directly. Plus, if the company is a sizable C corporation (annual gross receipts in excess of \$7.5 million), the company's receipt of life insurance proceeds may trigger an alternative minimum tax.<sup>254</sup>

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254. I.R.C. §§ 55(e), 56(g).

*C. Real Estate and Life Insurance Trade-Offs*

A partial solution to the inside-outside child dilemma may exist when a portion of the value of the family business is real estate owned by the parents directly. Often the parents own business-related real estate outright or in a separate pass-through entity, such as a partnership or an LLC. The real estate is leased to the operating business, usually a corporation. In those situations where the value of the overall business, including the real estate, exceeds the value of the estate shares allocable to the inside children at the death of the parents, the preferred solution may be to leave the outside children the business real estate and the inside children the business. If the value of the real estate exceeds the equal shares allocable to the outside children, a portion of the real estate may also be allocated to the insiders so that the overall shares passing through the estate are equal. If the value of the real estate is not sufficient to equalize the shares (the more common scenario), this strategy may be combined with one of the other strategies to achieve an overall equal allocation.

When this real estate strategy is used, care needs to be taken to mitigate conflicts that may surface between the insiders who own the business and need use of the real estate and the outside children who own the real estate and want to maximize its earning potential. If the real estate is essential to the success of the business, leaving the real estate to the outside children creates the potential for conflict. The solution is to make sure that, at the appropriate time, the operating company enters into a lease that secures its rights to the use of the real estate. The lease should be for a long term and provide the company with a series of renewal options. The lease payment obligation of the company should be adjusted periodically to reflect a fair market rent for a long-term single user tenant. This will help ensure that the outside children realize the benefits of the income and value elements of the real estate that is left to them. The lease, for example, may require that, unless the parties agree otherwise, independent appraisers will be used every five years to adjust the rent to reflect current market values and to set annual escalators in the rent for the next five years. The lease should spell out the rights and obligations typically included in commercial leases between unrelated parties, including the parties' respective obligations to maintain and repair the building and to pay real estate taxes and insurance premiums.

A similar trade-off opportunity may exist if one or both of the parents are insurable and there is no desire to hassle with the complexities of the

other options. Life insurance may provide a solution. The parents acquire a life insurance policy through an irrevocable trust. It may be a second-to-die policy that pays off on the death of the surviving spouse. The beneficiaries of the life insurance trust are the outside children. The amount of the life insurance is based on the mix and value of the other assets in the parents' estate to ensure that there will be sufficient assets to fund the tax and liquidity needs of the estate and to provide each outside child with a benefit equal to the value of the family business interest that will pass to each inside child.

*D. King Solomon Solution*<sup>255</sup>

In select situations, the best solution to the inside-outside children conflict may be to do what King Solomon proposed—cut the baby into two pieces. One piece of the business goes to the inside children, who can manage and grow it. The other piece is sold for the benefit of the outside children. Of course, the solution has merit only in those situations where the business can be divided into profitable pieces, one of which can be sold. It is not a viable option for most businesses, but it may be attractive in those situations where the business has separate divisions or facilities, only some of which are of interest to the inside children or, because of their size, are incapable of being purchased by the inside children. Also, it may be the answer in those situations where there are conflicts among different inside children who work in separate divisions of the family business. Instead of forcing the insiders to coexist in the same company, the company may be divided, and each insider may be given his or her own company to manage.

In cases where a division makes sense, the tax challenge is to divide the company into pieces without triggering a taxable event. For partnership-taxed entities, there is seldom a problem. Corporate entities also can make it work if the division is structured as a spin-off, split-off, or split-up that qualifies as a tax free D reorganization.<sup>256</sup>

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255. The biblical King Solomon, when faced with two women each claiming to be the mother of a baby, proposed the ultimate solution—divide the baby in half. 1 *Kings* 3:16–28.

256. I.R.C. § 368(a)(1)(D). If done right, the assets of a C corporation (referred to as the “distributing corporation”) can be transferred to multiple C corporations (referred to as “controlled corporations”), and the stock of the controlled corporations can be distributed to the shareholders of the distributing corporation, all tax free. I.R.C. §§ 355(a), 361(a), 1032(a). Six requirements must be satisfied: (1) A control requirement governed by I.R.C. §§ 355(a)(1)(A) and 368(c); (2) A complete distribution requirement governed by I.R.C. § 355(a)(1)(D); (3) A five-year active trade or business requirement governed by I.R.C. § 355(a)(1)(C) and Treas. Reg. § 1.355-3 (2007); (4) A 50 percent

The foregoing strategies are geared at providing the outside children with a fair share of the parents' estate without them ever acquiring an interest in the business. Often it is inevitable that the outside children are going to end up owning an interest in the company on the death of the parents. There may be insufficient other assets and insufficient cash flow to implement a strategy that gives each child an equal share while keeping the outsiders out of the business. Or it may be one of those situations where the family business is an integral part of the family culture that binds everyone, and the parents and the children want all family members to own a part of the culture. Whatever the reason, the parents want a strategy that will enable each child to own an interest in the business and that will reduce or eliminate potential conflicts between the insiders and the outsiders. The following strategies are potential candidates in those situations.

*E. Preferred Stock Recapitalization*

One option is for the parents to leave preferred stock to the outside children and common stock to the inside children. The value of the preferred stock often is capped so that all of the future growth in the business shifts to the owners of the common stock—the inside children. The preferred stockholders typically are given a priority right to receive their share values on liquidation before any amounts are paid to common stockholders (hence the name “preferred”), thus shifting all value losses first to the common stockholders (the insiders). This shifting of the future risk of loss to the common stock usually is regarded as an appropriate tradeoff for also shifting the future growth to the common stock. Generally, preferred stockholders are given a fixed cumulative income right, although there are a wide variety of income rights that can be granted to preferred stockholders.

One advantage of using preferred stock for the outside children is that it reduces the potential conflict between the insiders and outsiders regarding income distributions being structured as compensation or dividends payments. If the insiders and outsiders both own common stock, the outsiders will have a vested interest in dividends, while the insiders will favor compensation payments. With preferred stock, the dividend rights of the preferred stockholders (the outside children) are

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continuity of interest requirement governed by Treas. Reg. § 1.355-2(c)(2); (5) A business purpose requirement governed by Treas. Reg. § 1.355-2(b)(2); and (6) A no dividend “device” requirement governed by I.R.C. § 355(a)(1)(B) and Treas. Reg. § 1.355-2(d).

fixed and are not dependent on the payment of dividends on the common stock. So the outsiders have no incentive to push for more common stock dividends and less compensation for the insiders. In fact, as owners of preferred stock, the outsiders may prefer the compensation characterization for all payments to the insiders because of the tax savings to the company. Although the outsiders' concern over the characterization of the insider payments is gone, the amounts paid to the insiders, however characterized, may still be a source of conflict to the extent there is any uncertainty regarding the company's capacity to pay dividends on the preferred stock, now or in the future. Excessive compensation payments or common stock distributions to insiders in early years may hinder the corporation's ability to fund preferred stock dividend payments in later years. A solution to this potential conflict may be a shareholders' agreement between the parties that conditions additional payments to the insiders on the company maintaining defined liquidity ratios (e.g. current ratio or acid-test ratio) and debt-to-equity ratios. Such ratio conditions, if fairly structured, may provide the outsiders with comfort that the insider payments will not impair the company's ability to fund preferred dividends and provide the insiders with the desired flexibility to increase their incomes free of outsider hassles, as they grow the business.

Preferred stock can either be voting or nonvoting. If the objective is to keep control in the hands of the insiders while the outsiders collect their preferred dividends, nonvoting preferred may seem to be the obvious choice. But with nonvoting preferred, the inside children have control over whether and when preferred dividends get paid and, absent an agreement to the contrary, their own compensation levels. Of course, dividends on the insiders' common stock must take a back seat to preferred dividends to the outsiders, but this likely will be an irrelevant concern because of the double tax hit on dividends generally and the insiders' capacity to set their own compensation and bonus levels.

Often there is a need for creativity in this situation. As described above, one option is ratio requirements, contractually protected through an agreement between all the shareholders. Another option is to make the preferred stock nonvoting only so long as the dividends on the preferred stock are timely paid. If the dividends ever become delinquent, then the preferred stockholders acquire voting rights that remain forever or until specified conditions are satisfied. This option gives the insiders a strong incentive to always keep the preferred dividends current. But if things get bad, the preferred stockholders have voting rights and can

involve themselves in the challenges of the business.

With this preferred stock strategy, there are three tax issues to consider. First, the conversion of the parents' common stock to both common and preferred stock should be structured to qualify as a tax-free recapitalization.<sup>257</sup> Second, after such a recapitalization, any gifts of common stock to the insiders by the parents during life will be subject to the valuation rules of section 2701.<sup>258</sup> Generally, the value of the preferred (determined by appraisal) will be based on its fixed dividend rate, and the value of the common will equal the total equity less the value of the preferred. Third, and usually of greater significance, dividends on the preferred stock will be subject to a double tax—one at the corporate level and one at the preferred shareholder level. The most common solution to the double tax problem, the election of S corporation status, is not available because S corporations cannot have preferred stock.<sup>259</sup> So although the preferred stock solution addresses some of the conflicts of passing business interests to both inside and outside children, it does so at a tax cost.

#### *F. Preferred Interests in a Limited Partnership or LLC*

In select situations, a family limited partnership or family LLC may be used to transfer preferred units to the outside children and growth units to the inside children and avoid the double tax burdens of a C corporation. The preferred interest for the outside children is in the form of a preferred limited partnership or LLC interest rather than a preferred stock interest. The preferred partnership or LLC interest can be structured to have all of the elements of C corporation preferred stock: capped liquidation rights; preferred liquidation rights; and fixed, preferred income distribution rights. Also, the limited partnership or LLC agreement may be structured to give the preferred partnership interest holders voting rights in the event the preferred income distributions become delinquent, just as discussed in connection with preferred stockholders.

There are a few principal distinctions between the preferred interest approach using a family limited partnership or LLC and the preferred stock approach using a C corporation. The first difference is the

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257. I.R.C. § 368(a)(1)(E). *See* related discussion *supra* note 140.

258. *See generally* I.R.C. § 2701. *See* related discussion *supra* section IV.A.4.

259. I.R.C. § 1361(b)(1)(D).

elimination of the double tax problem. With the family partnership or LLC, the payment of preferred partnership distributions to the outside children does not result in double taxation because the partnership is not a tax-paying entity. A second distinction is a negative factor that can be neutralized with a little added complexity. When there is a family limited partnership, the general partners have personal liability exposure for the debts of the company. If the inside children are the general partners, they will have personal liability exposure. One solution to this liability problem is to have the inside children hold their general partner interests through an S corporation. This introduces another entity into the equation, but the added expense and complexity usually are minimal. Another alternative is to use an LLC rather than a limited partnership. The LLC can be structured to eliminate personal liability exposure for all its members while spelling out the preferred and limited rights of the outside children. A potential negative of the LLC is that the limited rights of the outside children are a function of negotiation and agreement. In a limited partnership, the status of being a “limited partner” usually does the job automatically.

There is a huge obstacle, often insurmountable, to this strategy of using a family partnership or LLC when the business has been operated as a C corporation. That obstacle is the tax cost of converting from a C corporation to a partnership-taxed entity. Such a conversion triggers a tax on all built-in gains for the corporation, followed by a tax at the shareholder level.<sup>260</sup> The impact of these taxes often makes it prohibitively expensive to even consider converting from a corporate form to a partnership or LLC form.<sup>261</sup> For this reason, the strategy is limited to those situations where the business is already operated in a partnership or LLC or as a sole proprietorship.

#### *G. S Corporation Voting and Nonvoting Stock*

An S corporation may issue voting and nonvoting common stock, but not preferred stock.<sup>262</sup> If the family business has been operated in an S corporation or has recently converted from C to S status, the transition plan may be structured to have the parents transfer nonvoting common

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260. I.R.C §§ 331, 336.

261. If, for example, the corporation is subject to a 34 percent marginal tax rate and the shareholder pays a 15 percent capital gains rate, the combined tax burden on any distributed appreciation in the liquidation will be 43.9 percent [ $34 + (15 \times (1-34))$ ].

262. Treas. Reg. § 1.1361-1(l)(1).

stock to the outside children and voting common stock to the inside children. Often when nonvoting stock is used, the outside children are given limited control rights through a shareholder agreement that kicks in under defined conditions. Usually income distributions are the biggest challenge with this S corporation strategy. The primary advantage, of course, is that dividends of S corporation earnings can be distributed to both the insiders and the outsiders free of any double tax concerns. But if the insiders have control, they will have the ability to pull out substantially all of the earnings of the corporation, or at least a disproportionately large amount, in the form of compensation payments. A solution is for the parents, either during life or through their estate plan, to impose contractual compensation limitations on the insiders. Usually this is done with mandated employment agreements. The insiders' compensation under the employment agreements can be based on a formula that provides strong incentives for the insiders to grow the business, while ensuring that the income interests of the outsiders are protected.

Two keys factors should be considered in the planning process whenever equity interests are given to both the inside and outside children. First, future value growth may be a concern of the insiders. Depending on the nature and terms of the interest given to the outsiders, the outsiders may have a right to participate in equity growth generated by the business. This may dilute the insider's incentive to grow the business. The issue may be addressed, although usually not completely solved, by special compensation incentives for the insiders. The inside children may be granted stock appreciation or phantom stock deferred compensation rights that give them a larger stake in the future growth of the enterprise. Second, any strategy that passes ownership interests to multiple family members should include a properly structured buy-sell agreement to ensure that all interests are maintained within the family and that adequate exit options exist when a family members dies, becomes disabled, gets divorced, encounters credit problems, or wants out.

## VII. CONCLUSION

Every family business transition plan should be a custom job. Stock solutions do not work and often will do more harm than good. The initial driving force in the planning process should be those factors that shape the non-tax needs and objectives of the family—the parents' financial

security; the expectations and aspirations of the children (both insiders and outsiders); the retirement plans of the parents; the strength, durability, and cash needs of the business; the relative ages, health and life expectancies of the parents; realistic assessments of future opportunities for value growth; the nature and scope of non-business assets; the liquidity needs of the family; life insurance options; and all the other concerns and desires of the particular family. Certain elements need to be carefully evaluated in every plan, including transition timing, the smart use of the marital deduction, entity restructuring options, and compensation planning for those family members who make the business their career. Care must be exercised to anticipate and avoid various traps that can trigger unpleasant surprises and dilute the entire planning effort.

Usually the driving tax fear is the potential impact of a large estate tax bill on the death of the surviving parent. In select situations, a tax-protected life insurance policy owned by an irrevocable trust will quell the fear. But many families want or need something more than just a funding mechanism for the ultimate tax bill; they want to implement strategies that will meaningfully reduce the bill. Certain strategies, particularly those that leverage the parents' gift tax annual exclusions and generate favorable valuation discounts, will produce positive tax savings even if the future growth in the value of the business is modest or nonexistent. These strategies should be given high priority in the tax design of any plan. The tax value of other strategies, including many of the most complicated, is predicated entirely on the extent of the future value growth of the business. If there is no significant value growth, the strategy may produce little or no estate tax saving, trigger needless income and gift tax consequences, and create useless complications for the family. Some families will want and need to explore every available tax savings option. For many others, less will be more. In each situation, the challenge is to carefully develop and implement over time the best mix of tax strategies that realistically reflect the prospects for the business, address the family's non-tax objectives, and conform to the family's tolerance for complexity.