

EFFECT OF THE 1976 TAX REFORM ACT ON STOCK BUY-OUT AGREEMENTS AND OTHER CLOSE CORPORATION PLANS

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The owner of a controlling block of stock in a profitable closely held corporation is often in an enviable but difficult situation. Enviable because he controls the terms of his own employment, compensation and fringe benefits and because he has an asset constantly appreciating as earnings are plowed back into the business. Difficult, because upon his death the stock is likely to generate an estate tax in an uncertain amount which requires cash hard to come by in view of the limited marketability of such stock and because although there may be cash in the corporation, its distribution to the shareholder or his estate may occasion a taxable dividend.

Congress has been sympathetic to the estate tax problems of the close corporation stockholder and has sought in various ways to ease this tax burden.¹ At the same time, there is a strong congressional policy to tax all corporate earnings twice, first at the corporate level and then at the shareholder level. The way in which the conflict between the divergent policies is resolved has been changed substantially by the 1976 Tax Reform Act. These changes in turn have a profound impact on planning for the disposition of closely held stock.

This article is intended to provide temporary guidance for attorneys asked to advise on buy-out agreements, recapitalizations, and other non-testamentary arrangements relating to the stock of closely-held companies. The article therefore will begin with a brief discussion of those provisions of the new law that bear on estate planning involving close corporations.² This discussion may be used as a check list in reviewing existing plans for any necessary changes. The article then will deal in a more general way with the effect of the law on certain pervasive problems in this area: the desirability of reducing the value of closely held stock, the selection of commonly used corporate capital structures, the choice between cross purchase and redemption agreements, and finally, the role of life insurance in close corporation planning.

Temporary guidance is all that can be provided now, for there are virtually no regulations under the relevant provisions of the new law. Further, the air is filled with suggestions to change various parts of the Tax Reform Act,³ to say nothing of more far reaching proposals such as the in-

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¹ See I.R.C. §§ 303, 6166, 6166A, 6161. See text at notes 63-74 *infra*.

² For excellent discussions of these problems under prior law, see the following articles, large portions of which are still relevant today: Barton, *Methods of Terminating Stockholder Interests in Closely Held Corporations*, 32 N.Y.U. INST. FED. TAX. 811 (1974); Meyer, *Avoiding Adverse Tax Consequences in the Operation of a Closely Held Corporation*, 32 N.Y.U. INST. FED. TAX. 731 (1974); Goldstein, *Stock Redemptions and the Attribution Rules*, 27 N.Y.U. INST. FED. TAX. 793 (1969).

³ H.R. 6715, 95th Cong., 1st Sess. (1977) as reported by the House Committee on Ways and Means on October 12, 1977, 123 CONG. REC. H10,876 (daily ed. Oct. 12, 1977) and passed by the House on October 17, 1977, 123 CONG. REC. H11,094-11,112 (daily ed. Oct. 17, 1977).

tegration of corporate and individual taxes, the elimination of special tax benefits for capital gains and the realization of gains at death. All of these would, of course, have a tremendous impact on planning for the close corporation.

Given the present uncertainties, some cautionary remarks are in order. First, before acting on what is written here, the reader should check for changes in the rules. Second, in planning, the reader should not try to be "too cute," to go too close to the borderline, for these lines are still shifting, and one who is just safe today may be just sorry tomorrow. Finally, it is important in developing plans now to make a conscious effort to keep options open and to schedule periodic reviews that will provide an opportunity to adapt plans to changing law as well as changing facts.

It would be tempting under the circumstances to say "wait until the dust settles." But since dying owners of closely held companies cannot take their stock with them, their stock is bound to be disposed of on some basis. Planning based on the new law should be better than no planning at all.

I. THE PERTINENT PROVISIONS OF THE NEW LAW

Many of the changes enacted by Congress in the Tax Reform Act of 1976 affect the broad spectrum of estate taxation.⁴ The act altered the tax rate applicable to estates, generally reducing taxes on estates below \$1,200,000 and over \$9,350,000 and increasing them on estates between these amounts.⁵ Congress also increased the marital deduction for smaller estates,⁶ reducing the tax liability of the estate and the beneficiary spouse,⁷ but at the same time it required the inclusion in the estate of lifetime taxable gifts,⁸ increasing the tax liability. These changes, although not specifically relevant to close corporations, must be taken into account in planning for the owner of stock of a close corporation, since all have a bearing on the tax burden and the liquidity needs of an estate.

Other changes bearing on liquidity projections relate specifically to close corporations and are discussed below. These include some which are likely to reduce liquidity needs, such as special valuation for real estate⁹ and new provisions to defer payment of estate tax for reasonable cause¹⁰ or because a large percentage of holdings is represented by close business interests or farms.¹¹ However, also included are changes such as the carryover of basis and the resulting income tax on sales or redemption of close corporation stock,¹² the barring of section 303 redemptions for many estates that formerly were eligible for such treatment¹³ and changes in the

⁴ For an outstanding discussion of the relatively limited effect of the new law on major estate planning, see Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

⁵ I.R.C. § 2001.

⁶ See I.R.C. § 2056(c)(1)(A).

⁷ See in this issue Piper & Fremont-Smith, *Principles for Effective Use of Marital Deductions*, at p. 403 *supra*.

⁸ See I.R.C. § 2056(c)(1)(B).

⁹ I.R.C. § 2032A. See text at notes 54-62 *infra*.

¹⁰ I.R.C. § 6161. See text at note 74 *infra*.

¹¹ I.R.C. §§ 6166, 6166A. See text at notes 67-73 *infra*.

¹² See I.R.C. § 1023(a). See text at notes 15-24 *infra*.

¹³ See text at notes 32-40 *infra*.

taxation of income in respect of a decedent.¹⁴ All of these are likely to increase the cash drain on the estate.

A. Carryover of Basis at Death

One recurring problem in planning for the disposition of stock in a closely held corporation is the choice whether to sell all or part of the stock during the shareholder's lifetime or to sell it following his death. Prior to the 1976 Act, perhaps the most basic tax factor in weighing these alternatives was that a sale shortly following the owner's death could be made without incurring income tax. The reason was that generally speaking the income tax basis of property in the hands of the estate or heirs was equal to its value at the time of death. This step up in basis allowed the "gain" from the decedent's basis to the fair market value of the property upon post mortem transfer to go untaxed.

This rule has now been changed. Section 1023(a), added by the 1976 Act, provides that there is a carryover of the decedent's basis to his estate and his heirs.¹⁵ Therefore, the previous advantage of selling property after the death of the property holder has been lost. However, because the section includes a "fresh start" provision,¹⁶ its effect will be felt only gradually. Under the fresh start provision, the carryover basis is increased by the amount of appreciation attributable to the period prior to December 31, 1976. Nevertheless, the carryover of basis will mean that the estate planner will have to consider income taxes as well as estate taxes in determining the liquidity needs of an estate, because when the estate disposes of the stock, it will have to pay a capital gains tax on the difference between the sales price and the adjusted carryover basis. Further, the carryover of basis has other far reaching effects upon the use of section 306 stock, discussed at length later in this article.¹⁷ For present purposes, it is sufficient to note that the 1976 Act provides that section 306 stock retains its character even after it has passed through an estate, thereby exposing the recipient of such stock to the risk that any proceeds of the disposition will be taxed as ordinary income.¹⁸

In general, the carryover of basis rules applicable to determining gain on sale of stock of a closely held corporation that has passed through an estate are as follows:

- (1) The basis of the stock in the hands of the estate or heirs is

¹⁴ I.R.C. § 691(c)(2)(C). See text at notes 43-45 *infra*.

¹⁵ I.R.C. § 1023(a). Section 1023(a)(1) provides:

Except as otherwise provided in this section, the basis of carryover basis property (defined in section 1023(b)) acquired from a decedent dying after December 31, 1976, in the hands of the person so acquiring it shall be the adjusted basis of the property immediately before the death of the decedent, further adjusted as provided in this section.

For a full discussion of all the carryover basis provisions, see in this issue Silverstein, *Section 1023 Carryover Basis: Planning Problems and Opportunities*, p. 467 *supra*.

¹⁶ See I.R.C. § 1023(h).

¹⁷ Section 306 stock is defined in I.R.C. § 306(c). See text at notes 86-87 *infra*.

¹⁸ I.R.C. § 306(c). Carryover of basis also has a bearing on the choice between stock redemption agreements and cross purchase agreements, tending to some degree to favor cross purchase agreements. See text at note 92 *infra*.

the same as it was in the hands of the decedent subject to two major adjustments.¹⁹

- (2) The first major adjustment is the fresh start exception.²⁰ Under the fresh start formula, the carryover basis is increased by the portion of the stock's appreciation which is attributable to the holding period prior to January 1, 1977.²¹ For the purposes of this formula, it is assumed that the appreciation occurred ratably throughout the time the property was held by the decedent.²²

To illustrate, assume that the stock was purchased on December 31, 1956 for \$10,000 and is worth \$40,000 at the date of the decedent's death on December 31, 1986. The irrebuttable presumption of the law is that the stock's appreciation of \$30,000 occurred ratably throughout the 30 year span, or \$1,000 per year. Accordingly, on December 31, 1976, it had appreciated \$20,000. Therefore, the new basis in the stock would be \$30,000, the sum of the adjusted basis of the property in the hands of the decedent, \$10,000, plus the ratable appreciation of \$20,000.

- (3) The second major adjustment to the carryover of basis provision is for federal and state death taxes paid on the appreciation element in the value of the stock after the "fresh start" adjustment is made.²³ In the above example, this is the \$10,000 excess of the \$40,000 value at death over the \$30,000 carryover basis after the "fresh start" adjustment. If it is assumed that the stock is part of a \$500,000 estate on which the combined federal and state death taxes are \$175,000, then a further increase of \$3,500 can be made in the basis, bringing it to \$33,500. $(\$10,000 \div \$500,000) \times \$175,000 = \$3,500$

To sum up the effect of these rules, the decedent's basis in the example stock was only \$10,000, as compared to the estate tax value of \$40,000 which would have been the new basis under prior law. Although one would expect the new carryover of basis rule to result in a \$10,000 basis to the heirs, due to the fresh start adjustment and the adjustment for the estate tax paid on the appreciation in the estate tax value of the stock over the

¹⁹ In addition to the two adjustments to basis discussed in this article, the Code provides another possibly relevant adjustment to assure that the carryover basis of all property passing through the estate is not less than \$60,000 (but not more than fair market value). I.R.C. §§ 1023(d), 1023(f)(1). See generally Channing, "Carryover Basis," in *ESTATE AND GIFT TAX AFTER TAX REFORM 59* (P.L.I. ed. 1977).

²⁰ The fresh start provision here discussed does not apply to marketable securities. I.R.C. § 1023(h)(1). For purposes of this article it will be assumed that the closely held stock is not a "marketable" security, a term that includes securities that are traded locally provided that quotations can be readily obtained.

²¹ I.R.C. § 1023(h)(2)(B)(ii).

²² See I.R.C. §§ 1023(h)(2)(B)(i), 1023(h)(C).

²³ Section 1023(c) provides for an increase in basis to reflect "Federal and State estate taxes," a term defined in I.R.C. § 1023(f)(3). Section 1023(e) provides for an increase to reflect state succession taxes paid by a transferee.

It may be noted that the rule relative to the basis of property transferred by a lifetime gift has been amended to correspond to the basis of property transferred on death. Where formerly there was a step-up in basis for the entire gift tax paid on the transfer, now it will be only for the gift tax on the appreciation in the transferred property. I.R.C. §§ 1015(d)(1), (6).

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fresh start value, the basis of the stock in the hands of the estate or the heirs in fact is \$33,500.²⁴

As December 31, 1976 recedes into the past, the benefit of the fresh start rule will be reduced because the period prior to 1976 will represent a smaller portion of the time the stock was held. Further, the fresh start adjustment is not available at all for stock acquired after 1976.

B. Section 303 Redemptions

Under section 303 of the Code, redemptions of stock by a corporation are likely to result in dividend taxation to the redeeming shareholder²⁵ unless they effect a complete termination²⁶ or at least a substantial and disproportionate reduction²⁷ in the redeemed shareholder's participation in the company. Because of attribution rules²⁸ under which an estate or trust is deemed to own the stock owned by its beneficiaries and various family members are deemed to own the stock of their relatives, it is often difficult to structure a stock redemption following a controlling shareholder's death so as to avoid dividend treatment.²⁹

Section 303 has long provided an important exception to these dividend redemption rules.³⁰ The redemption of stock included in the decedent's gross estate, if qualifying for section 303 treatment,³¹ is treated in section 303 as a sale, taxed at capital gains rate, rather than as a dividend, taxed as ordinary income, to the extent that the amount paid in redemption does not exceed the death taxes and funeral and administration expenses of the estate.³² The new law has narrowed substantially the availability of section 303 in three respects: the requisite percentage of the estate represented by the stock,³³ the taxpayer entitled to avail himself of section 303,³⁴ and the time within which the redemption must be carried out.³⁵

First, in the past, stock qualified for section 303 redemption if it was either 35% of the gross estate or 50% of the net estate. Under the new law, to qualify for section 303 treatment, the stock redeemed must have a value

²⁴ The foregoing rules apply only for purposes of determining the amount of gain that the estate or heirs of the original stockholder may realize on sale of their stock. If the stock is sold for less than for the basis that reflects the fresh start adjustment, the adjustment is not made. The basis for determining loss is the sum of the carryover basis and the adjustment for death taxes on the appreciation, which, however, is limited to prevent adjustments that would bring the basis above fair market value. I.R.C. § 1023(f)(1).

²⁵ I.R.C. § 302(b)(1).

²⁶ I.R.C. § 302(b)(3).

²⁷ I.R.C. § 302(b)(2).

²⁸ I.R.C. § 318.

²⁹ See generally Barton, *supra* note 2; Goldstein, *supra* note 2.

³⁰ See Tiger, *How to Plan Stock Redemptions to Pay Estate Taxes—The Problems of Section 303*, 24 J. TAX. 92 (1966).

³¹ I.R.C. § 303(b).

³² I.R.C. § 303(a).

³³ I.R.C. § 303(b)(2)(A).

³⁴ I.R.C. § 303(b)(3).

³⁵ I.R.C. § 303(b)(4).

of more than 50% of the adjusted gross estate, that is, the total estate less the deductions under sections 2052 and 2053 for administration expenses, debts, taxes and losses.³⁶

As a result estate plans which counted on the availability of section 303 to make funds available to pay death taxes now will have to be reviewed in order to assure continued availability of that section. If the value of the stock is no longer sufficient to meet the new 50% rule, consideration should be given either to decreasing the gross estate by lifetime gifts of other assets or to increasing the value of the stock to assure the availability of section 303. Such increase in value may come from additional investments in the company or from increasing the value assigned to the stock in the buy-out agreement.³⁷

The second major change in section 303 made by the new law requires that a section 303 redemption be carried out by a taxpayer who is burdened with the death taxes and expenses which serve as a measure of the amount that can be redeemed under section 303.³⁸ Under prior law, use of section 303 was not so restricted.³⁹ From the change, it follows that in the usual case, a section 303 redemption can no longer be made by a marital deduction trust, which is not liable for death taxes generated by decedent's death. This is not to say that closely held stock should never be left to a marital deduction trust. It may make sense, for instance, to leave closely held stock to such a trust so that, at the time of the surviving spouse's death, that trust which is liable for death taxes due on the estate of the spouse-beneficiary also can carry out its own section 303 redemption. What the new rule does mean, however, is that to the extent the estate plan contemplates a section 303 redemption, the shares must be left to the nonmarital deduction portion of the estate, since that is the only portion entitled to make such redemption.

³⁶ I.R.C. § 303(b)(2). Under prior law an estate of \$1,000,000 which included a \$500,000 marital deduction would qualify for § 303 redemption if the closely held stock was worth \$250,000, that is, 50% of the net estate. Under the new law the marital deduction is left out of consideration and the stock will have to be worth about \$500,000 (50% of the adjusted gross estate). For purposes of meeting the 50% test, the stock of two or more corporations may be treated as the stock of a single corporation if the decedent owned 75% of each. I.R.C. § 303(b)(2)(B). Even if the redemption is carried out soon after death, any capital gain is likely to be long term because the estate is permitted to tack the decedent's holding period to its own. I.R.C. § 1223(2).

³⁷ This is not intended to suggest the use of unreasonable values. But within a fairly broad range the parties, by agreement among themselves, may determine the value for tax purposes if the agreement has some business reason, is mandatory on the estate and is binding on the testator during his lifetime. See Corneel, *Valuation Techniques in Buy-Sell Agreements: Effect on Gift and Estate Taxes*, 24 N.Y.U. INST. FED. TAX. 631 (1966).

If an estate cannot meet the new § 303 requirement, one should explore whether it will be possible to carry out a redemption that will be taxed as a sale by meeting the test of § 302 for redemptions that are "substantially disproportionate" or not "essentially equivalent to a dividend" or effect a "complete termination."

There is currently a disagreement between the Internal Revenue Service and the courts as to the extent to which an estate may avoid application of the family attribution rules. Compare Rev. Rul. 59-233, 1959-2 C.B. 106 and Rev. Rul. 68-388, 1968-1 C.B. 122 with *Lillian M. Crawford*, 59 T.C. 830 (1973), *nonacq.*, and *Rickey v. United States*, 427 F. Supp. 484 (N.D. La. 1976).

³⁸ I.R.C. § 303(b)(3).

³⁹ See INT. REV. CODE OF 1954 § 303.

Finally, the new law has added a new limitation relating to the time of section 303 redemptions. Under the 1976 Act, redemption distributions made more than four years after death are afforded section 303 treatment only for the amount of taxes, funeral and administration expenses then remaining unpaid and which in fact are paid within a one year period beginning with the distribution.⁴⁰

If an estate cannot qualify under the new section 303 rules, one should consider the possibility of redemptions qualifying as sales under the general rules of section 302. There are, of course, other arrangements for the disposition of closely held stock that avoid the tax problems of redemptions. These include cross purchase agreements, sales, mergers, and liquidations. But as a rule, redemptions are the preferable method where continuation of the business as a close corporation is contemplated. Therefore, a plan providing for redemptions should not be abandoned without a struggle.

The carryover of basis provided for in section 1023(a) when combined with section 303 creates a problem which the 1976 Act failed to deal with. Under prior law, if shares were redeemed under section 303 to pay death taxes and expenses, the sale, if made at the same price as the date of death value, would be made without any income tax consequence at all to the redeeming shareholder because of the step-up in basis. In contrast to the tax free redemptions possible under the old law, the carryover of basis will force the taxpayer to recognize as capital gain the difference between the sale price and the carryover basis.⁴¹ Section 303 was not changed to allow redemptions to cover the income tax due on this gain. Therefore, this tax, if any, will have to be paid from sources other than the section 303 redemption.

C. Higher Tax on Income in Respect of Decedent

Income in respect of a decedent may arise in the setting of a close corporation either by reason of the payment of earned but unpaid salaries, bonuses, commissions or pension owed the decedent or his family or because the decedent sold the stock of the corporation prior to death against notes and elected to report the gain on the installment basis. The law has long provided a deduction for such income in respect of a decedent to reflect the estate tax paid on that income.⁴² The new law has changed the method of computing the income in respect of the decedent unfavorably from the point of view of the taxpayer.

Formerly, the deduction from income was the difference between the estate tax that actually was paid on the estate which included the right to the income and the lower estate tax that would have been payable if there

⁴⁰ I.R.C. § 303(b)(4). Prior to the Tax Reform Act of 1976, the benefits of § 303 were available without the imposition of such limitations in the case of distributions made more than four years after death. This provision has a bearing on the interaction between § 303 and §§ 6166 and 6166A which authorize extensions of time for payment of taxes, which are discussed below. See text at notes 63-74 *infra*. See generally Smith, *Estate Liquidity: Section 303 Redemptions and the 1976 Tax Reform Act*, 55 TAXES 625 (1977).

⁴¹ The carryover of basis may be stepped up under I.R.C. § 1023(h). See text at notes 22-24 *supra*.

⁴² See I.R.C. § 691(c)(1)(A).

had been no such right to income. By contrast, under the new law, the applicable estate tax is computed by applying to the value of the income in respect of the decedent the average tax rate applicable to the entire estate.⁴³ For example, if in a \$300,000 estate, there is a \$30,000 item of income in respect of a decedent, under prior law the estate tax deduction would have been the difference between an estate tax on \$270,000 and an estate tax on \$300,000. Under the new law, the deduction will be simply ten percent of the estate tax paid—the percentage of the gross estate represented by the income in respect of a decedent. Under the 1976 Act, therefore, the taxpayer loses the benefit of a deduction for the high brackets applicable to the "last dollar" in the estate.⁴⁴

Because of the reduced deduction for income in respect of decedent, a decedent may obtain a tax benefit by paying the entire income tax which results from the sale of closely held stock prior to his death. In that case, the income tax of the estate in effect will be paid with the "last dollars" of the estate, preventing imposition of brackets that might otherwise apply to the estate. Here, as elsewhere, no firm rule can be laid down as to whether this approach is preferable to paying an estate tax on an estate undiminished by the income tax and taking the deduction available under section 691.⁴⁵ The estate planner must make the computations for each alternative, taking into account probable death taxes and the income taxes of the decedent prior to his death, his estate and its beneficiaries. In making these computations, one must also take into account the differences in the timing of the tax payments and after weighing the tax consequences of the alternatives, decide on the preferable approach.

D. *Repeal of Byrum Rule*

Power may be more important than money, particularly for those who already have wealth. Accordingly, many estate plans involving lifetime gifts of stock of closely held corporations involve plans under which the founding father of the corporation gives away most of the economic benefit represented by stock ownership but retains for himself control over the corporation's destiny by retaining voting power. In *United States v. Byrum*,⁴⁶ the Supreme Court dealt with a particularly extreme example of such arrangements. There, the donor had given stock of his closely held corporation in trust, but retained for himself the right to vote the stock, the right to remove the trustee and to appoint a successor other than himself, and also the right to veto sales of trust property and changes in investment.⁴⁷

⁴³ Section 691(c)(2)(C) provides: "The estate tax attributable to such net value shall be an amount which bears the same ratio to the estate as such net value bears to the value of the gross estate."

⁴⁴ I.R.C. § 691(c)(2)(C). Not to be churlish, one also should mention that while formerly the only tax giving rise to a deduction was the federal estate tax, now state estate taxes are also taken into account.

⁴⁵ There is a choice among three alternatives:

(1) Sell the stock and report the gain prior to death.
(2) Sell the stock prior to death, elect the installment method and report the gain after death as income in respect of a decedent.

(3) Sell the stock and report the gain after death.

⁴⁶ 408 U.S. 125 (1972).

⁴⁷ *Id.* at 126-27.

In spite of this accumulation of retained powers, the Supreme Court rejected the Commissioner's attempt to include the transferred stock in the donor's estate.⁴⁸ The Treasury did not surrender, however, and in the 1976 Act succeeded in convincing Congress where it had failed to persuade the Supreme Court. Section 2036 of the Code was amended so that a retention of the right to vote just as the retention of the right to income will cause the inclusion in the estate of the donated stock.⁴⁹

Although the repeal of the *Byrum* rule appears simple, the actual legislation has created problems.⁵⁰ The amendment is not restricted in application to stock in closely held corporations, so that no matter how small the relative voting power of the donated stock, the retention of voting power by the donor will cause the stock's inclusion in his estate. Certain indirect methods of retaining practical control over the vote of stock, such as might be deemed to exist where the donor as in *Byrum* had the right to remove the trustee, are not dealt with in the legislation. Provisions in the Technical Corrections Bill are designed to cover some of these deficiencies.⁵¹

One important question dealt with in neither the Tax Reform Act nor its legislative history, is whether the amendment to section 2036 is aimed at such common plans as the creation of two classes of common stock, voting common and nonvoting common, followed by a gift of the nonvoting common stock to the children, the founding father retaining the voting stock. However, the report of the House Ways and Means Committee on the Technical Corrections Bill makes it clear that such arrangements are not included in the prohibition against a grantor's retention of voting power in stock he had transferred.⁵² Accordingly, the repeal of the *Byrum* rule should not affect estate plans in which the donor gives away nonvoting shares of stock while retaining the voting stock for himself.

E. *Special Use Valuation of Realty*

All of the changes in the law dealt with so far have an adverse effect upon owners of closely held corporations. There are also a limited number of provisions in the Tax Reform Act of 1976 intended to be helpful to taxpayers. In most cases, though, the help taxpayers will derive from these sections is unlikely to be substantial. Moreover, these sections unfortunately not only are complicated but also elective, thus opening wide the door to possible claims against attorneys and executors who fail to point out or take advantage of the various benefits hidden in the twists and turns of the new law.

⁴⁸ *Id.* at 137, 147-49. For a more extensive discussion of *Byrum* and the repeal of the *Byrum* rule, see in this issue, Note, *The Applicability of Section 2036(a) to Retained Voting Rights Devices After the Tax Reform Act of 1976*, p. 597 *infra*.

⁴⁹ "For purposes of paragraph (1), the retention of voting rights in retained stock shall be considered to be a retention of the enjoyment of such stock." I.R.C. § 2036(a).

⁵⁰ In the first place, the specific language used—"the retention of voting rights in retained [sic] stock shall be considered a retention of enjoyment of such stock—makes no sense due doubtless to a clerical error.

⁵¹ H.R. 6715, 95th Cong., 1st Sess. § 3(i) (1977).

⁵² H.R. Rep. 95-700, 95th Cong., 1st Sess. § B.21 (October 12, 1977).

The first of these elective provisions is Section 2032A, which provides for special use valuation of real property used as a farm for farming purposes or used in a trade or business other than farming.⁵³ Where section 2032A is applicable, for estate tax purposes real property may be valued, at the election of the executor, based on its use in farming or in a closely held business, rather than on its fair market value—which in the absence of this section might be based on its highest and best use.⁵⁴ The total decrease in the value of qualified real property resulting from this alternative valuation cannot exceed \$500,000⁵⁵ and there are numerous other limitations, only some of which can be mentioned here since the Code provision itself runs four closely printed pages.

Several limitations are particularly relevant to close corporations. The sum of the real property and personal property used in the closely held business must be at least 50% of the adjusted gross estate, and the realty by itself must be at least 25%.⁵⁶ The real property must have been used in the closely held business for five of the last eight years preceding the decedent's death and the decedent or member of his family must have materially participated in the operations of the closely held business during this period.⁵⁷ There is a further requirement: The property must pass to "qualified heirs," namely certain defined members of the decedent's family or certain trusts for their benefit.⁵⁸ If, prior to the expiration of fifteen years from the date of inheritance, the property ceases to be special use property in the hands of qualified heirs, then all or part of the tax saved by the special use valuation must be paid.⁵⁹ An agreement to pay this additional tax, a provision specially holding open the period of limitations and a special tax lien⁶⁰ for this potential additional tax are all part of the statutory package of section 2032A.

Whatever the application of special use valuation in the case of farms, it is unlikely to be used frequently in the case of closely held corporations. The value of the realty used in a closely held business in most cases will not reach the 25% of the gross estate required to qualify for a section 2032A election. It should be noted that for purposes of these percentage provisions it is not the special use value, but the full value of the property that is taken into account.⁶¹ Therefore, in case of doubt, it will be necessary to compute the percentage of the gross estate represented by the full value of the realty. Under the valuation methods required to establish the special use value,⁶² however, substantial savings are unlikely to result from a section 2032A election in the case of closely held businesses.

⁵³ I.R.C. § 2032A.

⁵⁴ See generally O'Sullivan, "Special Use" Valuation of Farm, Ranch and Closely Held Business Real Property, in *ESTATE AND GIFT TAX AFTER TAX REFORM 95* (P.L.I. ed. 1977).

⁵⁵ I.R.C. § 2032A(a)(2).

⁵⁶ I.R.C. § 2032A(b)(1)(A) and (B).

⁵⁷ I.R.C. § 2032A(b)(1)(C).

⁵⁸ I.R.C. § 2032A(e)(1).

⁵⁹ I.R.C. § 2032A(c)(2).

⁶⁰ I.R.C. § 6324B.

⁶¹ I.R.C. § 2032A(b)(3).

⁶² I.R.C. § 2032A(e)(8).

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F. Extension of Time for Payment of Tax

One of the primary difficulties in developing an estate plan involving a closely held business is that the estate tax on the value of the property must be paid within nine months of the date of death. As a matter of economic fact, however, it often will require much more time to convert all or part of this property into cash at a reasonable price and thereby raise the money with which to pay the tax.

In the past, two provisions helped the cash-poor estate in this situation. The first was section 6166, which provided in effect that if a closely held business constituted a substantial part of an estate, the estate tax attributable to this property might be spread over ten years.⁶³ Second, section 6161 authorized the Commissioner, upon presentation of evidence of "undue hardship," to permit extensions of payment of the estate tax beyond the nine month period, up to a maximum of ten years.⁶⁴

The Tax Reform Act continued the provisions of section 6166, but, perhaps as a sign of demotion, changed its number to 6166A. The rank and number of section 6166 was conferred on a new provision which is similar to the old but provides greater benefit where the property constitutes a larger percentage of the estate.⁶⁵ The Act also eased the test under section 6161 so that extensions are now available to estates which demonstrate "reasonable cause"⁶⁶ rather than the "undue hardship" required for an extension prior to the amendment. As a result, there are now three Code provisions designed to alleviate liquidity problems likely to be faced by estates which include significant amounts of stock in close corporations.

1. Sections 6166 and 6166A

The estate tax extension under sections 6166 and 6166A is available only for an "interest in a closely held business," a term which with respect to corporations requires that either of two tests must be met. Either the decedent must have 20% or more in value of the voting stock,⁶⁷ or there must be only a limited number of shareholders in the close corporation. Quite perversely this alternative test permits fifteen or fewer shareholders in the case of the generally more difficult section 6166⁶⁸ but requires ten or fewer shareholders in the case of the generally less restrictive section 6166A.⁶⁹

Section 6166 applies where the farm or closely held business constitutes 65% of the adjusted gross estate.⁷⁰ Section 6166A requires that the percentage be only the lesser of 35% of the gross estate or 50% of the taxable estate.⁷¹

⁶³ INT. REV. CODE OF 1954 § 6166.

⁶⁴ I.R.C. § 6161.

⁶⁵ See text at note 73 *infra*.

⁶⁶ I.R.C. § 6161(a)(2).

⁶⁷ I.R.C. §§ 6166(b)(1)(C), 6166A(c)(3).

⁶⁸ I.R.C. § 6166(b)(1)(C)(ii).

⁶⁹ I.R.C. § 6166A(c)(3)(B).

⁷⁰ I.R.C. § 6166(a)(1).

⁷¹ I.R.C. §§ 6166A(a)(1), (2). The alert reader may recognize this as the old § 303 test, which has now been changed to 50% of the adjusted gross income. See text at note 32 *supra*.

The benefits of new section 6166 are substantially greater than the ten year spread out of estate tax payments provided by section 6166A because if new section 6166 applies, the executor can elect not to pay any tax at all for the first five years following death, paying during this period only interest on the deferred amount. After expiration of this five year period, the estate tax can be paid in ten equal yearly installments. By contrast, section 6166A merely allows the taxpayer to spread out the estate tax over ten years with no initial five year period during which interest alone is paid.

Another advantage of section 6166 over section 6166A is that the interest on the tax deferred for the five year period, rather than accruing at the 7% regular rate, accrues at only 4% with respect to that part of the estate tax attributable to the first one million dollars of a closely held business property or a farm. The difference of 3% in the interest rate represents a considerable savings.

Although this 4% interest rate is attractive, it does not follow that the election to defer taxes should be made in every case when it is available. The problems involved in the computations and compliance with the section and the administrative problems that result from keeping the estate open for so long a period of time may well outweigh the benefit of deferral.

The deferral permitted by section 6166 applies only so long as the interest in the farm or closely held business is not disposed of or money withdrawn from the business.⁷² There are special exceptions to this acceleration to cover section 303 redemptions the proceeds of which are used to pay taxes.⁷³

Executors are personally liable for the obligations of the estate and therefore might be reluctant to elect section 6166. For executors who are queasy about continued personal liability for fifteen years with respect to the payment of estate taxes, section 6324A provides for their release if a lien furnishing appropriate security for the deferred tax is granted to the government.⁷⁴ This special lien is elective and requires the consent of all interested parties.⁷⁵ No one should try to remember all of these distinctions between the requirements for election of sections 6166 and 6166A and the results of such election. They are mentioned merely to illustrate the needless complexities of what are intended as relief provisions for the owner of a small business, and as a warning that in each case a different rule applies.

2. Section 6161

The other change made by the new law, which is much less technical and not bound to the specific value of the farm or closely held business property, relates to discretionary extensions of payment of tax for periods up to ten years under section 6161 of the Code. In applying the "undue hardship" standard that formerly governed the exercise of discretion under that section, the Internal Revenue Service had, in the view of the congressional committees, taken too restrictive an approach in granting extensions.

⁷² I.R.C. § 6166(g).

⁷³ I.R.C. § 6166(g)(1)(B).

⁷⁴ I.R.C. § 6324A.

⁷⁵ I.R.C. § 6324A(c).

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Hence section 6161, as amended by the new law, authorizes the Service to grant extensions for "reasonable cause," a test which most estates having genuine liquidity problems arising from closely held stock should be able to meet even though they do not meet the mechanical tests of sections 6166 and 6166A.

II. THE PRACTICAL EFFECTS OF THE NEW PROVISION

The discussion so far has focused on the provisions of the new law and has briefly noted their impact on various aspects of estate planning involving close corporations. The following will do the converse and examine in the light of the changes brought about by the new law three frequently recurring practical questions: What is the best type of capital structure to implement an estate plan involving a close corporation? Should agreements relating to the sale or purchase of the stock be among the shareholders as such or between the shareholders and the corporation? Finally, what is the best way of utilizing life insurance?

Before considering the effect of the Act upon these problems, it should be recognized that a major consideration in estate planning is the percentage of the estate represented by close corporation stock. The value of the close corporation stock usually constitutes too large a portion of a total estate when seen from the point of view of the beneficiaries. They will need cash to pay estate taxes, and close corporation stock is difficult to turn into cash, compared not only to marketable securities and life insurance proceeds but even to real estate leased to the corporation. Further, the family needs security, but the history of close corporations following the death of the founder gives little cause for confidence that the stock will be a continuing source of income and value to the family.

It is because of these doubts as to the liquidity and continuing value of close corporation stock that buy-out agreements in which shareholders agree to purchase the stock of fellow stockholders who die or retire are so common a part of a close corporation's capital structure. To provide its intended benefits, however, the buy-out agreement itself must be backed by some reasonably certain source of liquidity such as insurance. Thus, corporate assets that might otherwise be devoted to the growth of the business must be set aside to provide liquidity.

In most cases, then, the owners of close corporation stock would be better off if the value of their stock constituted a smaller part of their estate and instead a larger part of the corporate earnings were made available to them during their lifetime. This may be accomplished in many different ways: qualified or nonqualified pension plans,⁷⁶ payment of the maximum salaries possible without violating the rules against unreasonable compensation,⁷⁷ the use of group term life insurance,⁷⁸ accident, health and medical reimbursement plans and other fringe benefits skewed to the

⁷⁶ See I.R.C. § 401.

⁷⁷ I.R.C. § 162(a)(1). See, e.g., *Charles McCandless Tire Serv. v. United States*, 422 F.2d 1336 (Cl. Ct. 1970). See also McKenney, *The Worth of a Man: A Study of Reasonable Compensation in Close Corporations*, 38 S. CAL. L. REV. 269 (1965); Zimmer, *Excessive Salaries in a Closely Held Corporation*, 18 CLEV.-MAR. L.R. 188 (1969).

⁷⁸ I.R.C. § 79. See Chodorow, *Life Insurance: An Excellent Compensation Device for the Close Corporation*, 7 TAX. FOR ACCOUNTANTS 30 (1971).

extent permissible in favor of the shareholder-employees, the lease of stockholder-owned realty or equipment to the corporation and the like. It also may make sense to have members of the founder's family serve as officers or directors of the corporation—not only to siphon off corporate earnings by means of compensation for their services, but also in line with that sage, if lugubrious, advice: "train your wife to be a widow, train your child to be an orphan."

All of these arrangements, by permitting a portion of the corporate earnings to be distributed to the owner-employees on a tax deductible basis, not only reduce the value of the corporate stock and increase the assets that the shareholders have outside the corporation, but also avoid the double taxation of corporate earnings which the carryover of basis rules have made almost unavoidable. Of course, every rule has its exceptions and it may be that in particular borderline cases the value of corporate stock should be maintained or even increased in order to qualify for a redemption under section 303⁷⁹ or for a deferral of estate tax under section 6166 or 6166A.⁸⁰ But, as a general rule, the problem relating to close corporation stock will be easier to deal with if the value of the stock is reduced.

Even if the value of stock is reduced, however, the estate planner still must face the question how best to use stock plans, buy-out and cross-purchase agreements, and life insurance to provide for the continuity of control of the closed corporation. The 1976 Tax Reform Act affects all three areas of planning.

A. *The Capital Structure*

A number of plans have been devised to facilitate estate planning for a close corporation by changes in the capital structure of the corporation. These include various combinations of classes of stock such as voting and nonvoting stock or common and preferred stock. The usual purpose of these plans is to provide for a gradual transfer of ownership and income in a way that avoids estate tax on the full value of the company at the time of the founder's death.

1. Voting and Nonvoting Common Stock

The taxpayer who is willing to relinquish some of the economic benefits of ownership while maintaining management control may do so by creating a second class of nonvoting common stock and distributing it by means of a tax-free stock dividend.⁸¹ The controlling shareholder, who for the sake of brevity will be called "Father," gives the nonvoting stock to his family or trusts for their benefit. By doing so he removes a portion of the future stock appreciation from his estate but retains the control.⁸²

⁷⁹ See text at notes 26-42 *supra*.

⁸⁰ See text at notes 68-76 *supra*.

⁸¹ See I.R.C. § 305(a).

⁸² Of course, a Father who retains 100 shares of voting common stock and gives away 900 shares of nonvoting common stock, may have retained a good deal more than 10% of the value by reason of the premium assigned to voting power.

It is possible that an arrangement of this type may be claimed to involve a transfer of stock coupled with retention of the voting power formerly represented by the transferred stock thereby coming within the ambit of section 2036.⁸³ While the legislative history of section 2036 indicates that the anti-*Byrum* amendment to section 2036 was not aimed at this type of arrangement, the arrangement is sufficiently close to the line that lawyers should move cautiously in advising on such plans and should be alert to developments.

2. Common Stock and Preferred Stock

Another type of common close corporation capital structure involves the use of voting or nonvoting preferred stock which is received as a tax-free dividend on the outstanding common stock or is exchanged in a tax-free recapitalization for such stock. The Father receiving the preferred may use it to make gifts to his family and thus channel the dividend stream to lower rate taxpayers—and also, of course, eliminate the dividends from his own estate. On the other hand the Father may hold on to the preferred stock, using it as a source of retirement income. If it is voting stock, he also may maintain control of the corporation, and give the common stock with its growth opportunities to his family.⁸⁴

While preferred stock arrangements continue to be valuable estate planning tools in a close corporation, they may involve serious difficulties because of the interaction of section 306 of the Code and the new carryover of basis provisions. In this situation, a post mortem redemption of preferred stock by the heirs may be treated as a dividend and thereby become prohibitively expensive.⁸⁵

⁸³ See text at notes 46-49 *supra*.

⁸⁴ See text at note 52 *supra*. For a thoughtful discussion of these arrangements under the law in effect prior to the Tax Reform Act of 1976, see Ehrlich, *Corporate Recapitalization as an Estate Planning Business Retention Tool*, 34 N.Y.U. INST. FED. TAX. 1661 (1976).

⁸⁵ To understand this problem and the manner of dealing with it, it may be helpful to give a thumbnail sketch of § 306. Prior to the enactment of the 1954 Code, some taxpayers used so-called preferred stock bailout plans. The corporation would declare a tax-free dividend in preferred stock on its outstanding common stock. The common shareholders would sell their preferred stock to a bank or an insurance company which, after a suitable passage of time, in turn, would sell the stock back to the company. As a result, the original common shareholders would still be the only shareholders of the company. After the bailout, however, they would also have the cash they received from the bank or insurance company which in turn was reimbursed by the preferred stock redemption payment from the corporation. In sum, the shareholders would have cash that formerly was in the corporation. The effect was a dividend taxable at the capital gain rate applicable to sale of their preferred stock rather than at the ordinary income rate applicable to dividends. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 10.01, 10.02 (3d ed. 1971). To prevent this form of tax avoidance, Congress declared preferred stock received as a tax-free dividend to be "section 306 stock." Receipt of the stock continued to be tax-free but it could not subsequently be sold without giving rise to a dividend tax. (The preferred stock can be issued as a tax-free dividend under § 305 or in a tax-free exchange for common stock under section 368(a)(1)(E). See Rev. Rul. 77-238, 1977-28 I.R.B. 7. However, where preferred stock is already outstanding any new issue of preferred stock must be junior to the outstanding in order to avoid tax under § 305.) Section 306 stock is "tainted" not only in the hands of the first holder who received it as a tax-free stock dividend or in a tax-free recapitalization, but also in the hands of any subsequent holder whose basis in the stock was determined by reference to its basis in the hands of another in whose hands it was § 306 stock. I.R.C. § 306(c)(1)(C). The

Under prior law, after Father's section 306 preferred stock passed through his estate, its basis was no longer determined by reference to its basis in his hands. Accordingly, it would no longer be classified as section 306 stock. However, the carryover of basis provision of the 1976 Act provides that the basis of the property after it passes through the estate is the same as its basis in Father's hands.⁸⁶ Hence, the post mortem redemption of what was section 306 stock in Father's hands may now give rise to ordinary income tax. This may be so even where the redemption is a 303 redemption.⁸⁷ These consequences of the new carryover basis provision argue for caution in the use of a plan in which Father keeps preferred stock and gives common stock to his family.

Preferred stock recapitalizations nevertheless serve many valid nontax purposes. Father may want to retire and needs both the security and income provided by the preferred stock, leaving to his children the risks and rewards of common stock. Accordingly, there are efforts through the Technical Corrections Bill or otherwise to remove the section 306 barrier to such transactions.⁸⁸ The planner also should be aware that even if there is no further change in the law, the use of preferred stock is by no means barred by the new law. Not all preferred stock received tax-free is section 306 stock. For example, where Father exchanges all his common stock for preferred stock in a tax-free recapitalization, the Service has ruled that the preferred stock so received is not section 306 stock.⁸⁹ Moreover, not all sales or redemptions of section 306 stock result in dividend treatment. The Code sets forth specific circumstances under which a sale or redemption of section 306 preferred stock will not be treated as giving rise to dividend income to the seller.⁹⁰ Basically, the Code requires a disposition of all of the stock, common and preferred, owned directly and by attribution, or satisfying the Service that income tax avoidance is not the principal purpose of the plan.⁹¹

In summary, the lifetime recapitalization plans here described have been valuable in the past and with qualifications will continue to be in the future. Such plans tend to reduce the amount of the closely held stock in Father's estate, and thereby the size of the problem to be dealt with by a buy-out agreement or other arrangement. In the future, while plans of this type should continue to be useful, the planner will need to check as to the current status of problems under sections 2036 and 306.

Technical Corrections Bill of 1977, H.R. 6715, 95th Cong., 1st Sess. § 3(a)(2) would permit § 306 stock to be redeemed under § 303 at capital gains rates. Section 3(a)(1) of the Bill lightens the impact of the new rules on § 306 stock issued prior to January 1, 1977.

⁸⁶ But see text at notes 19-22 *supra*.

⁸⁷ See text at note 30 *supra*.

⁸⁸ H.R. 6715, 95th Cong., 1st Sess. § 3(a)(2).

⁸⁹ See Rev. Rul. 59-84, 1959-1 C.B. 71. See also Rev. Proc. 74-26, 1974-2 C.B. 478, clarified by Rev. Proc. 75-24, 1975-1 C.B. 719.

⁹⁰ See I.R.C. § 306(b).

⁹¹ Many of the people to whom the controlling stockholder would wish to distribute stock are included in the attribution provisions of § 318. Under § 318, stock owned by family members is considered to be constructively held by each other. Therefore, the escape provided by § 306(b) would be of no help if other family members are given shares.

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B. Cross Purchase or Stock Redemption

Planning to meet the cash needs of an estate which consists largely of stock in a close corporation often presents the estate planner with a choice between a cross purchase agreement among stockholders and a redemption agreement with the company, that is, should a deceased shareholder's stock be bought by the shareholders or by the company. All of the technical considerations favor the cross purchase.

Several problems arise if the redemption route is taken. Because of the attribution rules,⁹² redemption of the stock of the estate may be treated as a taxable dividend because all stock will not have been disposed of.⁹³ While section 303 exempts some redemptions from dividend treatment,⁹⁴ the section is not available where the closely held stock does not constitute 50% of the excess of the gross estate over the sum of deductions under sections 2053 or 2054.⁹⁵ In other cases, its use may be limited because the shareholder needs to dispose of more stock than can be redeemed under section 303. The use of funds to redeem a controlling shareholder's stock may give rise to accumulated earnings tax problems if the redemption covers more than is authorized under section 303.⁹⁶ In addition, the requirements for a section 303 redemption have become more stringent, so that in many estates this safeguard against dividend treatment and accumulated earnings tax may no longer be available.⁹⁷

None of these problems applies to a cross purchase arrangement. Nevertheless, for reasons of economics and simplicity the agreement in the largest number of cases will be a redemption agreement. It appears easier for the corporation than for the individual shareholders to provide the funds needed for acquisition of the decedent's stock. It makes no difference whether the agreement is funded by insurance or the funds are to be raised from other sources. They must come out of someone's pocket and the deeper pocket is usually that of the corporation.

The question arises whether the new carryover of basis rules do not in some cases tip the balance in favor of the cross purchase agreement. The following example illustrates the rationale of this question. A and B own a corporation which is now worth \$500,000 but was formed with only \$100,000, each shareholder contributing \$50,000. If A dies and B buys his stock for \$250,000, then B and B's estate will have a basis of \$300,000 in the stock representing ownership of the entire company. In contrast, if the corporation had purchased A's stock, then B's stock alone would represent ownership of the entire company and would still have a basis of only \$50,000. Accordingly, the cross purchase agreement produced \$250,000 more of basis than the stock redemption agreement, a basis advantage which because of the new carryover rules will be valuable not only during

⁹² I.R.C. § 318.

⁹³ See Goldstein, *Stock Redemptions and the Attribution Rules*, 27 N.Y.U. INST. FED. TAX. 793 (1969).

⁹⁴ See text at note 31 *supra*.

⁹⁵ I.R.C. §§ 303(b)(2)(A)(i), (ii).

⁹⁶ I.R.C. § 537 permits an accumulation of earnings for the "section 303 redemption needs" of the business arising after a shareholder's death. But redemptions not covered by this provision may be troublesome. See *John B. Lambert & Assocs. v. United States*, 38 A.F.T.R. 2d (P-H) ¶ 76-5355, at 76-6207 (Cl. Ct. 1976) (per curiam) (adopting opinion of trial judge).

⁹⁷ See text at notes 32-39 *supra*.

B's lifetime, if he should decide to sell; but also following his death because his heirs will have the greater basis as well.

Though superficially persuasive, this argument disregards two salient points. First, under the cross purchase agreement, B will have paid \$250,000 for A's shares with assets that presumably already had a basis of \$250,000. Second, under the redemption approach, the company has paid out \$250,000, which presumably will reduce its worth by \$250,000. Under the cross purchase approach, where B supplied the funds from outside the corporation, no such reduction of the corporation's worth will occur. The lower value of the redeeming company should reduce the proceeds and gain on the ultimate sale of the stock by B.

Altogether, then, the redemption approach is consistent with the policy of minimizing the value of the close corporation and reducing the shareholder's investment in the corporation. Unless shareholders are driven to a cross purchase agreement by the inability to redeem stock under section 303, the redemption agreement is therefore likely to be the better approach in spite of the new carryover of basis.

If the choice between cross purchase and redemption is not clear, it may be best to keep all options open in order to maximize the flexibility to meet the cash needs of the estate and its beneficiaries. Thus, the planner might provide for redemption of the decedent's shares by the corporation, but also provide that if the corporation does not redeem, the other shareholders will buy or alternatively will cause the company to be liquidated. The corporation should have the initial obligation to redeem because, if it is the shareholders who have the primary obligation to buy, the purchase by the corporation which relieves the continuing shareholders of their obligation may be treated as resulting in a dividend to them.⁹⁸

C. Life Insurance

Since in most cases the close corporation stock itself cannot be converted easily into cash, life insurance forms an important part of many buy-out agreements by guaranteeing that funds will be available to purchase or redeem the stock. Under the new tax law, life insurance proceeds are not "carryover basis property" for purposes of section 1023.⁹⁹ This, together with the general exclusion of life insurance proceeds from income tax,¹⁰⁰ makes insurance a particularly valuable estate planning tool. Life insurance is particularly valuable where the decedent has no incidents of ownership in the insurance policy and the proceeds of the policy are not payable to his estate. In such a case, the insurance proceeds will be free not only from the income tax but also from the estate tax, and thus none of the cash generated by the insurance need go to the payment of taxes on the insurance.¹⁰¹

These general rules relating to life insurance lead to three general considerations to be kept in mind when planning for the use of life insur-

⁹⁸ See *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947); Rev. Rul. 59-286, 1959-2 C.B. 103. In some situations a combination may make sense: The corporation agrees to buy what it can under § 303—the other shareholders agree to buy the balance.

⁹⁹ I.R.C. § 1023(b)(2)(B).

¹⁰⁰ I.R.C. § 101.

¹⁰¹ See I.R.C. § 2042.

ance in the context of a close corporation. First, life insurance proceeds paid directly to the family of the decedent are tax-free, while their receipt by the corporation and subsequent redemption may give rise to tax liability. Second, the inclusion of the insurance in the estate increases the value of the estate and the estate's tax liability. Third, to avoid characterization of insurance receipts as dividend or compensation, the beneficiaries should own the policies.

1. Direct Insurance Proceeds

Life insurance payable on the life of a deceased shareholder employee may be more valuable to the family of the deceased if it comes directly to them in the form of insurance rather than indirectly by way of the redemption of their shares. If the insurance is paid to the corporation to help fund its stock redemption obligation, it may boost the value of the stock for estate tax purposes. But, even if this is not the case, some portion of the purchase price received for the stock is likely to be treated as capital gain due to the carryover of basis rules. If the insurance were received by the estate directly, it would be entirely income tax free.¹⁰² It is true that if the corporation or the other shareholders do not receive insurance proceeds they might not be able to pay as much for the stock or possibly may not be able to buy it at all. But what matters to the family of the deceased is not that they be able to dispose of the stock but that they receive cash in a given amount. That can be provided by insurance proceeds themselves.

This is not to say that corporate-owned insurance is always a mistake. If in fact the salary to Father is such that no further pay increase to help him buy insurance is possible, the corporate purchase may be the best alternative. Corporate-owned insurance also is useful when it serves to back up a nonqualified pension obligation to Father's widow or children. The pension will be taxable to the latter, but their bracket will probably be lower than the corporation's, which will be entitled to a deduction. Therefore, in contrast to insurance-funded stock redemption plans which give rise to some tax at the individual level and permit no deduction at the corporate level, the insurance funded pension plan is more tax economic.

2. Excluding Insurance From Estate

Insurance best fulfills its role of providing needed cash if it is not included in the estate. If an estate that is in a 40% estate tax bracket requires \$200,000 in cash to meet projected liquidity needs and the insurance to provide this amount is included in the estate, then \$80,000 of the life insurance proceeds will go merely to pay the taxes caused by the insurance itself and only \$120,000 will remain to meet the \$200,000 of needs. In most cases, therefore, the insurance should be owned by a member of the shareholder's family or a trust for the family's benefit.¹⁰³ Where the insurance is held by the corporation and the shareholder is a controlling

¹⁰² See I.R.C. § 101(a)(1).

¹⁰³ See McGaffey, *Planning the Client's Life Insurance Program*, 35 N.Y.U. INST. FED. TAX. 1295 (1977).

shareholder, care must be taken to follow the regulations in order to avoid a claim by the Internal Revenue Service that, through the corporation, the decedent had indirect incidents of ownership in the policy.¹⁰⁴

3. Split Dollar Insurance

A split dollar insurance policy is one which is owned by the corporation and the employee-shareholder or his spouse.¹⁰⁵ The premiums are paid entirely by the corporation or by the corporation together with either the employee-shareholder or spouse.¹⁰⁶ On the employee's death, the corporation receives a portion of the death benefit equal to the premiums it has paid and the spouse receives, free from any income or estate taxes, the balance of the proceeds. This arrangement has been blessed by a recent revenue ruling.¹⁰⁷ Whether the employee has paid his portion of the premiums or the corporation has done so on his behalf, the employee will be deemed to have made a gift to his spouse with every premium payment.¹⁰⁸ However, these gifts may be covered entirely by the \$6000 present interest gift tax exclusion available for gifts to spouses.¹⁰⁹ Even if the employee's share of the premiums is substantially larger than this amount, the gift tax, if any, to which the premiums may give rise will be far offset by the income and estate taxes avoided.

4. Ownership of Policies

The ownership of insurance policies generally should be in the beneficiary in order to avoid any income tax questions as to the character of the proceeds in the hands of the recipient. If a corporation owns a policy on the life of one of its shareholders and the proceeds of the policy are payable to the shareholder's spouse, the proceeds may be treated as a dividend to the spouse.¹¹⁰ And if the deceased was an employee, the spouse may be taxed with compensation income.¹¹¹

Even if the corporation has no ownership rights in the policy, the division between ownership and beneficiary designation may give rise to problems. The wife who owns a policy on the life of her husband payable to the children, may be deemed to have made a taxable gift to them when they collect the proceeds.¹¹² Thus, to avoid estate taxes on insurance proceeds, the insured should not be the owner of an insurance policy. To

¹⁰⁴ See Treas. Reg. § 20.2042-1(c)(6) (1958).

¹⁰⁵ For a general description of the Internal Revenue Service view of split-dollar arrangements, see Rev. Rul. 64-328, 1964-2 C.B. 11.

¹⁰⁶ Normally it will be preferable for the employee to pay the premiums himself, perhaps using cash bonuses from the employer. He will have the same amount of income whether the company pays the premiums or gives him the cash with which to pay. However, the company will have a compensation deduction for the bonus payments, while the deduction for the premium payments would be barred by I.R.C. § 264(a)(1).

¹⁰⁷ Rev. Rul. 76-274, 1976-2 C.B. 278.

¹⁰⁸ I.R.C. § 2503(a).

¹⁰⁹ The \$6,000 figure is arrived at by combining the \$3,000 exclusion under § 2503(b) and the \$3,000 marital deduction under § 2523.

¹¹⁰ See Rev. Rul. 61-134, 1961-2 C.B. 250. *But see* Estate of J.E. Horne, 64 T.C. 1020 (1975).

¹¹¹ *Essenfeld v. Commissioner*, 311 F.2d 208 (2d Cir. 1962).

¹¹² *Goodman v. Commissioner*, 156 F.2d 218 (2d Cir. 1946).

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avoid income and gift taxes, beneficiaries should be the owners. The split dollar arrangement mentioned in the preceding section does not counter this advice. To meet the conditions of the cited ruling regarding split dollar arrangements, the wife must be in fact the owner of that portion of the insurance that will go to her benefit.¹¹³

The approach most beneficial to the estate and survivors is quite simple: the beneficiary of insurance proceeds, whether the entire proceeds or split dollar proceeds, should own the policy or that portion of the policy which relates to the portion of the proceeds of which he is beneficiary.

CONCLUSION

In the past, many attorneys confronted with planning for the successive ownership of a close corporation, have been too ready to reach for a form book, assuming that, like Army issue, one coat will fit all. The new law mandates a tailormade approach. The provisions which enable capital gain redemptions and the extension of estate-tax payments for as long as fifteen years require that the close corporation stock constitute a significant portion of the estate. The benefits of these sections must therefore be weighed against the difficulties created when a large portion of an estate consists of nonliquid securities. The carryover of basis has further complicated the choice of stock structure because post mortem sales will now generate increased capital gains tax. Although the new rules are even more technical than the old, the attorney's first attention still should go to clarifying the economic and personal considerations involved. What is the family's need for cash? To what extent can it be met through pension arrangements or insurance rather than through a buy-out agreement? How important is it to the surviving shareholders to be able to buy the stock of the decedent? Is it sufficient if they are protected through a right of first refusal against the transfer of decedent's stock to strangers rather than a mandatory buy-out agreement? By keeping such basic economic considerations foremost in his mind, the attorney can best protect a client against the risk that the desire to meet the technical requirements of the new law will lead to an arrangement that is not really in the best interests of the parties.

¹¹³ See text at note 107 *supra*.