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# Structuring Ownership of Privately-Owned Businesses:

# Tax and Estate Planning Implications

**Presented Friday, October 20, 2006, 8:30-11:30 am, as part of Estate Tax Planning for the Transfer of Business Interests for the RPPT Business Planning Group and Tax Section's Closely Held Businesses Committee. Materials prepared September 12, 2006.**

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by Steven B. Gorin[*]

With rapid changes in our global economy, flexibility in structuring a business entity is more important than ever. This article focuses on income tax flexibility in buying into a business and also exiting from or dividing a business, also lightly touching the taxation of operations. It then discusses estate planning implications, including drafting and administering trusts to hold business interests, transfer tax issues, and fairness within families.

## I. Introduction

This article focuses on the distinctions between corporations and partnerships. The glossary focuses on how an entity becomes taxed as a corporation or a partnership and discusses some of the state business law aspects under various model state laws. The glossary's section on S corporations includes special provisions regarding the single class of stock rules. The main body of this article focuses on federal tax issues and state law non-tax issues.

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This article does not attempt to do an in-depth analysis of choice of entity issues, income tax on operations, or entity split-ups. Rather, it tries to distinguish between the most basic issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

## II. Income Tax Flexibility

Income tax flexibility is divided into general considerations for corporations, LLCs and partnerships; buying into a business; income taxation of operations; and exiting from or dividing a business.

### II.A Corporation

#### II.A.1 C Corporation

A C corporation is a corporation that is not taxed as an S corporation. It pays income taxes on its own earnings, and its shareholders pay income tax on any dividends they receive. Corporations whose stock is publicly traded are C corporations.

Some corporations are C corporations simply because they were formed before S corporation taxation was even available. They may have ignored or been unaware of tax planning opportunities. Or, they may not be eligible to be taxed as an S corporation, because they have too many shareholders, shareholders who are not eligible to own stock in an S corporation, or a capital structure that is inconsistent with an S corporation's requirement that all shares of stock have the same distribution and liquidation rights.

Other corporations are C corporations to minimize taxes. The income tax on the first $50,000 of a corporation's taxable income is only 21% (15% federal plus 6.25% Missouri).[1] The shareholders are not subject to income tax or self-employment tax on the reinvested income. More fringe benefits are allowed to C corporation shareholders than the owners of any other entity. If the shareholders do not take dividends, and later sell the company, even the wealthiest taxpayer could eventually pay federal capital gains tax of only 15%. Some special rules provide for even more favorable capital gains tax on the sale of stock in a C corporation.

#### II.A.2 S Corporation

An S corporation is a corporation whose income generally is taxed to its owners rather than being taxed to the corporation itself. Below are some examples of when it is possible that an S corporation may be appropriate:

- **Existing Corporation - Avoiding Double Taxation**. An existing corporation would like to start paying dividends to its shareholders. However, as a regular corporation (described by

[1] Note that, even with a lower dividend income tax rate, 15% federal plus over 6.25% Missouri corporate income tax, together with the shareholder paying 15% federal and 6.25% Missouri income tax, is not really a bargain at all unless the corporation retained its earnings for a while for some business purpose.

tax practitioners as a C corporation), it would pay tax on its earnings, and its shareholders would pay tax on the dividends. The shareholders make an S election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings while the corporation was an S corporation.

- **Existing Corporation - Paying Retired Shareholder-Officers**. One of the shareholders decides to retire but would still like the company to pay him the substantial salary he is used to receiving. The shareholders have never formally agreed what would happen when one of them retires. If the company pays "compensation" to a shareholder who is not working, the IRS could try to disallow a deduction for the payment, claiming that it is really a dividend. The shareholders make an "S" election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. Each shareholder receives a pro rata share of the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings while the corporation was an S corporation. At the same time, the shareholders agree on a formula for how much compensation each shareholder-officer will receive, so that the retired shareholder can be sure that the remaining shareholders do not receive all of the profits through compensation.

- **New Corporation - Avoiding Double Taxation and Self-Employment Tax**. As a new business owner, clients should be concerned with double taxation - once when the company earns profits, and again when the company pays dividends. Even if a reduced capital gain tax rate applies to dividends, one must add up two levels of federal income tax and two levels of state income tax. However, partnership income tax might not be desirable, either, since the owners generally must pay self-employment tax (under which the owner in effect pays the company's and the employee's share of Social Security and Medicare tax) on all of her share of the company's earnings. Instead, the client might want to pay payroll taxes on only what they receive as compensation and not pay self-employment tax on money that is reinvested in the business. As the business grows, clients do not want to pay self-employment tax on a return of their investment, just on compensation they receive for services they perform. It is possible that an S corporation may be an appropriate entity. We also use several tools to try to transfer S stock free from estate and gift taxes.

### II.A.2.a Making the S Election

S elections are made on IRS Form 2553, filed no later than two months and 15 days after the beginning of the tax year the election is to take effect. The instructions to IRS Form 2553 discuss when an extension of time to file might be granted.

### II.A.2.b Single Class of Stock Rules

### II.A.2.b.i Generally – Voting and Nonvoting Stock

Although S corporations cannot have more than one class of stock,[2] differences in voting rights do not by themselves create a second class of stock.[3] Generally, if all outstanding shares of stock

[2] Code § 1361(b)(1)(D). All references to a "Code" section are to the Internal Revenue Code, 26 U.S.C.

confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[4] Thus, the corporation should issue voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. This capital structure also avoids gift and estate tax problems under the anti-freeze valuation rules of Chapter 14.[5]

Typically, the S corporation starts with one type of voting stock. Then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[6] The author's tendency is to distribute 19 shares of nonvoting stock for each share of voting stock. This allows the voting stock to retain a significant portion, yet allows the original owner to shift 95% of the distribution and liquidation rights when transferring the nonvoting stock to the next generation. Retention of voting stock while transferring nonvoting stock does not create estate tax inclusion issues.[7]

Future reallocations between voting and nonvoting stock would not create income tax consequences.[8] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their values.[9]

### II.A.2.b.ii Providing Equity-Type Incentives Without Violating the Single Class of Stock Rules

As discussed earlier, S corporations cannot have more than one class of stock.[10] The single class of stock rules focus on rights to distribution and liquidation proceeds.[11] However, many techniques allow employees to be compensated in a manner similar to a shareholder without being considered to be a shareholder. Or, employees could hold actual stock whose liquidation rights materially differ from the other stock but is not deemed a second class of stock because of special exceptions that apply only to shareholders who are employees.

Certainly, an employer can give an employee a bonus based on the company's profitability. How far can an employer go in providing compensation that functions like stock ownership without actually being stock?

- An employment agreement is not a binding agreement relating to distribution and liquidation proceeds (and therefore is not a second class of stock) unless a principal purpose of the agreement is to circumvent the single class of stock rules.[12] Even if

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3 Code § 1361(c)(4).

4 Reg. § 1.1361-1(l)(1). All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.

5 Code § 2701(a)(2)(C) provides that Code § 2701 does not apply to such a capital structure.

6 Code § 301(a) taxes only a distribution of property, and refers to the Code § 317(a) definition of "property." Code § 317(a) provides that "property" does not include stock in the corporation making the distribution.

7 Rev. Rul. 81–15; Prop. Reg. § 20.2036-2(a).

8 Code § 1036. Voting trust certificates are also eligible for an income tax-free swap. Letter Rul. 200618004.

9 *Bosca*, TC Memo 1998-251.

10 Code § 1361(b)(1)(D).

11 Reg. § 1.1361-1(l)(1).

12 Reg. § 1.1361-1(l)(2)(i).

the IRS finds that one shareholder's compensation is excessive, that finding will not violate the single class of stock rules unless a principal purpose of the agreement is to circumvent those rules.[13]

- If a call option issued to an employee does not constitute excessive compensation, the option is not treated as a second class of stock if it is nontransferable and does not have a readily ascertainable fair market value when issued.[14] However, if the strike price is substantially below the stock's fair market value when the option becomes transferable, it may be treated as a second class of stock if the option is materially modified or transferred to an ineligible shareholder.[15] The safest course of action would be to (1) make the option always be nontransferable without a readily ascertainable fair market value as described above, or (2) start with an option that is transferable only to eligible shareholders and has a strike price that, at inception, is at least 90% of the stock's fair market value.[16]

Under certain circumstances, an employer may issue stock to an employee and repurchase it at a bargain price without violating the single class of stock rules:[17]

Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of section 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

The company can redeem an employee's stock for an amount significantly below its fair market value on the termination of employment or if the company's sales fall below certain levels, when the employee did not receive the stock in connection with his performing services and a principal purpose of the agreement is not to circumvent the single class of stock rules.[18] Could a sale price that is nominal be considered not to be bona fide or be considered to make the stock forfeitable, throwing it into the rules that apply to forfeitable stock? The author has not researched whether this is a legitimate issue, but generally would feel comfortable with a redemption price at book value, because Reg. § 1.1361-1(l)(2)(iii)(A) provides (emphasis added):

> Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless --

[13] Reg. § 1.1361-1(l)(2)(v), Example (3). Disparate employee fringe benefits are similarly acceptable. *Id.*, Example (4).
[14] Reg. § 1.1361-1(l)(4)(iii)(B)(2).
[15] Reg. § 1.1361-1(l)(4)(v), Example (2).
[16] Reg. § 1.1361-1(l)(4)(iii)(C).
[17] Reg. § 1.1361-1(l)(2)(iii)(B). But see Letter Ruling 200632004, in which the IRS ruled that a bargain repurchase of stock held by a director would constitute a second class of stock.
[18] Reg. § 1.1361-1(l)(2)(vi), Example (9).

(1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and

(2) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.

**Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.** For purposes of this paragraph (l)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

Such a price would prevent the terminated employee from benefiting from valuation methods based on earnings or unrealized appreciation in the company's tangible or intangible assets.

## II.B Limited Liability Company

A limited liability company (LLC) is a business entity that generally has liability protection similar to that of a corporation. However, for federal tax purposes, an LLC is treated as follows:

- **Disregarded Entity**. If it has only a single member (owner), it is disregarded for federal tax purposes, unless it elects otherwise.[19] Ordinarily, a disregarded entity uses its owner's taxpayer ID.[20]

- **Partnership**. If it has more than one member, it is taxed as a partnership for federal tax purposes, unless it elects otherwise.[21]

- **Corporation**. An LLC can elect to be taxed as a corporation for federal tax purposes.[22] It may further elect taxation as an S corporation, if every unit of ownership has identical rights to distributions and liquidation proceeds.[23]

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[19] Reg. § 301.7701-3(b)(1)(ii).

[20] Reg. § 301.6109-1(h), T.D. 8844 (preamble) (11/29/99), and IRS Notice 99-6.

[21] Reg. § 301.7701-3(b)(1)(i).

[22] Reg. § 301.7701-3(c)(1)(i) provides that the election is made on IRS Form 8832.

[23] The instructions to IRS Form 2553 originally provided that, to be taxed as an S corporation, an LLC must elect taxation as an association under IRS Form 8832 and make the S election using IRS Form 2553. The Instructions to the March 2005 revision to IRS Form 2553 allow many LLCs to skip the step of filing IRS Form 8832.

Below are examples of situations when an LLC taxed as a sole proprietorship or partnership might be the best bet.

- **Real Estate - Sole Owner**. A client holds one or more parcels of real estate. The client would like to insulate his/her other assets from liability for what occurs on his/her real estate. Furthermore, the client would like each parcel to be insulated from liability for what happens on each other parcel. A possible solution may be to form a separate LLC to hold each parcel. Because each LLC would be disregarded for federal tax purposes, forming the LLCs would not complicate his/her tax situation.

- **Real Estate - Co-Owners**. A client own real estate with one or more other co-owners. One of the client's co-owners manages the property, or perhaps the client has a management company manage the property. In some situations, co-ownership is considered a general partnership even if there is no formal partnership agreement. If the client is considered a general partner under state law, the client is jointly and severally liable for acts or omissions by the client's co-owners or those the client's "partnership" hires. Furthermore, if most, but not all, of the co-owners agree to sell or lease the property, the sale or lease cannot proceed without unanimous consent or court action. One dissenter could cause the client to lose valuable business opportunities. Finally, if a co-owner gets into creditor problems, the creditor may take his place and try to sell the property prematurely, perhaps even going to court to force a sale. A possible solution may be to form an LLC to hold the property. The LLC may relieve the client from joint and several liability and provide a mechanism for a majority to control the property. Any creditor who obtains an interest in the LLC would have no right to vote on how the LLC is run and should not be able to get a court order to sell the property.

- **Sole Proprietorship - Unsure of Best Entity for Tax Purposes**. A client starts his/her own business. Initially, the client wants to keep it simple, as a sole proprietorship. Later, the client may want to become an S corporation to avoid self-employment tax or a C corporation after making a public offering. The client starts as an LLC. Instead of transferring all of his/her assets to a new corporation when he/she later decides to change the LLC's tax treatment, he/she simply makes an election for the LLC to be taxed as an S corporation or a C corporation.

- **Sole Proprietorship - Future Co-Owner**. A client starts his/her own business. He/She expect to eventually have co-owners as his/her business grows. However, the client does not want to have to re-title assets when he/she adds his/her first co-owner. Perhaps the client has a valuable lease, patent, copyright, franchise right, etc. that would be difficult to transfer. The client may want to start as an LLC and admit his/her new co-owners as members of the LLC.

- **Multiple Owners, Coming and Going**: In a client's profession or industry, it is common for new people to invest in his/her business or perhaps even to become co-owners without investing any cash (providing services instead). Similarly, it is possible that the business may split up some time in the future, each person taking his/her own share of the business with him/her, as often happens in professional firms. For federal tax purposes, partnership income tax may provide the most opportunity to minimize tax on new co-owners or on split-ups. As the only business entity taxed as a partnership in which generally no co-owner is personally liable, it is possible that an LLC may be appropriate.

- **One Business, Multiple Locations**. A client's business has several locations, whether in the same city or even in different states. He/She would like each location to be insulated from the liabilities of other locations. His/Her business could set up a separate LLC for each location, but for federal income tax purposes nothing has changed.

These are just some of the possible reasons to consider forming an LLC. We integrate LLCs with clients' business objectives and estate planning goals. We also use several tools to try to transfer interests in LLCs free from estate and gift taxes.

An LLC formed in Missouri needs to register with the Secretary of State at inception. Future registrations are not necessary, except to the extent that the registration information changes. Missouri follows federal tax laws.

An LLC formed in Missouri can do business in another state. It just needs to register with that other state, and such foreign registrations generally are as simple as if the LLC had been formed in that state originally. Missouri apportions its state income tax consistent with the way many other states do. If all the business activities are conducted in that other state, generally the other state, not Missouri, would tax those activities.

## II.C Partnership

If clients are doing business as a partnership and are concerned about protection from liabilities incurred by the business, we help them determine whether registering as an LLP, converting to an LLC, converting a general partner to an LLC, or forming one or more LLC subsidiaries might be an appropriate strategy.

### II.C.1 General Partnership

In general partnerships, which are governed by the Uniform Partnership Act, all partners have management rights and are jointly and severally liable for the partnership's activities. A general partnership can be formed by an express agreement or through an activity in which co-owners work together to try to earn a profit (even if a general partnership was not intended).

### II.C.2 Limited Partnership

A limited partnership is formed by filing a Certificate of Limited Partnership with the secretary of state for the state in which the partnership is formed. The Uniform Limited Partnership Act limits the rights and liability of limited partners and vests control in the general partners. The rights and liabilities of the general partners among themselves, including joint and several liability for the limited partnership's activities, are governed by the Uniform Partnership Act.

### II.C.3 Limited Liability Partnership Registration

In recent years, the Uniform Partnership Act has added an optional feature to limit the liability of general partners of general or limited partnerships. This feature allows the general partners to limit their liability by registering the entity as a limited liability partnership (LLP) with the secretary of state. In Missouri, a limited partnership with an LLP registration is known as a limited liability limited partnership. However, Missouri LLP (or LLLP) registration often is not quite as easy as LLC registration, and it cannot be retroactively reinstated if not renewed timely.

## II.D Buying into a Business

Buying into a business includes starting a business from scratch and buying into an existing business. Each of those two issues is discussed as applied to corporations, as applied to partnerships, and as compared between the two.

### II.D.1 Corporations

Generally, initial incorporation is not a taxable event[24] except to the extent that liabilities (other than accounts payable regarding ordinary business expenses) assumed by the corporation exceed the adjusted basis of assets contributed to the corporation.[25] However, gain is fully recognized if the transaction's principal purpose is to avoid federal income tax.

To qualify for non-recognition of gain, the transferor(s) must control at least 80% of the shares' votes and at least 80% of each class of nonvoting stock. Various other restrictions on favorable tax treatment may apply depending on the situation.

### II.D.2 Partnerships

Generally speaking, when a partner contributes property to a partnership, the partner does not recognize any gain or loss inherent in the property at the time of contribution.[26] Thus, when no gain or loss is recognized, the partnership's adjusted basis in the contributed property is the same as it was in the hands of the contributing partner.[27] The partner's basis in the partnership is also equal to the partner's basis in the partner's contributed property.[28]

However, a contributing partner must recognize gain on certain occasions. First, § 721(b) requires a contributing partner to recognize built-in gain on contributed property if the partnership is equivalent to an "investment company," as defined in § 351. Thus, when a partner contributes property with a fair market value that is greater than its adjusted basis to an

[24] Code § 351.
[25] Code § 357(c).
[26] Code § 721(a).
[27] Code § 723.
[28] Code § 722.

"investment company" partnership, the partner recognizes the appropriate gain.[29] The gain recognized by the contributing partner increases the basis of not only the contributor's partnership interest,[30] but also the partnership's basis in the property.[31] Generally, the contribution to a partnership will be considered to be made to an investment company if (a) the transfer results in a diversification of the transferor's interests, and (b) more than 80% of the partnership's assets are held for investment and are readily marketable stocks or securities or interests in regulated investment companies or real estate investment trusts.[32] Thus, the main way to avoid having a contribution treated as having been made to an investment company is to ensure the transfer does not result in diversification of the transferor's interests.[33] One way to do this would be to have all transferors contribute identical stock and securities in the same proportions, but this could require gifts or sales among the transferors before any contributions are made.[34] Another way to avoid investment company status would be to have each transferor contribute a portfolio of stock and securities that is already diversified.[35] Finally, the transferor will not attain diversification (and will not recognize gain) if the contributions of other partners are de minimis.[36]

Another exception to the general nonrecognition rule of Code § 721(a) can occur when a partner's share of liability in the partnership shifts. If a partner's share of liabilities increases, that increase is treated as hypothetical cash contribution and the partner's partnership interest basis is increased by that amount, but there are no immediate tax consequences.[37] However, if the partner's share of liability decreases, then the decrease is treated as a hypothetical cash *distribution*, the partner's partnership interest's basis is decreased, and the partner must recognize gain to the extent the hypothetical distribution is greater than the partner's basis in

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[29] Code § 721(b).

[30] Code § 722.

[31] Code § 723.

[32] Reg. § 1.351-1(c)(1). Code § 351(e)(1)(A) requires that, in determining whether a company is an investment company, one must take into account all stock and securities held by the company. § 351(e)(1)(B) lists the following assets that are to be treated as stocks and securities: (1) money (contrary to the Regulations), (2) stocks, options, forwards, futures, notional principal contracts and derivatives, (3) foreign currency, (4) interests in real estate investment trusts, common trust funds, regulated investment companies, publicly traded partnerships, (5) interests in precious metals, (6) interests in any entity if substantially all of that entity's assets consist of the aforementioned assets, or (7) any other assets specified in the Regulations. The Regulations have not been amended to reflect Code § 351(e).

[33] As discussed later, partnerships that invest substantially all of their assets in stock, bonds, etc. have certain favorable rules when distributing marketable securities. Investing directly in real estate or operating a trade or business generally precludes using these favorable rules.

[34] Reg. § 1.351-1(c)(5). Pre-contribution transfers between spouses may be an excellent solution. PLR 200317011.

[35] See Reg. § 1.351-1(c)(6), referring to the "25 and 50-percent tests of § 368(a)(2)(F)(ii)" to determine whether a portfolio is diverse. Under § 368(a)(2)(F)(ii), the twenty-five percent tests requires that not more than twenty-five percent of the value of the portfolio be invested in the stock and securities of any one issuer, and the fifty percent test requires that nor more than fifty percent of the value of the portfolio's total assets be invested in the stock and securities of five or fewer issuers.

[36] Reg. § 1.351-1(c)(7) includes an example where the partner whose contribution was being tested for diversification contributed $20,000, while all other partners contributed $200. The $200 was disregarded for purposes of testing diversification, and no gain was recognized by the partner who contributed $20,000.

[37] Code § 752(a); Code § 722.

such partner's partnership interest immediately before the deemed distribution.[38] One situation that could lead to an increase or decrease in partnership liabilities is when a partner contributes to the partnership property subject to a liability. In such a case, the partner's partnership interest basis is increased to the extent of the partner's allocated share of liabilities, but is also decreased by the amount of the liability that is allocated to the other partners. The net result could be a decrease in the partner's share of partnership liabilities, which could lead to gain recognition.[39]

Another case in which a partnership contribution can lead to tax consequences is when a partner transfers property to the partnership and there is a related transfer back to the partner. Under Code § 707(a)(2) and Reg. § 1.707-3(b), when a partner receives a direct or indirect transfer of money or other property related to a transfer he made to the partnership, the transfer can be treated as a sale or exchange of property between partner and the partnership.[40] Such transfers are presumed to be a sale or exchange if made within two years of one another, unless the facts and circumstances clearly establish the transfers were not a sale or exchange.[41]

This rule can be especially important when a partner contributes to the partnership property subject to a liability. If the partnership assumes or takes subject to the liability, the transfer may be considered a sale and some or all of the liability amount may be treated as consideration received by the contributing partner.[42] If the liability assumed or taken subject to is considered a "qualified liability" under Reg. § 1.707-5(a)(6),[43] then the liability is not treated as consideration for a sale unless there is some other reason for the transfer to be treated as such.[44] If the liability is not a qualified liability, then the partner is treated as having received consideration for his

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[38] Code § 752(b); Code § 731(a).

[39] Reg. § 1.752–1(f). Generally, the allocation rules for nonrecourse liabilities will prevent the hypothetical distribution amount to the contributing partner from exceeding the basis of the contributing partner's partnership interest. Reg. § 1.752-3(a). Often, the contributing partner's Code § 704(c) responsibility will cause the contributing partner to be allocated nonrecourse debt sufficient to take care of this issue. Reg. § 1.752-3(a)(2). Additionally, if the partner contributes property subject to a recourse liability and the property remains recourse only to him, there will be no hypothetical distribution and no related recognition. Reg. § 1.752-1(g), Ex. 1. If the debt is part recourse and part nonrecourse, it is bifurcated. Reg. § 1.752-1(i). See also T.D. 9207, promulgating Reg. §§ 1.752–6 and 1.752–7 regarding certain assumptions of liability.

[40] Reg. § 1.707-3(b)(2) lists facts and circumstances to be considered in determining whether the transfers constitute a sale.

[41] Reg. § 1.707-3(c)(1).

[42] Reg. § 1.707-5.

[43] This section gives four definitions for a qualified liability. The first definition is a liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to the transfer or the date of the transfer and that has encumbered the transferred property throughout that two-year period. The next "qualified liability" is a liability that was not incurred in anticipation of the transfer to the partnership, but that was incurred by the partner within two years prior to the earlier of the date of agreement to transfer or the date of the transfer and that has encumbered the property since it was incurred. Third, a qualified liability includes a liability that is allocable under Reg. § 1.163-8T to capital expenditures with respect to the property. Finally, a qualified liability can be a liability that was incurred in the ordinary course of business in which the property transferred was used or held but only if all the assets related to that trade or business are transferred, other than assets not material to the continuation of the business. In cases of recourse liabilities, in addition to falling into one of the four categories, the amount of the liability must not exceed the fair market value of the transferred property (less other liabilities) at the time of the transfer.

[44] Reg. § 1.707-5(a)(5)(i).

transfer to the extent the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.[45] If the non-qualified liability is a recourse liability and the contributing partner continues to be the only recourse party, then the liability will never be treated as consideration because the partner's share of the liability does not change.[46] However, if the partner contributes a non-qualified, non-recourse liability, then some of the liability may be treated as consideration, since some of the liability will shift to other partners, but the amount of the non-recourse liability that shifts is not determined under the normal Code § 752 rules for allocating partnership liabilities.[47]

### II.D.3 Comparison, Including Providing Equity to Key Employees

Avoiding non-recognition of gain is much easier for a partnership than for a corporation. Assumption of liabilities generally does not cause problems with partnerships, because the partner who contributes the liability generally receives a special allocation of that liability under the partnership rules if the liability exceeds the contributing partner's basis.[48] Neither the 80% control test nor any business purpose rule applies.

An employee who receives stock as compensation for services must pay tax on that stock. Code § 83. However, if the corporation awards nonvested stock, then the employee does not recognize compensation until the stock vests, unless the employee makes a Code § 83(b) election no later than 30 days after the award.[49] Usually the corporation will "gross-up" the employee's pay by paying the employee's taxes on that compensation.

However, a partnership can award a profits interest to a service partner. This usually makes more sense, in that a service provider usually is interested more in sharing the fruits of the business' future success than in buying its existing assets. Awarding a profits interest is also less expensive, because it does not require buying any of the business' current value.

Under Rev. Proc. 93-27, if a person receives a profits interest[50] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, generally the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership. However, that rule does not apply:

[45] Reg. § 1.707-5(a)(1).
[46] Reg. § 1.707-5(a)(2)(i).
[47] Reg. § 1.707-5(a)(5).
[48] However, a shifting of liabilities might constitute a disguised sale.
[49] Code § 83(b)(2).
[50] Under the Rev. Proc., a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code § 7704(b).

If Rev. Proc. 93-27 applies, the profits interest is treated as a capital asset when the service provider sells it.

Rev. Proc. 2001-43 applies Rev. Proc. 93-27 to the grant of a partnership profits interest that is substantially nonvested for the provision of services to or for the benefit of the partnership. Under Section 4 of Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, and a Code § 83(b) election will not be required, if:

.01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;

.02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and

.03 All other conditions of Rev. Proc. 93-27 are satisfied.

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest, then the service provider recognizes ordinary income (and the partnership is deemed to have paid compensation) when the profits interest vests. The holding period for a later sale f the profits interest would be based on the date of vesting, rather than the date of grant.

The IRS has proposed regulations[51] that would change these rules for profits interests, effective only when the regulations are finalized. Under the proposed regulations, a service provider would be required to recognize income upon receipt of a vested profits interest. A Code § 83(b) election would be required to treat a substantially nonvested as if it were vested. At any rate, determining the value of the profits interest generally would require an appraisal and complicate future accounting on many levels. IRS Notice 2005-43 proposes a Rev. Proc. to allow taxpayers to elect to determine the value based on the awarded partnership interest's liquidation value determined immediately after the grant of the partnership interest. If the partnership interest is

[51] REG-105346-03, proposing changes to Reg. §§1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, 1.761-1.

merely a profits interest, the liquidation value would be zero. The proposed Rev. Proc. would supersede Rev. Proc. 93-27 and Rev. Proc. 2001-43; however, until the proposed Rev. Proc. is finalized, taxpayers may continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

As described in part II.G.3.a.ii, the issuance of a profits interest is, from an income tax perspective, an excellent way to transition a closely-held business to the next owners. However, profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact of Code § 2701.[52] Until further guidance is issued, Code § 409A does not apply to profits interests.[53]

Performance bonuses that are due March 15 after a calendar year-end can have excellent motivational effects and comply with all of the various rules discussed in these materials. The main obstacle to overcome is to make sure that, when the performance bonus is added to other compensation, the service provider's total compensation must be reasonable. Performance bonuses based on profits should not constitute an equity interest under Code § 2701 if the service provider does not have any other equity interest, the service provider is not identified to the IRS or third parties as being an owner, and the service provider does not share in any losses. Finally, because the date is fixed no later than 2.5 months after yearend, paying compensation after that fixed date would not cause the payment to violate Code § 409A if the payment is made during the calendar year including the fixed date.[54]

Further below, we discuss that a fixed payment upon attaining a particular age would satisfy Code § 409A without causing Code § 2701 or other income or estate tax problems, coupling that with a disability and death benefits.[55] Suppose, for example, that $100,000 payments begin when the parent attains age 65, and the parent currently makes $150,000 per year. If the parent is not ready to retire at age 65, then:

- The parent receives the $100,000 deferred compensation each year, even though the parent has not retired.

- ***Before*** the beginning of any calendar year with respect to which the parent would earn $150,000 for working, the parent elects to defer the compensation the parent would have received. For example, the parent might elect to take $50,000 of what the parent earns currently (for a total of $150,000, including the deferred compensation) and postpone payment of the remaining $100,000 to a later date. Another alternative might be for the parent's annual compensation to be cut back to $50,000 per year, keeping the parent's total package at $150,000 ($100,000 deferred compensation plus $50,000 current earnings). These alternatives provide nice flexibility, with the parent deciding each year how to treat what he or she will earn the following year.

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[52] See part III.B.4 for a discussion of Code § 2701.
[53] Notice 2005-1, Q&A-7.
[54] Prop. Reg. § 1.409A-1(b).
[55] See text accompanying footnotes 454-460.

Change in the entity's control is an event that can trigger payment of deferred compensation without the harsh consequences of Code § 409A.[56] Generally, such a change in control in a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.[57] Similar rules apply to partnerships.[58] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

Finally, options to acquire equity are deductible at the time a Section 83(b) election is made, or, if a Section 83(b) election is not made, when the option is exercised; if an important goal is to convert them to deductible compensation upon the transfer of an interest in the business to the holder, a Section 83(b) election should not be made. They do not constitute an equity interest in a corporate setting and, if the service provider is not a partner, do not constitute an equity interest in a partnership interest.[59] Thus, they should not be subject to Code § 2701. However, they are subject to Code § 2703 in a family-controlled business, so they must be binding during life and after death and must satisfy the comparability test. The rest of these materials focus on the requirements to exclude stock options from Code § 409A; satisfying these tests is likely to bring a taxpayer into compliance (or least close to compliance) under the Code § 2703(b) comparability test under the Amlie case.[60]

The Treasury and IRS have not issued guidance on options to acquire partnership interests, other than to provide that such options are subject to rules similar to those governing corporate stock options.[61] If the stock option's exercise price is never less than the underlying stock's fair market value on the date the option is granted, then generally the stock option does not constitute deferred compensation.[62] Thus, the key to a successful stock option is determining the value on the date that the option is granted.

For stock options issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers have two ways to determine fair market value:[63]

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[56] In order to cover earn-out provisions where the acquirer in a change of control contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, delayed payments may meet the requirements for a payment at a specified time or pursuant to a fixed schedule if they are paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control event to the extent paid not later than five years after the change in control event. Prop. Reg. § 1.409A-3(g)(5)(iv).

[57] Prop. Reg. § 1.409A-3(g)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Prop. Reg. § 1.409A-3(g)(5)(i).

[58] Third paragraph of Part VI.E. to the Preamble to the Prop. Regs., allowing taxpayers to rely on similar rules until further guidance is issued for a partnership setting.

[59] A partner's option to acquire a partnership interest might or might not constitute an equity interest. See text accompanying footnotes 469-472.

[60] The *Amlie* case is described in the text accompanying footnote 122.

[61] Notice 2005-1, Q&A-7.

[62] Prop. Reg. § 1.409A-1(b)(5)(i)(A).

[63] Notice 2006-4.

- Notice 2005-1, Q&A-4(d)(ii) provides that for purposes of determining the value of the underlying stock upon the grant of a nonstatutory stock option, "any reasonable valuation method may be used." This includes estate tax valuation under Reg. § 20.2031-2.

- Prop Reg. § 1.409A-1(b)(5)(iv)(B) provides additional details in response to commentators' assertions that the above Notice is too vague:

  (B) Stock not readily tradable on an established securities market.

  (1) In general. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation whose stock is to be valued, the value of which can be readily determined through objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology, all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

  (2) Presumption of reasonableness. For purposes of this paragraph (b)(5)(iv)(B), the consistent use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

  (i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations thereunder as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the grant date of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or substantially similar class of stock), and all noncompensatory purposes requiring the valuation of such stock, including regulatory filings, loan covenants, issuances to and repurchases of stock from persons other than service providers, and other third-party arrangements, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of an illiquid stock of a start-up corporation. For this purpose, an illiquid stock of a start-up corporation is service recipient stock of a service recipient corporation that has no trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put or call right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(g)(5)(v) or §1.409A-3(g)(5)(vii) or make a public offering of securities within the 12 months following the event to which the valuation is applied (for example, the grant of a stock option or exercise of a stock appreciation right). For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons with significant knowledge and experience or training in performing similar valuations.

A form of compensation similar to stock options is a stock appreciation right (SAR). A SAR is like a stock option, except that the employee never buys the stock. In many cases involving stock options, an employee borrows to exercise the stock option, repays the exercise price by selling the shares, and then keeps the remaining stock. A SAR gives the employee the same cash the employee would have received if the employee had borrowed to exercise the option, sold all of the stock immediately, and repaid the loan, without making the employee go through all of those steps and without the employee ever owning any of the underlying stock. If properly structured, a SAR would receive Code § 409A treatment similar to an option.[64] A SAR is likely have few, if any, Chapter 14 implications because the employee never receives any equity in the company.

Finally, awards of restricted stock could work well. Code § 409A does not apply merely because property is not includable income in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture under Code § 83 or is includable in income solely due to a valid election under Code § 83(b).[65] The service provider must receive actual shares of stock subject to forfeiture; a promise to transfer stock in the future is subject to Code § 409A,[66] although it could be excluded from Code § 409A for other reasons. However, the IRS takes the position that a gift of a stock option is an incomplete gift until exercise of the option is no longer conditioned on the performance of services by the transferor;[67] presumably, this attitude would also apply to restricted stock. The author disagrees with the IRS' position regarding incomplete gifts but cautions planners to consider whatever litigation risks the IRS' position might entail when making transfers of property conditioned on the performance of services by the transferor.

## II.E Buy-Sell Agreements

### II.E.1 General Buy-Sell Concepts

A buy sell agreement is a contract between owners and/or the entity that provides for the sale of an owner's interest upon the occurrence of a triggering event such as disability, retirement, or death. The three types of buy-sell agreements are: (1) redemption agreements; (2) cross-purchase agreements; and (3) a combination of redemption and cross-purchase. Deciding which type to use requires consideration of a number of factors including the number and ages of the shareholders involved and the weighing of tax consequences for each type of agreement.

These agreements determine the price and payment terms and restrict who can own an interest in the business. In a limited liability company (LLC), the buy-sell agreement is integrated into the operating agreement. In a partnership, the buy-sell agreement is integrated into the partnership agreement. In a corporation, whether a C corporation or an S corporation, the buy-sell agreement is integrated into a shareholders' agreement.

Key circumstances triggering a buy-sell agreement include the owner's divorce, bankruptcy, incapacity, or death. Special considerations may apply to an owner who works in the business,

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[64] Prop. Reg. § 1.409A-1(b)(5)(i)(B).
[65] Prop. Reg. § 1.409A-1(b)(6)(i).
[66] Prop. Reg. § 1.409A-1(b)(6)(ii).
[67] Rev. Rul. 98-21, reversing the IRS' prior private letter ruling position.

especially if the ownership interest was granted as an employment incentive. Also, owners like to choose their partners, so frequently the buy-sell provisions restrict transfers to outsiders.

In LLCs and partnerships, voting and management rights are not transferred automatically when ownership is transferred. An owner without voting and management rights is called an assignee. LLC and partnership buy-sell provisions specify whether a transferee is an assignee or has voting and management rights.

An S corporation may revert to a C corporation if too many shareholders own stock or if stock is transferred to an ineligible shareholder. Special buy-sell provisions are required to preserve the S election.

### II.E.2 Spousal Issues in Buy-Sell Agreements and Related Tax Implications

A number of issues can arise related to spouses holding interests in closely-held businesses. If these issues are not addressed, closely-held business owners could end up in losing a portion of their business to an ex-spouse, or an owner's estate could lose part or all of the marital deduction.

Some courts have held a business owner's buy-sell agreement not binding on the spouse, so spousal consent should be considered necessary to ensure enforcement of buy-sell agreements. First, such consent can prevent a divorce proceeding or elective share from causing an ex-spouse to be involved in the business. It also prevents a spouse from leaving her community property interest in the business to a third party. Finally, it protects the spouse from claiming a community property interest in the business upon the business owner's death.

However, even if the spouse consents by signing the buy-sell agreement, a court might rule that the spouse did not truly consent to the agreement because the spouse did not fully understand the agreement.[68] Preferably, the spouse would be represented by his or her own counsel. Be sure to update spousal consent when amending the buy-sell agreement.

In order to accomplish its objectives, a buy-sell agreement needs to specifically address transfers incident to divorce. If an agreement focuses on voluntary transfers, it is possible a court would not apply the restriction in the case of an involuntary transfer, such as a divorce transfer.

When a business interest is transferred to a spouse pursuant to a divorce agreement and the stock is then redeemed by the business for cash pursuant to the buy-sell agreement, the non-recognition rules for spousal transfers and the stock redemption rules collide. Before tax regulations addressed this situation, there was some question as to whether the transferring spouse should be taxed on the redemption or the spouse receiving the interest should be taxed. Reg. §1.1041-2(c) addresses this question and states that the spouses may chose who will be taxed on the redemption.

[68] See, e.g. *Suther v. Suther*, 627 P.2d 110 (Wash. App. 1981).

The buy-sell agreement price can have a significant effect on the estate tax marital deduction. If stock held in a marital trust is subject to a bargain buy-sell agreement, the marital deduction might be totally disallowed.[69] Such a provision might run afoul of Code § 2056(b)(5), which allows a marital deduction only if no other person has the power to appoint any portion of the interest to anyone except the surviving spouse, and Code §2056(b)(7), which requires that the spouse be the only beneficiary.

When a business passes to a surviving spouse in a trust, a QSST or an ESBT election must be made. All marital trusts qualify as QSST, and QSSTs generally have more favorable income tax effects than ESBTs. These issues are discussed elsewhere in these materials.

Minority and fractional discounts for closely-held businesses and marital trusts need to be considered in estate planning as well. When spouses together own a majority in a business under community property laws, they will be considered to own one-half of that interest, and thus will be entitled to discounts for lack of control in determining their estate value.[70] Additionally, fractional interest discounts may come into play when property interests are divided between a QTIP trust and a spouse. For example, if the surviving spouse owns 60% of a business and the remaining 40% is held in a QTIP trust, one might assume discounts for lack of control will not come into play when the second spouse dies. However, courts have held that the spouse's estate will be entitled to a discount for lack of control by disaggregating the QTIP trust from the spouse's other assets (in this example, providing a discount for lack of control for the QTIP stock).[71] However, this disaggregation would not apply to a general power of appointment marital trust (Code §2056(b)(5)).

Another issue arises when a business owner has a controlling interest in the company and bequeaths some portion of that interest to his spouse. Upon the owner's death, the full controlling interest value must be included in determining the owner's gross estate, and the estate will be entitled to some marital deduction for the portion passing to the spouse. However, that deduction is based on what passes to the spouse, not what is included in the estate. In *Estate of Chenoweth v. Commissioner*,[72] the decedent owned 100% of a business and left his spouse a 51% interest. The IRS claimed the highest marital deduction the estate could take was 51% of the full value of the business included in the gross estate, but the estate claimed it should be entitled to increase the deduction by some control premium. The court ruled that the estate should be entitled to attempt to prove the increased value and that no rule required that the marital deduction amount equal the value the property was assigned when included in the gross estate. While this holding can lead to a potential tax advantage for an estate, it also has a potentially negative effect. What if the decedent owned a controlling interest but passed a minority interest to the spouse? In this case, the marital deduction will be based on the value of the minority interest, even though the full value of the interest will be used in calculating the

[69] See *Estate of Rinaldi v. US*, 38 Fed. Cl. 341 (1997); *Estate of McCabe v. US*, 475 F.2d 1142 (Ct. Cl. 1973); TAM 9147065.
[70] See *Estate of Bright v. US*, 658 F.2d 999 (5th Cir. 1981).
[71] See *Estate of Bonner v. US*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999); *Nowell v. Comm'r*, T.C. Memo 1999-15.
[72] 88 T.C. 1577 (1987).

gross estate.[73] This same result can occur in the charitable contribution deduction context, when a decedent leaves a minority interest in stock to a charity.[74] Thus, estate planners need to be aware of this whipsaw effect when determining how the estate will be divided.

Generally speaking, it is usually best to have a spouse hold a business interest through a trust, rather than through outright ownership. The trust can protect the property from creditors and from new spouses if the surviving spouse remarries. A trust also allows the decedent to chose to have a third party involved in the management and investment of the property, if desirable. Additionally, a trust allows the decedent to designate who the remainder interest in the property passes to upon the spouse's death and might enable the decedent to devise property to successive generations without incurring estate tax. Finally, the trust form will allow the donor to structure the estate plan to take advantage of any potential minority discounts or control premiums that may apply.

## II.F Operations

Taxation of operations focuses on whether income from operations is taxed to the entity or to its owner(s), effect of contributed property on taxation of operations, to what extent are FICA taxes imposed, and miscellaneous issues.

### II.F.1 Income Taxation of Operations

#### II.F.1.a Generally

C corporations are taxed on their own operations. C corporations that have losses carry them back or forward to other years; C shareholders generally may not take current deductions for a decrease in the value of their stock unless the stock becomes worthless. A founding shareholder might be able to take an ordinary loss of up to $50,000 ($100,000 for joint returns) on the sale of stock under Code § 1244.

S corporations and partnerships generally do not pay income tax.[75] Instead, their income is taxed to their owners, whether or not their owners receive distributions. Accordingly, it is not uncommon for their organizational documents to mandate distributions to pay income tax. Owners generally may deduct losses to the extent of the owners' basis in their S stock or partnership interest. Owners of S corporations generally may not deduct losses financed by the corporation's debt except to the extent that the shareholders are the lenders; instead of guaranteeing a corporation's bank loan, S shareholders should borrow from the bank and then loan the proceeds to the corporation. In contrast, partners generally may deduct losses financed by bank loans to the partnership to the extent permitted by the Code § 465 at-risk rules.

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[73] TAM 9403005.

[74] See generally *Estate of Schwan v. Comm'r*, T.C. Memo 2001-174 (taking into account post-mortem transformations occurring in funding a charitable bequest).

[75] However, S corporations that had been C corporations might pay a tax on any built-in gain (excess of value over tax basis) if property that survived the conversion is sold within ten years. Code § 1374.

### II.F.1.b Allocations of Income in Partnerships and S corporations

Partnership income taxation of owners is more complex but more flexible than S corporation income taxation of owners.

#### II.F.1.b.i Allocations of Income in Partnerships

Allocation of income, gain, loss, deductions and credits among partners are governed by Code § 704(b) and Reg. § 1.704-1. These provisions set up a rule that requires the allocation of such income, gain, loss, deduction, or credit to have substantial economic effect or to be in accordance with the partner's interest in the partnership. These rules are set up to ensure that when a partner is allocated income, the partner is able to enjoy the economic benefit associated with that income, or that when he is allocated economic loss, the partner suffers the burden of that loss. This allocation is usually achieved through the use of partner capital accounts, that, in most basic terms, are increased by a partner's contributions or share of income and are decreased by distributions or the partner's share of a loss.[76] The goal of the capital account is to track the distribution amount a partner would receive if the partnership sold all of its assets at book value, paid off all liabilities, and then distributed any remaining cash to the partners in liquidation of the partnership.

Special allocation rules govern contributions of property and the income, gain, loss, and deductions associated with contributed property. Under Code § 704(c), contributed property's income, gain, loss, and deductions are allocated to all partners to account for differences between the partnership's basis in the property and the fair market value of the property at the time of its contribution.[77] This allocation ensures that the right person, the contributing partner, will realize any net pre-contribution gain or loss. Code § 704(c)(1)(B) prevents a partner from avoiding Code § 704(c) gain or loss by contributing property and having the partnership turn around and distribute it to another partner. When contributed property is distributed to any non-contributing partner within seven years of its contribution, the contributing partner is treated as though the property was sold to the recipient partner at its fair market value and must recognize the proper gain or loss under Code § 704(c)(1)(A). Note that a partner cannot erase the "Code § 704(c) taint" by transferring his interest to a third party. When a partnership interest is transferred, any tax attributes associated with the interest travel from the old partner to the new partner, and the new partner becomes the "contributing partner."[78] In addition to allocating gain or loss, Code § 704(c) also requires allocations of depreciation and amortization related to contributed property, as outlined in Reg. § 1.704-3.

If one partner transfers a partnership interest to another person, the transferee receives the transferor's capital account.

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[76] Reg. § 1.704-1(b)(2)(iv).
[77] Code § 704(c)(1)(A).
[78] Reg. § 1.704-4(d)(2).

Because of very complicated estate and gift tax rules governing family businesses,[79] generally family partnerships should be set up with one class of partnership interests. In other words, each partner's capital account is proportionate to that partner's percentage in interest in profits and losses.[80] However, businesses not involving family members can be more flexible, allocating different tiers of income as rewards for each partner's relative contributions of capital or services. In any event, the tax allocations need to be consistent with the economic arrangements; the tax jargon is that tax allocations must have a "substantial economic effect."

Whether the partnership has one or multiple classes of equity, issues arise when a partner contributes property whose value exceeds its basis. This excess value is known as Code § 704(c) responsibility. When contributed property is subjected to depreciation or amortization or is later sold, the contributing partner receives a special allocation to properly take into account that partner's Code § 704(c) responsibility.

### II.F.1.b.ii Allocations of Income in S corporations

As described further below, S corporations generally must have a single class of stock. Special allocations of profits are not permitted, and Code § 704(c) responsibility does not exist.

Also described further below are ways to creatively compensate employees, providing incentive that is the same as, or similar to, the results one can attain from partnerships.

S corporations are superior to C corporations in that undistributed S corporation income adds to the basis of the shareholders' stock.

### II.F.1.b.iii Advantages of C and S Corporation Reporting of Owners' Compensation on Forms W-2

C and S corporations must withhold taxes and file quarterly forms 941 and annual forms W-2 for owners' compensation, whereas partnerships and sole proprietorships are not involved in withholding taxes regarding owner compensation. Filing W-2 forms for owners provides some minor benefits:

(a) Unless the employee elects otherwise, federal income tax withheld is deemed paid evenly throughout the year. If the owner falls behind during the year, the owner may withhold large amounts at year-end which generally will be deemed paid evenly throughout the year.

(b) Qualified retirement plans have a cap on compensation that can be considered in allocating contributions to the plans. Owners of corporations could adjust their W-2 income to reduce their compensation in good years and increase it in bad years to plan around this

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[79] Code § 2701.

[80] Not only does a pro-rata capital structure help a family partnership avoid Code § 2701 problems, it also enables the partnership to comply with Code § 704(e) rules governing family partnership allocations. Code§ 704(e) requires a partner's capital account to be proportionate to the partner's profit-loss percentage when capital is a material income-producing factor in the partnership.

cap. Partners and sole proprietors do not have this flexibility. Of course, all businesses on the cash basis could delay or accelerate billings or disbursements.

### II.F.2 FICA

### II.F.2.a FICA: Partnership or Sole Proprietorship

Generally, all of a partnership's or sole proprietorship's operating income is subject to income tax and FICA (self-employment tax) tax. Self-employment (SE) tax is 15.3% on income up to the taxable wage base (TWB) and 2.9% on all (RRA 1993 repealed the cap) income above the TWB. See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount ($94,200 in 2006). Half of the SE tax is deductible for income tax purposes.

However, income from rental activity generally is not subject to SE tax.[81] Income from any other activity that is not a trade or business is not subject to SE tax.[82]

Also, a limited partner's income is not subject to SE tax,[83] except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[84] How this exclusion for limited partners is to be applied to LLCs and LLPs is uncertain.[85] Subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 provide:

> **(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.
>
> **(h) Definition of limited partner.**
>
>> *(1) In general.* Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.
>>
>> *(2) Limited partner.* An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—

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81 Reg § 1.1402(a)-4.
82 Reg. § 1.1402(a)-1(b).
83 Code Sec. 1402(a)(13).
84 Prop Reg §1.1402(a)-2.
85 See RIA's *Fed. Tax Coord. 2d* ¶A-6158.

(i) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter for the debts of or claims against the partnership by reason of being a partner;[86]

(ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[87] or

(iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

*(3) Exception for holders of more than one class of interest.* An individual holding more than one class of interest in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

*(4) Exception for holders of only one class of interest.* An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

[86] Does this mean personal liability as an inherent state law attribute of being an owner, or personal liability because lenders require all owners to guarantee loans?

[87] Does this mean a manager-managed LLC and the "limited partner" is not a manager, or member-managed with voting and nonvoting interests?

*(5) Exception for service partners in service partnerships.* An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

*(6) Additional definitions.* Solely for purposes of this paragraph (h)—

(i) A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

**(i) Example.** The following example illustrates the principles of paragraphs (g) and (h) of this section:

*Example.* (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) Application of general rule of paragraph (h)(2) of this section. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section. B's guaranteed payment of $6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) Distributive share included in net earnings from self-employment. C's guaranteed payment of $10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

### II.F.2.b FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax. Income retained by the corporation and not paid as compensation is not subject to FICA tax. For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners.[88] However, it is subject to FICA only if offered in a plan that discriminates in favor of owners. The owners may deduct health insurance subject to the same rules as partners and sole proprietors.[89]

[88] Rev. Rul. 91-26.

[89] IRS Announcement 92-16. *See also* IRS Notice 2005-8 (health savings accounts).

### II.F.3 C Corporation Advantage Regarding Fringe Benefits

Only a C corporation may deduct the following items without including them in the recipient's income:

(a) Dependent care (child care) assistance payments for owners subject to a dollar cap (generally $5,000).

(b) The owners' meals and lodging for the employer's convenience without including them in the owner's income.[90]

(c) Non-discriminatory premiums for up to $50,000 in group-term life insurance covering the owners without including them in the owner's income.

### II.F.4 Conversions for Tax Purposes

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership on S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable.

### II.F.4.a From C Corporations to Partnerships and Sole Proprietorships

The liquidation of a C corporation is a taxable event. The corporation is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis. The shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis.

### II.F.4.b From C Corporations to S corporations

This conversion is not, by itself, a taxable event. However, when any asset is disposed of within 10 years of the S election, generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the gain on disposition or the unrealized gain on the effective date of the S election.[91] Assets subject to this tax include inventory and a cash basis taxpayer's accounts receivable.

### II.F.4.c From Partnerships and Sole Proprietorships to C Corporations

This is the same as terminating a partnership and then forming a corporation. See the discussion of this topic elsewhere.

### II.F.4.d From S corporations to C Corporations

Conversion from S status to C status is not a taxable event. However, it requires an additional tax return if done mid-year and precludes an S election for 5 years.

[90] Code § 119.

[91] Code § 1374.

### II.F.4.e From Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. There is more than one way to structure each of these conversions, and the order of the steps taken can affect whether the conversion is taxed.[92]

## II.G Exiting from or Dividing a Business

A business' value is the present value of the expected future cash flows to its owners. A buyer uses these cash flows to pay the purchase price:

- ***Third-Party Financing***. A third-party lender provides cash to pay the purchase price in a lump sum. Business risk is shared between the buyer and the third-party lender, with the buyer assuming substantially all of the risk. Because the seller receives all cash up-front, the seller's risk is minimal.

- ***Seller Financing***. A series of payments from the buyer to the seller is evidenced through a promissory note. From a technical legal viewpoint, the buyer has all of the risk. However, as a practical matter, the seller is subject to business risk because the buyer is much less likely to pay if the business' cash flow is insufficient to service this debt. At any given point in time, the buyer is likely to withhold part or all of the remaining payments if the business' cash flow is less than expected.

- ***Equity Financing***. The seller receives payments based on the business' performance over a short period of time following the transfer, or the timing of buyer's payments depends on the business' profitability.

When the buyer uses debt to pay for the business, two layers of tax are imposed:

- First, the buyer pays income tax on the earnings used to repay the debt.

  - For a partnership or S corporation, if owners are taxed on income from operations at a 40% ordinary federal and state income tax rate, the business must earn $167 of profits to fund a $100 principal payment on the debt.[93]

  - A C corporation structure exacerbates this. If dividends are taxed at a 20% combined federal and state income rate, a $125 dividend generates $100 after tax. To distribute $125 to its shareholders, a C corporation that is subject to taxes on income from operations at a 40% ordinary federal and state income tax rate must

[92] See T.D. 8844 (preamble) (11/29/99) and Rev. Ruls. 99-5 and 99-6. See Rev. Rul. 2001–61 regarding retention of employer identification number.

[93] However, if the owner is a partner who must pay self-employment tax on the earnings, additional earnings are required to pay the self-employment tax. Holding the partnership interest through an S corporation should avoid this issue.

generate over $208 of income. Thus, over $208 of business earnings are required to fund a $100 principal payment on the debt.

- o The interest component is easier to finance, assuming the interest is fully deductible.[94] For a partnership or S corporation, only $100 of earnings is necessary to make a $100 interest payment. However, for a C corporation that is subject to taxes on income from operations at a 40% ordinary federal and state income tax rate, earnings of $167 are required to pay a $100 dividend.[95]

- The seller pays tax on the sale. For example, if the seller has a combined 20% federal and state income tax rate, the seller nets $80 on every $100 of purchase price that constitutes capital gain. However, the seller would pay ordinary income tax on any interest component, so that $100 of interest payments would net only $60 to a seller subject to taxes on income from operations at a 40% ordinary federal and state income tax rate.

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $167[96]-$208[97] of income to be generated to provide the seller with $80[98]-$100[99] after tax. Thus, the tax cost of principal payments represents 40%-62% of the earnings.

- ***Paying Interest***. Interest payments require $100[100]-$167[101] to provide the seller with $60 after tax. Thus, the tax cost of interest payments represents 40%-60% of the earnings.

- ***Efficiency of Entity***. The tax cost is lowest for:

  - o Interest or other deductible payments on the sale of a partnership or S corporation, or

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[94] However, if an electing small business trust borrows to buy stock in an S corporation, interest on that debt is not deductible. Reg. § 1.641(c)-1(d)(4)(ii).

[95] If an individual buyer/shareholder itemizes deductions, the buyer would deduct the interest as investment interest expense. Investment interest expense is deductible to the extent of net investment income. Code § 163(d). Preferably, the buyer would have ordinary interest or nonqualified dividends sufficient to generate this net investment income. Otherwise, the qualified dividends would need to be taxed at ordinary rates to constitute investment income; however, investment interest deducted at ordinary income tax rates generally would offset dividend income taxed at ordinary income tax rates. This comparison is not totally accurate, however, in that the dividend income is included in adjusted gross income (AGI) and can result in reduced itemized deductions and have other adverse AGI-related tax effects. If the buyer is a C corporation, these concerns are not present, and the corporation may also benefit from a dividends-received deduction that can reduce or eliminate the tax on the dividends; however, the buyer's own shareholders would be taxed when the buyer distributes whatever return it receives on its investment.

[96] For a partnership or S corporation.

[97] For a C corporation.

[98] For the gain component of principal payments, net of capital gain tax.

[99] For the portion of principal payments representing a return of basis.

[100] For a partnership or S corporation.

[101] For a C corporation.

- Principal payments to the extent of the seller's basis.

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

| | | |
|---|---|---|
| Capital Gain | 20% | (federal and state income tax) |
| Ordinary Income | 40% | (federal and state income tax) |

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

| | Capital Gain to Seller | Ordinary Income to Seller |
|---|---|---|
| Profit | $ 167 | $ 133 |
| Tax to Buyer | - 67 | - 0 |
| | $ 100 | $ 133 |
| Tax to Seller | - 20 | - 53 |
| Net to Seller | $ 80 | $ 80 |

To minimize a sale's tax bite, tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation. Further below is a discussion of special opportunities for partnerships. For now, let's focus on ways to extract value that any entity can try to use.

***Leasing***. Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment tax by leasing property instead of owning it.[102]

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[103] real estate should not be held in a corporation.

[102] Lease payments received on a long-term basis are not subject to self-employment tax. Reg. § 1.1402(a)-4(a).

[103] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. Together with the rules governing income taxation of shareholders:

***Personal Goodwill and Covenants not to Compete***. If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these. When goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments.[104] When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[105] Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to sellers than either of the above alternatives. Even in the case of goodwill being taxed to the seller at capital gain rates, the benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the seller needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring the deduction the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario).

***Deferred Compensation***. A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or

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- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.

- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates <u>not</u> available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

[104] Code § 197(a), (d)(1)(A).

[105] Code § 197(a), (d)(1)(E), (f)(3).

income equity component of any deferred sale proceeds.[106] Under Code § 409A, however, generally one must pay an immediate lump sum if a plan is not already in place.[107] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

***Conclusion***. Other than separating certain assets from the entity that runs the business operations, a tax-efficient way to sell a business is to provide current or deferred compensation to the owners who work in the business. Part II.G.3. explores using a partnership to create a similar effect.

## II.G.1 Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity

### II.G.1.a Funding the Buy-Sell

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Funding with insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the proceeds to purchase the decedent's shares.

If a shareholder is uninsurable, a sinking fund may be used to accumulate funds for premium payments or at least to provide a down payment. The remainder of the purchase price can be subject to an installment agreement whereby the payments can be spread out over a long time period.

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the

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[106] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Com.*, 344 US 6 (1952).

[107] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation and must be documented in writing to satisfy Code § 409A. Prop. Reg. § 1.409A-1(c)(3). If the future payments relate to compensation earned in the current year, then the taxpayer must prove that (a) the total compensation (current and deferred payments) earned that year is reasonable (to obtain a Code § 162 deduction) and (b) that it was entered into before January 1 of calendar year in which the services were provided (to satisfy Code § 409A(a)(4)(B)(i) and Prop. Reg. § 1.409A-2(a)(2)). If the taxpayer cannot satisfy these conditions, then an immediate lump sum payment could be structured to satisfy a special exception for payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Prop. Reg. § 1.409A-1(b)(4).

owner and beneficiary of the policy,[108] and the insurance proceeds received by the corporation will not be subject to income tax.[109] Unless there is a valid agreement providing otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business.[110] Insurance premiums used to fund the agreement are not deductible by the corporation.[111]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[112] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[113] However, tax deferral on installment sales can be limited,[114] so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax.

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rules state that if consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[115] The transfer for value rules do not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured, a partnership in which the insured is a partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.[116]

### II.G.1.b Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[117]

> **(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his

[108] Reg. § 20.2042-1(c)(6).
[109] Code § 101(a)(1).
[110] *Newell v. Comm.*, 66 F.2d 102 (7th Cir. 1933).
[111] Code § 264(a)(1).
[112] However, in a partnership, part of the sale might constitute ordinary income under Code § 751.
[113] Code § 453.
[114] Code § 453A.
[115] Code § 101(a)(2).
[116] *Id.*
[117] Reg. § 20.2031-1(b).

> death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at §25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[118]

For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. These rules extend to all sorts of arrangements:[119]

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

However, Code § 2703(b) provides that the above rules shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

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[118] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, TC Memo 2004-116, *aff'd* 428 F.3d 1338 (11th Cir. 2005).

[119] Reg. § 25.2703-1(a)(3).

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[120]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of [Reg.] § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to [Reg.] § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[121]

(i) <u>In general</u>. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.

(ii) <u>Evidence of general business practice</u>. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[122]

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[120] Reg. § 25.2703-1(b)(3).
[121] Reg. § 25.2703-1(b)(4).

For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

### II.G.2 Exiting From or Dividing a Corporation

Double taxation applies to C corporations: taxation when the corporation earns profits and taxation when it distributes the profits. To encourage corporations to distribute profits (triggering the second level of taxation), penalties are imposed for accumulating excessive profits. Before discussing these concepts, consider strategies to avoid future double taxation.

Once commonly used strategy is to distribute the profits to owners through wages to owners (subject to immediate income and FICA taxation at individual rates) or through contributions to qualified retirement plans (subject to income taxation upon distribution from the plans). However, note that a corporation may not deduct unreasonably high compensation. This issue applies primarily when profits come from the sale of goods (rather than services) or from the efforts of non-owners. Generally, a professional should be able to justify compensation based on profits derived directly from the professional's work.

Any assets that could appreciate may be held by the owners directly and rented to the corporation. The owners should hold these assets in one or more LLCs.

### II.G.2.a Corporate Redemption

In a redemption by an entity taxed as a corporation, the seller generally is taxed on the extent to which the redemption proceeds exceed the seller's tax basis.[123] However, if the seller retains an interest in the corporation, and other family members also retain an interest, the redemption might be considered a distribution rather than a sale of the stock.[124] In other words, what for state law purposes is a redemption is not necessarily treated as a redemption for income tax purposes.[125] Although for the next few years dividends will be taxed at the same rates as capital gains, taxation of dividends might be less favorable, in that the recipient of a dividend generally cannot use his or her basis to reduce the gain on sale and would not be able to defer tax if a note is used in the redemption.[126] However, if the corporation has an S election in place, then taxation

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[122] TC Memo 2006-76.

[123] Code §§ 302(a), 1001.

[124] Code §§ 302(b)(2)(C) and 302(c) provide that family attribution can cause redemptions to be treated as distributions that might be taxed as dividends rather than as sales.

[125] However, since Code § 302(a) looks to the Code § 317(b) definition of "redemption," generally a transaction must be a redemption for state law purposes before it might be considered a redemption for tax purposes.

[126] Code § 301(c)(1) states that the amount distributed as a dividend is ordinary income. Code § 316 generally provides that distributions are taxable as dividends to the extent of the corporation's current and accumulated earnings and profits. However, if and to the extent that a distribution is not a dividend, it is treated more favorably

as a distribution generally is favorable, in that distributions generally reduce basis, without any part of the distribution being treated as profit on the sale of stock.[127]

### II.G.2.a.i Avoiding Dividend Treatment: Redemptions Under Code §§ 302 and 303

Although recent tax law changes tax dividends at the same rate as capital gains, redemptions have an advantage in that the shareholders may deduct tax basis against redemption proceeds. For stock passing from a decedent, the basis adjustment at death might eliminate any tax on redemption. Also, tax deferral using the installment method is not available if the state law redemption is treated for tax purposes as a dividend.[128]

Code §§ 302 and 303 set forth two methods by which a stock redemption can be qualified to avoid dividend treatment.

Code § 303 provides a way for the estate of a deceased shareholder to obtain cash from a closely held corporation to pay estate taxes and expenses while obtaining the favored tax treatment of an exchange. To qualify for Code § 303, the estate's total stock holdings in the closely held corporation must exceed 35 percent of the total adjusted gross value of the estate, and the distribution must occur within 90 days after the expiration of the three-year limitations period for the assessment of estate tax set forth in Code § 6501(a) (subject to extension in Tax Court proceedings or if a Code § 6166 election is in place). The amount eligible for Code § 303 redemption cannot exceed the total administration expenses allowable under Code § 2053, including estate taxes and interest.

For amounts exceeding estate taxes and expenses, one of the following four exceptions must apply to qualify as an exchange under § 302:

(a) <u>The redemption is not essentially equivalent to a dividend</u>. The applicability of the first exception is made on a case-by-case basis and the determinative issue is whether the redemption results in a "meaningful" reduction. Revenue Rulings and case law provide guidance as to the applicability of this exception. *U.S. v. Davis*, 397 U.S. 301 (1970); Rev. Ruls. 75–502, 75–512, and 78–401.

(b) <u>The redemption is substantially disproportionate</u>. A substantially disproportionate redemption is one that decreases the shareholder's voting stock interest below 80 percent and the shareholder's ownership of outstanding stock below 50 percent immediately following the redemption. The attribution rules apply, however, making this exception difficult to satisfy. Code §§ 302(c)(1), 318.

(c) <u>The redemption is a complete termination of the shareholder's interest</u>. If the shareholder completely terminates his or her interest in the corporation, the redemption may qualify under Code § 302.

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than a sale, in that such distributions first reduce the stock's basis, without any portion of the distribution considered to be a profit, until basis is exhausted. Code § 301(c)(2).

[127] Code § 1368.

[128] See Regs. §§ 1.301-1(d)(1)(ii), 1.301-1(h)(2)(i) and 1.301-1(l) and IRC § 312(a)(2).

(d) The redemption is a partial liquidation distribution. Under Code § 302(e), a distribution is a partial liquidation if:

(1) it is not essentially equivalent to a dividend (determined at the corporate level rather than the shareholder level);

(2) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year;

(3) the distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business which the corporation has actively conducted for the five years immediately prior to the distribution; and

(4) the distributing corporation is actively engaged in the conduct of a qualified trade or business.

However, a buy-sell agreement can convert what appears to be a redemption above into a deemed dividend followed by a deemed cross-purchase. The IRS takes this position if a shareholder has the primary, unconditional obligation to enter into a cross-purchase and the corporation redeems the stock instead.[129] However, the IRS does not take this position if a shareholder has a mere option to cross-purchase, if a shareholder's purchase obligation is contingent on the corporation not redeeming the stock, if a shareholder has the right to assign the purchase obligation to the corporation, or if the agreement is amended before a shareholder's purchase obligation became unconditional.[130]

### II.G.2.a.ii Redemptions and Alternative Minimum Tax

Life insurance proceeds received by a C corporation may be taxed under the corporate alternative minimum tax (AMT) because insurance proceeds increase a corporation's book earnings, but are not included in the taxable income of the corporation.[131] As the cash value of corporate owned life insurance policy grows over the amount of premiums paid each year, annual exposure to AMT will grow as well.

However, AMT does not apply to corporations whose average annual gross receipts do not exceed a threshold. Generally, the corporation's for all 3-taxable-year periods beginning after December 31, 1993 and ending before such taxable year cannot have exceeded $7,500,000.[132] However, for the first 3-taxable-year period (or portion thereof) of the corporation which is taken into account under this teat, average annual gross receipts cannot have exceeded $5,000,000.[133]

This tax does not apply to S corporations.[134]

129 Rev. Rul. 69-608, Situations 1, 2 and 3.
130 Rev. Rul. 69-608, Situations 4, 5, 6 and 7, respectively.
131 Code § 56(g).
132 Code § 55(e)(1)(A).
133 Code § 55(e)(1)(B).
134 Code § 56(g)(6).

### II.G.2.a.iii Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the accumulated earnings tax.[135] The tax rate through 2008 is 15%.[136] However, the tax does not apply if the corporation can show that the payment investment is a reasonable business need of the corporation, is being used to fund a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[137]

### II.G.2.b Corporate Division

### II.G.2.b.i Code § 355 Requirements

Code § 355 provides seven requirements that must be met for a tax-free corporate division. The main corporation to be divided may be referred to as the distributing corporation. A corporation, stock in which is being distributed, may be referred to as the controlled corporation.

The first requirement Code § 355 sets out for a tax-free corporate division is that a distribution is made to a shareholder with respect to the shareholder's stock.[138] The distribution can be made in one of three ways. First, the distribution could be a disproportionate distribution, where some of the shareholders receive a distribution and some do not. This type of division, a "split-off," is most often used when all of a company's stock is owned by the second generation of a family. One group of shareholders will receive a distribution of stock in the controlled corporation in exchange for their stock in the distributing corporation. The distribution could also be a pro-rata distribution, as noted in Code § 355(a)(2)(A). However, in family business succession planning, the pro-rata distribution scheme can be hard to use, since tax-free treatment might not be allowed if the distribution's stated purpose was to end shareholder dispute. Another option for distributions under Code § 355 would be a partially disproportionate distribution that involves a shareholder or group of shareholders leaving the distributing corporation completely, as in the disproportionate distribution, but one shareholder keeps his stock in the distribution corporation and receives some stock in the controlled corporation. This is another "split-off" scenario and is usually used when the corporate separation occurs before the death of the business founder or family patriarch and that person holds the ownership interest in both corporations.

The second requirement for a tax-free division under Code § 355 is that the distributing corporation must distribute stock of a "controlled corporation" which it controls immediately before the distribution.[139] Additionally, the distributing corporation must distribute all of the stock of the controlled corporation that it owns or at least must distribute enough of the stock to meet the Code § 368 control requirements.[140] Under Code § 368, a corporation controls another if it owns at least 80% of the total combined voting power of the controlled corporation and at

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[135] Code § 531.
[136] P.L. 108-27 §§ 302(e)(5), 303.
[137] Code § 537(a)(1), (2).
[138] Code § 355(a)(1)(A)(i). A distribution with respect to other securities is beyond the scope of these materials.
[139] Code § 355(a)(1)(A).
[140] Reg. § 1.355-2(e)(1).

least 80% of the total number of shares of all other classes of stock of the controlled corporation. If the distributing corporation retains any of the controlled corporation's stock, it must establish that the retention was not in pursuance of a plan to avoid taxes.[141]

In order to get tax-free status, Code § 355 sets out a third requirement that the corporate division cannot be used principally to distribute the earnings and profits of either the distributing or controlled corporations or both.[142] This rule prevents a corporation from helping its shareholders avoid dividend treatment by abusing Code § 355 and enabling shareholders to avoid immediate tax consequences, and to get capital gains treatment when one of the divided corporations is eventually sold. Although the Jobs and Growth Tax Relief Reconciliation Act of 2003 temporarily diminished the incentive to transform dividends into capital gains by lowering the tax rate on dividend income, sale treatment remains more beneficial than dividend treatment, because sale treatment allows the seller to use the seller's basis to offset gain and to defer tax using the installment method.

The determination that a division is being used as a device to avoid taxes is a facts and circumstances based test, but a number of "device factors" are strong evidence of tax avoidance. For example, when a distribution is pro-rata and no stock is surrendered back to the corporation, the IRS will take a close look at the transaction and make sure the distribution is not in fact a dividend.[143] Another factor that may indicate abuse is when stockholders "cash-out" shortly after the division.[144] The purpose of the Code § 355 tax-free provisions is to allow a corporation to continue its business is the form of two corporations instead of one, not to allow stockholders a quick tax-free way out of the company. The IRS will take into consideration significant changes in economic conditions that may have caused a stockholder to cash-out shortly after a distribution,[145] but it is a situation the IRS will examine closely. The IRS will also examine the "nature, kind, amount, and use of the assets" of both the distributing and controlled corporations immediately after the transaction.[146] This examination prevents a company from attempting to distribute assets unrelated to the corporation's business under a guise of splitting the corporation's active business. Another questionable situation arises when the controlled corporation and the distributing corporation have an exclusionary post-division relationship where one corporation is the secondary corporation that essentially serves the other.[147] When such a relationship exists and the secondary corporation could be sold without adversely affecting the other corporation's business, the IRS considers this to be evidence of a tax-avoidance device.[148]

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[141] Reg. § 1.355-2(e)(2).
[142] Code § 355(a)(1)(B).
[143] Reg. § 1.355-2(d)(2)(ii).
[144] Reg. § 1.355-2(d)(2)(iii).
[145] PLR 9030037 (approving later trades when publicly traded stock was to be sold, but not by insiders), PLR 8932038 (approving post-division gift of 10% of corporation), PLR 9041078 (approving later trades when publicly traded stock was to be sold, but not by insiders).
[146] Reg. § 1.355-2(d)(2)(iv)(A).
[147] Reg. § 1.355-2(d)(2)(iv)(C).
[148] *Id.*

In addition to listing numerous "device factors" in the Regulations, the IRS also provides a number of "nondevice factors" that are evidence of no tax avoidance purpose. Again, this determination is based on facts and circumstances, but the presence of one of these factors can help a corporation defend its division. These "nondevice factors" include having a strong business purpose of the transaction, having a distributing corporation that is publicly traded and widely held, and having a distribution to shareholders that are domestic corporations eligible for the dividends-received deduction.[149]

The fourth requirement of Code § 355 is the "active business" test. Code § 355(b)(1) requires that either (A) immediately after the division the distributing and controlled corporations are engaged in the active conduct of a trade or business, or (B) immediately before the distribution, the distributing corporation has no assets other than stock or securities of the controlled corporation and the controlled corporation is engaged in an active business immediately after the distribution. Four specific requirements must be met in order for a corporation to be treated as engaged in an active business. First, the corporation must be engaged in the active conduct of a trade or business, or, immediately after the distribution, substantially all of its assets are stock and securities of a corporation controlled by it which is engaged is such a trade or business.[150] "Active trade or business" for purposes of Code § 355 is defined as a specific group of activities of the corporation being carried on for purposes of earning income or profit and the activities included in such group include all operations that form any part of, or step in, the process of earning income or profit.[151] Next, such trade or business is required to have been actively conducted throughout the five-year period ending on the date of the distribution.[152] The trade or business also must not have been acquired within that five-year period in a transaction in which gain or loss was recognized either in whole or in part.[153] Finally, the control of a corporation conducting an active trade or business must not have been acquired in a taxable transaction in the same five year period.[154]

An important point to note regarding corporate divisions is that both the distributing corporation and the controlled corporation must be engaged in an active trade or business for five years before the distribution. Thus, it may not always be easy for a business owner to separate the business into two distinct corporations, and sometimes it may be more costly for the business owner to do so than it would be for him maintain is business as a whole and use less tax-advantageous business separation techniques when such separation becomes necessary. For example, two divisions could be separated into two wholly owned limited liability companies.

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[149] Reg. § 1.355-2(d)(3).

[150] Code § 355(b)(2)(A).

[151] Reg. § 1.355-3(b)(2)(ii). Specifically excluded from the definition of an active trade or business are activities such as holding of stock, securities, land or other property for investment purposes. Reg. § 1.355-3(b)(2)(iv). Additionally, owning or operating real or personal property used in a trade or business is not considered an active trade or business unless the owner also performs significant services with respect to the operation and management of the property. *Id.*

[152] Code § 355(b)(2)(B). See Rev. Rul. 2002–49 regarding business conducted through an LLC.

[153] Code § 355(b)(2)(C).

[154] Code § 355(b)(2)(D).

The fifth requirement is that the transaction must have at least one corporate business purpose.[155] This requirement ensures that nonrecognition treatment is given only to distributions that are part of readjustments of corporate structures caused by business exigencies and to readjustments of continuing interests in property under modified corporate form.[156] The purpose must be a "real and substantial non Federal tax purpose."[157] The distribution to shareholders does not satisfy a corporate business purpose if the corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and is neither impractical nor unduly expensive.[158]

The Regulations also note that a "shareholder purpose… is not a corporate business purpose."[159] However, there are times when a shareholder's purpose is so coextensive with the corporate business purpose that there is no real distinction between the two, and in such cases, the transaction will be considered to have a corporate business purpose.[160] Clearly, not all shareholder disputes will rise to the level of a corporate business purpose. For example, a dispute between shareholders who are not part of management would have little effect on the business itself, thus, such a dispute would not be co-extensive with a business purpose. The Regulations provide an example of a shareholder dispute that would be coextensive with a corporate business purpose.[161] The example involves a corporation, owned by two shareholders, engaged in two businesses – manufacturing and selling furniture and selling jewelry. Shareholder A wants to continue the furniture business, and Shareholder B wants to continue the jewelry business. If A and B decide to split up the business and cut ties with one another, the transaction will be considered to have a corporate business purpose – the business will likely benefit from having the interested shareholder running the business – even though the separation was also driven by a shareholder purpose.

Real world businesses may not have such neatly separable businesses within one corporation, as in the example from the Regulations. But even in "single function" businesses, a shareholder purpose (shareholder dispute) can still rise to the level of a corporate business purpose. For example, in PLR 8943038, the IRS approved a Code § 355 tax-free corporate division where the division was driven by friction that had developed between shareholders "regarding fundamental management policy and the expansion of the business" and the shareholders had been "unable to agree to a current fair market value of the stock."

Thus, for a shareholder dispute to rise to the level of a corporate business purpose, the dispute must be one that will negatively affect the corporation's business if it is not carried out. Disputes between purely passive shareholders will not reach that threshold. But disputes between active shareholders on whether to grow the company or other differences in business philosophies would likely reach the necessary corporate business purpose threshold. Essentially, as long as

[155] Reg. § 1.355-2(b).
[156] *Id*.
[157] *Id*.
[158] Reg. § 1.355-2(b)(3).
[159] Reg. § 1.355-2(b)(2).
[160] *Id.*
[161] Reg. § 1.355-2(b)(5), Example (2).

the dispute is between active shareholders, as is usually the case in the standard family business model, it should be relatively easy to establish that the dispute would affect the corporation's operations, thus establishing that the shareholder purpose is co-extensive with a corporate business purpose.

The sixth requirement is "continuity of interest."[162] The division really must be a division and not essentially a sale. One or more direct or indirect owners of the distributing corporation before the distribution must own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. Continuing ownership of fifty percent or more should be enough to establish a continuity of interest.[163] In most family business divisions, meeting this test will not be a problem, since both the distributing and controlled corporations will be owned by original shareholders.

The final requirement is that the active trade or business that existed five years before the separation must exist after the separation.[164] This requirement will normally be easy to fulfill, as long as all other requirements are met, since corporations that meet the "active business" requirements will likely meet this requirement as well.

### II.G.2.b.ii Tax Effects When Code § 355 Provisions Are Not Met

#### (a) Distributing Corporation

In a number of situations, a distributing corporation may have to recognize gain on a distribution that would otherwise qualify as tax-free, Code § 355 distribution.[165] The first of these exceptions to the non-recognition rule is the "disguised sale" rule of Code § 355(c)(2), as modified by Code § 355(d). Code § 355(c)(2) requires the distributing corporation to recognize gain when it distributes property, other than stock of the controlled corporation, if the fair market value of the property exceeds it adjusted basis.[166] Code § 355(d) applies to certain distributions of the controlled corporation's stock, and requires that the distributing corporation recognize gain if any one person holds a 50% or greater interest in disqualified stock in either the distributing or controlled corporation after the distribution.[167] In family business situations, often the majority shareholder (usually the founder) has owned the business for more than five years. Additionally, even if the founder has transferred equity in the business within the past five years through gifts

[162] Reg. § 1.355-2(c).
[163] See Reg. § 1.355-2(c)(2), Example (2) and Rev. Proc. 96-30, § 4.07.
[164] Code § 355(b), Reg. § 1.355-2(h) and 1.355-3(b)(3).
[165] Code § 355(c)(2).
[166] Code § 355(c)(2)(A)(ii). The distributing corporation is taxed as if it had sold the property to the distributee at fair market value. Code § 355(c)(2)(A) (flush language).
[167] Code § 355(d)(2). Under Code § 355(d)(4), the "50% or greater interest" means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Disqualified stock is defined in Code § 355(d)(3) as any stock of the distributing corporation acquired by purchase during the five year period leading up to the distribution and as any stock in the controlled corporation that was acquired by purchase in the five years leading up to the distribution or by distribution on disqualified stock in the distributing corporation.

or through a transfer at death, the disguised sale rule still will not apply, since they only apply to purchase transfers.[168]

Code § 355(e) is similar to Code § 355(d), but applies when distributions are part of a plan in which one or more persons will acquire 50% or greater interest in either the distributing or controlled corporation.[169] There is not a five year requirement, as in Code § 355(d), but if one or more persons acquires the 50% or greater interest in either corporation within two years before or after the distribution, then the transaction is considered to be "pursuant to a plan."[170] Additionally, Code § 355(e) makes no distinction between transfers made for consideration and those made for no consideration. However, to prevent Code § 355(e) from making tax-free corporation division impossible, a number of exceptions limit what is considered an "acquisition" for Code § 355(e) purposes. For example, Code § 355(e)(3)(A)(i) states that the acquisition of stock in a controlled corporation by a distributing corporation will not be taken into account for Code § 355(e) purposes. Additionally, in most family businesses, Code § 355(e) will not be an issue because of a related party provision similar to the one present in Code § 355(d), causing all stock owned by family members to be treated as owned by one person.[171] The only time that Code § 355(e) is likely to come into play in family business succession planning would be in cases where the founder plans to shift ownership to second generation family members who are not lineal descendants of the founder. In such cases, additional planning needs to be done to ensure the transfers and tax-free division will not be considered "pursuant to a plan."

### (b) Controlled Corporation

Regardless of whether Code § 355 is met, the controlled corporation will not recognize gain or loss on a corporate division.[172] Thus, the controlled corporation's basis in the property distributed to it by the distributing corporation before the distribution of the controlled corporation's stock will be equal to the property's basis in the hands of the distributing corporation, increased by any gain recognized by the distributing corporation on the transfer.[173] When such property distributions are made to the controlled corporation, the distributing corporation must allocate part of its earnings and profits to the controlled corporation.[174] This allocation will generally be made in proportion to the fair market value of the business and property interests retained by the distributing corporation and the business and property interests of the controlled corporation immediately after the distributions.[175]

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[168] Reg. § 1.355-6(d)(1)(i)(A).
[169] Code § 355(e)(2)(A).
[170] Code § 355(e)(2)(B).
[171] Code § 355(e)(4)(C)(i).
[172] Code § 118.
[173] Code § 362(b).
[174] Reg. § 1.312-10(a). However, a distributing corporation's unused NOL carryover will not be allocated to the controlled corporation. Rev. Rul. 77-133.
[175] Reg. § 1.312-10(a).

### (c) Shareholders

Generally speaking, shareholders of the distributing and controlled corporations will not recognize any gain or loss on the receipt of the controlled corporation's stock in a Code § 355 division. However, if the shareholders of the controlled corporation receive "boot" in addition to stock, then they will have to recognize some gain. This situation will arise when a controlled corporation's shareholder receives other property or money, in addition to the controlled corporation's stock, so that the amount received is equal to the fair market value of the stock the shareholder gave up in the distributing corporation. When this occurs, the shareholder must recognize gain, but not more than the sum of the fair market value of other property and money received.[176] This type of distribution could also lead to gift tax consequences if one of the shareholders receives more stock than he would have been entitled to based on his original ownership in the distributing corporation. If the proper donative intent exists, the shareholder may be deemed to have received a gift from the other shareholders. Thus, it is important to make sure that when a shareholder receives more than he was entitled to based on his ownership, the transfer is properly documented so that it is clear whether there was any intent to gift and the transfer can be properly taxed.

The total basis of all shareholders' stock in the distributing and controlled corporation after the division will be the same as the total basis of all shareholders' stock in the distributing corporation before the division, increased by gain or other income each shareholder recognized and reduced by returns of capital each shareholder received or loss recognized.[177] However, each individual shareholder's basis may be different before and after the division and must be recalculated after the division. The shareholder's basis is allocated among stock held after the distribution in based on each share's fair market value relative to the fair market value of all shares.[178]

## II.G.3 Exiting From or Dividing a Partnership

Below, a few themes emerge:

- ❖ Exiting a partnership in exchange for a portion of the partnership's assets can be a nontaxable event, in which the exiting partner's basis is reallocated among the distributed assets.
- ❖ Seller-financed redemptions for cash can save a level of capital gain tax, and the buyer and seller can come out ahead, if structured properly.
- ❖ If a partner contributes property with a basis not equal to its fair market value, and that partner or that property leaves the partnership within seven years of the contribution, beware of the tax effects!

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[176] Code § 356(a)(1).
[177] Code § 358(a)(1).
[178] Reg. § 1.358-2(a)(2).

Contrasting partnership and corporate tax-free divisions:

- ❖ A partnership division does not require a business purpose to be nontaxable, but a corporate division does.

- ❖ Contrast a seven-year waiting period for partnerships with a five-year waiting period for corporations. However, the waiting periods are for different reasons! In partnerships, it is to account for contributed property. In corporations, it is to make sure businesses are conducted continuously for at least five years.

### II.G.3.a Partnership Redemption

#### II.G.3.a.i Partnership Redemption – Generally

**Distribution of Property by a Partnership**

Distributions to a partner may be taxable under Code §§ 731, 704(c)(1)(B), and 737. After the discussion of Code § 731 follows the discussion of the other two sections.

**<u>Code § 731</u>**

Partnership distributions of property are usually tax-free to both the partnership and the partner under Code § 731(a) and (b). However, Code § 731(a)(1) requires a partner to recognize gain on a monetary distribution when the distribution exceeds the partner's adjusted basis in the partnership.[179] The amount of gain recognized is the excess of the distribution over the partner's adjusted basis.[180] When the distribution is a liquidation distribution, the partner's adjusted basis in the distributed property is equal to the adjusted basis of the partner's interest in the partnership, less any money distributed.[181] In non-liquidating distributions, the partner's adjusted basis in the property distributed is simply the partnership's adjusted basis in the property before the distribution.[182]

Marketable securities may not normally be considered cash, but are treated as "money" for purposes of Code § 731(a)(1) gain calculation.[183] Thus, distributions of marketable securities can result in gain under Code § 731(a)(1), if the total amount of money and securities distributed is higher than the adjusted basis of the partner's partnership interest. However, two exceptions to the "marketable securities are money" rule of Code § 731(c) often apply. First, a marketable

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[179] Code § 731(a)(2) explains potential loss recognition consequences of a partnership distribution.
[180] Code § 731(a)(1).
[181] Code § 732(b).
[182] Code § 732(a)(1). However, the partner's adjusted basis in the distributed property cannot exceed his adjusted basis in his partnership interest less any money distributed at the same time. Code § 732(a)(2).
[183] Code § 731(c)(1). Marketable securities are defined in Code § 731(c)(2)(A) as financial instruments and foreign currencies which are, as of the date of distribution, actively traded. Code § 731(c)(2)(B) includes mutual funds, derivatives and various other financial instruments. Code § 731(c)(2)(C) defines financial instruments to include stocks and other equity interests, evidences of indebtedness, options, forwards, futures, notional principal contracts and derivatives.

security is not treated as money if the security was contributed to the partnership by the partner receiving the distribution, except to the extent the security's value is attributable to other marketable securities or money contributed to the entity to which the distributed security relates.[184] Second, Code § 731(c) does not apply to distributions of marketable securities by investment partnerships to eligible partners.[185] An investment partnership is defined in Code § 731(c)(3)(C)(i) as a partnership that never has been engaged in any trade or business and whose assets have always substantially consisted of money, stock, notes and bonds, interest rate or currency contracts, foreign currencies, interests in or derivate financial instruments, and other specifically prescribed assets; and an eligible partner is a partner who has contributed only the aforementioned types of assets to the partnership.[186] With regard to investment partnership status, remember that, if the partnership owns an interest in an entity that is a disregarded entity or partnership for federal income tax purposes, that entity's activity will be treated as a trade or business activity of the holding partnership. Thus, it could be beneficial to set up two partnerships and have one hold the assets that will prevent investment partnership status and another be the investment partnership.

Two more exceptions might not apply frequently, but are still important to note. First, if the security was acquired in a nonrecognition transaction and the value of the securities and money exchanged in that nonrecognition transaction is less than 20% of the value of all the assets exchanged in the nonrecognition transaction, the securities will not be considered money.[187] Additionally, the security is not treated as money if it was not a marketable security on the date the partnership acquired it and the issuing entity did not have any outstanding marketable securities at that time, the partnership held the security for at least six months before it became marketable, and the partnership distributed the security within five years of when it became marketable.[188]

In addition to these four general exceptions to Code § 731(c), Code § 731(c)(3)(B) limits the amount of marketable securities treated as money, thereby limiting the amount of gain a recipient partner has to recognize. The limitation is calculated by first determining the partner's share of the partnership's built-in gain in all of its marketable securities, before the distribution is made.[189] From this amount you subtract the partner's distributive share of the built-in gain that is attributable to marketable securities held by the partnership immediately after the transaction.[190] The end result is the amount of marketable securities that are treated as "property other than money." Thus, to the extent a distribution of marketable securities does not decrease the recipient's share of built-in gain, the recipient will not be taxed under Code § 731(c).

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[184] Code § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i).
[185] Reg. § 1.731-2(e)(1).
[186] Code § 731(c)(3)(C)(iii).
[187] Reg. § 1.731-2(d)(1)(ii).
[188] Reg. § 1.731-2(d)(1)(iii).
[189] Code § 731(c)(3)(B); Reg. § 1.731-2(b)(2).
[190] *Id.*

**<u>Code §§ 704(c)(1)(B) and 737</u>**

The Code § 731(a) rule that there are no tax consequences to a partner when the partner receives a partnership distribution is subject to two exceptions if the distribution is made within seven years after the partner contributed property to the partnership. First, earlier it was discussed that Code § 704(c)(1)(B) triggers gain when the partnership distributes contributed property to a partner other than the contributing partner within seven years after the contribution. Second, Code § 737 will trigger gain to a distributee partner if the partner contributes property to the partnership and then receives a distribution of some other property within seven years of the partner's original contribution. When such a distribution is made, the partner must recognize gain equal to the lesser of (1) the excess of the fair market value of the distributed property over the partner's partnership interest's adjusted basis (less any money received in the distribution) or (2) the partner's net pre-contribution gain.[191] Net pre-contribution gain, as defined in Code § 737(b), is the gain that would have been recognized by the distributee partner under Code § 704(c)(1)(B) if all property the partner had contributed to the partnership within seven years of the distribution that was still held by the partnership immediately before the distribution was distributed by the partnership to some other partner.

Note that Code § 737 is applied after Code § 731(c), which means that any marketable securities that are treated as money for Code § 731(c) purposes are ignored when applying Code § 737.[192] This can lead to a favorable result for a distributee partner in two ways. First, since the property piece of the distribution is reduced by treating marketable securities as money, the Code § 737 gain potential is reduced. Second, the total amount of cash and marketable securities treated as money could be less than the basis of the distributee partner's partnership interest, resulting in no gain recognition under Code § 731.

As in the Code § 704(c) analysis, the prevailing view among commentators seems to be that a transferee of a partnership interest will "step into" the transferor's shoes in Code § 737 situations. This view is supported by the fact that regulations supporting Code § 704(c)(1)(B) and Code § 737 were written by the same people, at the same time, in the same project, and are likely to have been designed to work in coordination with one another. A partner should not be able to avoid the rules of Code § 737 by transferring the partnership interest to a third party. Thus, the transferee partner should be treated as the contributing partner under Code § 737.[193]

### II.G.3.a.ii Partnership Redemption – Complete Withdrawal Using Code § 736

When a partnership redeems a partner's interest in full, Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner. Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although

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[191] Code § 737(a)(1) and (2).

[192] Reg. § 1.731-2(g).

[193] *See* Robinson, "Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K," <u>ACTEC Journal</u>, Spring 2003, p. 302; Blum and Harrison, "Another View: A Response to Richard Robinson's Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K," <u>ACTEC Journal</u>, Spring 2003, p. 313; and Robinson's "Comments on Blum and Harrison's Another View," <u>ACTEC Journal</u>, Spring 2003, p. 318.

possibly depreciated or amortized) and capital gain to the partner. This brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, since capital gains rates are lower than ordinary income rates.

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Generally, the redemption agreement can provide that as much or as little of the redemption payments receive treatment under Code § 736(a) or (b).[194] However, capital gain payments:

1. Cannot exceed the fair market value of the withdrawing partner's share of the partnership property.[195]

2. Cannot include certain payments for goodwill, accounts receivable and inventory.[196]

See the example in II.G.1. The "Capital Gains to Seller" scenario in II.G.1 corresponds to Code § 736(b) payments, and the "Ordinary Income to Seller" scenario in II.G.1 corresponds to Code § 736(a) payments.

<u>Main Points</u>

1. Using a capital gain Code § 736(b) scenario, taxes consume $102, which costs $36 more (compared with $66 tax, which translates into 55% more taxes) to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and ease the stress of the buy-out. However, the additional $36 cushion would be subject to $16 tax, so the parties really have only $20 more. Thus, the true net tax savings are only $20.

2. The seller must receive 46% more ($146 versus $100) to produce this savings. Thus, the stated sales price would appear to be higher and more burdensome, although really the buyer is better off.

3. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

4. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[197] However, the complete redemption may be made over time.[198] If the partnership assumes

[194] Reg. § 1.736-1(b)(5)(iii).
[195] Reg. § 1.736-1(b)(5)(iii).
[196] Code § 736(b)(2).
[197] Reg § 1.736-1(a)(1)(i).
[198] Rev Rul 75-154.

the partner's share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated.[199]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account. Generally, the seller's capital account would be the LLC's earnings that are allocated to the seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

6. A partnership might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736 without the partner completely retiring. For example, suppose an older partner brought in a lot of business, but the agreement would be that the younger partners would take over the business after a number of years. The partnership might be structured to give the older partner a larger profits interest in early years and a smaller profits interest in later years. The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each partner generates and the services each partner performs.

7. A technique similar to Code § 736 ordinary income payments used to be available to corporations in some situations. If the corporation could make a case that the departing shareholder was under-compensated for prior services, the corporation would pay compensation to him or her, with economic results similar to that of Code § 736 ordinary income payments. Code § 409A has effectively eliminated that strategy, imposing a 20% penalty on deferred compensation to the extent substantially vesting occurs after December 31, 2004, unless the statute's strict requirements are satisfied. However, with sufficient advance planning, a deferred compensation plan could be arranged that would satisfy Code § 409A. The problem is that an appropriate level of compensation may be difficult to determine many years in advance of a sale.

### II.G.3.a.iii Partnership Alternative to Seller-Financed Sale of Goodwill

Is goodwill an asset that belongs to the individual owner or to the entity? If a non-compete agreement is not in place, goodwill belongs to the owner personally.[200]

As a practical matter, often the buyer will be able to pay the promissory note for goodwill only if the business is sufficiently profitable. If the business is not profitable, the seller would need to sue the buyer to enforce the note, and all that lawsuit would accomplish would be a judgement against someone who cannot pay it. The seller's most effective recourse might be to take over the business, which the judgment on the promissory note is unlikely to accomplish without further legal action.

The seller might prefer a mechanism in which:

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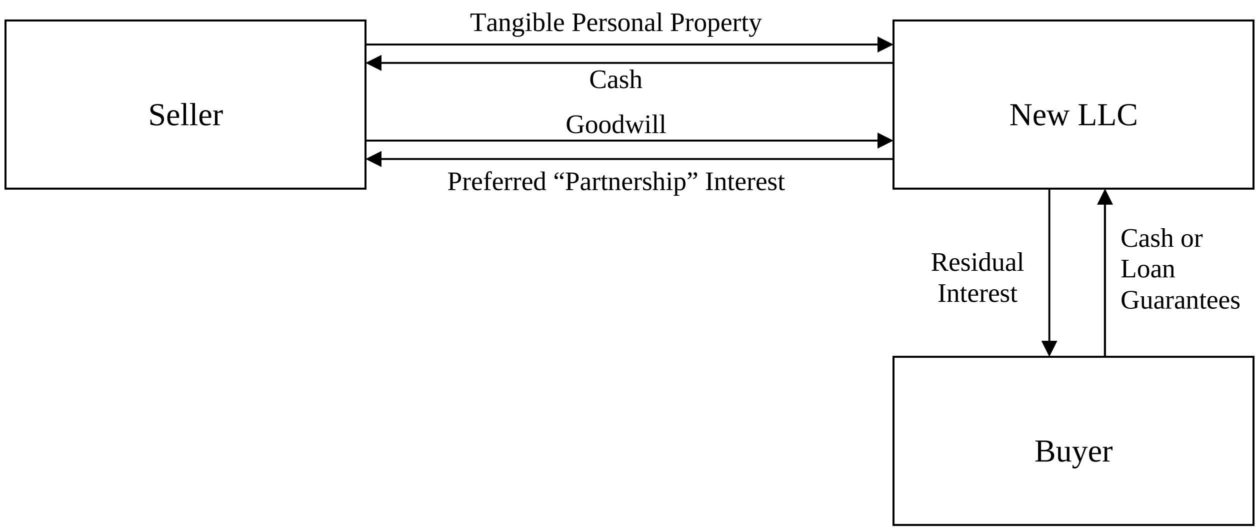
[199] *Whitman & Ransom*, TC Memo 2005-172.
[200] *Martin Ice Cream Co.*, 110 TC 189 (1998).

1. The seller has a quicker route to gaining control over the business if the buyer does not attain the results necessary to pay the seller.

2. The deal is more tax-efficient than the traditional sale of goodwill.

This mechanism recognizes that, although the transfer of goodwill is technically a debt-financed deal, it really carries risks similar to an equity interest.  Below is a diagram showing the transaction, in which the seller contributes the goodwill to a new entity (often a limited liability company) in exchange for what for tax purposes is considered a preferred partnership interest.




Let's look at the non-tax financial issues, then discuss the tax issues in addition to the advantages discussed in parts II.G. and II.G.3.a.ii.

<u>Non-Tax Financial Issues</u>

The seller receives preferred payments equal to the lesser of the LLC's net operating cash flow or a target amount before any amounts are distributed to the buyer.  If the target is not attained, then:

1. The deficiency is added to the following year's target amount.

2. The seller might be given control over certain aspects of running the business.  This could be as modest as limiting the buyer's compensation for services rendered or as far-reaching as taking over control of part or all of the business' operations.  The partial or total shift on control would be a focal point of negotiations.

These provisions would be built directly into the LLC's operating agreement.  So that they know that authority has not been transferred to the seller, third-party lenders would require assurances that the buyer is complying with the agreement with the seller, thus providing an independent check on the buyer's compliance with the deal.

After the seller has received all that has been bargained-for, the seller would no longer be a member of the LLC.

Tax Issues

Suppose the Seller is an S corporation. If all of an S corporation's assets were sold to a new entity, tax would be incurred at the corporate level. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180 months (15 years).[201] Furthermore, if the IRS were to find that goodwill was transferred to the new entity at a substantial value, without the S corporation retaining a sufficient interest in the new entity, then:

1. The S corporation would have income equal to the goodwill.

2. The shareholders would have immediate dividend income equal to the goodwill, which they then contributed to the new entity without receiving an immediate deduction (the deduction would be spread over 180 months).

If the S corporation transfers its assets to a new LLC, retaining a preferred interest at the AFR ("applicable federal rate" provided under the tax laws as an arms-length interest rate) that distributes only to the extent of operating cash flow, each of Reg. §§1.707-4(a)(2) and 1.707-4(b) separately creates a presumption that a sale has not occurred.[202] If the S corporation is receiving a return whose present value (using the AFR) is equal to the value of the contributed goodwill (if any), the S corporation should not be treated as having distributed such goodwill to its shareholders. It might be advisable to give the corporation a small but significant profits interest in the LLC.

### II.G.3.b Partnership Division

See Code § 708(b)(2)(B).

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[201] Code § 197 provides for 15 years, and Reg § 1.197-2(f)(1)(i) applies this starting with a particular month.

[202] It is unlikely that the partnership anti-abuse rules would come into play. To minimize the risk that they would under Reg. § 1.701-2(c)(3), the seller cannot be protected from loss. Reg. § 1.701-2(e)(2)(i) says that, if the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment; the proposed strategy contemplates a stream of payments clearly approved by the disguised sale regulations. Looking at the larger picture, the anti-abuse rule applies only if the transaction is inconsistent with the intent of Subchapter K. The intent of Subchapter K has three prongs under Reg. § 1.701-2(a):

- The partnership must be bona fide, and each transaction must have a "substantial business purpose." The proposed transaction splits income for generally around 5 years, and it provides the old owner with a way to take control over the business more quickly if the transaction does not work out than in a traditional sale. The new owner benefits by minimizing his risk, in that he is not personally liable. These are substantial, practical business issues.
- The form of each transaction must be respected under substance over form principles. No games are being played here: the parties have every incentive to ensure that the new entity's cash flow is distributed as promised in the transaction.
- Clear reflection of income. All distributions the old owner receives is being taxed. The new owner is not being taxed on income the new owner does not receive.

Generally, a partnership can be divided without immediate income tax recognition.

However, some divisions might be taxable. Also, tax elections may be revoked and re-started for the new partnership.

Furthermore, a division could re-start the seven-year waiting period for measuring 704(c) responsibility.

### II.G.3.c Transfers of Partnership Interests to New or Existing Partners

When a partner transfers part or all of the partner's interest via gift, part of that transfer will be treated as a sale if the partner's share of partnership liabilities exceeds the adjusted basis of the partner's partnership interest. The transfer is treated as such because liability is shifting from the donor to the donee, and the donor is treated as having received cash to the extent that the donor's share of liabilities is reduced. The shift can be analyzed in two potential ways. One way would be to argue the shift is governed by § 752(b), which treats a reduction in a partner's share of partnership liabilities as a deemed cash distribution. In this case, the donor would recognize gain to the extent the distribution exceeded his partnership interest adjusted basis. However, another view is that only a portion of the basis of the partner's partnership interest should be allocated to the sale portion of the transfer, and gain is recognized to the extent the shift in liabilities exceeds the allocated portion of the adjusted basis.[203]

Upon the death of a partner, or on the taxable transfer of a partnership interest, the partnership's property's basis is adjusted under Code § 743 if the partnership makes or has in effect a Code § 754 election.[204] If the transferee partner's basis in his interest is greater than the former partner's share of the basis of partnership assets, then the election will give the new partner a stepped-up basis in the partnership assets. In a sale or exchange situation, the transferee partner's basis step-up in partnership assets is based on the amount of gain recognized by the transferring partner.[205] If the transfer is caused because of a partner's death, the basis step-up is based on the fair market value of the deceased partner's partnership interest as of the date of death, plus the transferee partner's share of partnership liabilities, minus any allocable income in respect of a decedent items.[206] Once a Code § 754 election is made, it cannot be revoked without IRS consent. This is extremely important to remember, since the election can lead to a step-down in the basis of partnership assets if the basis of the transferee's interest is less than the transferor's partnership property adjusted basis.

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[203] Code § 752(d).

[204] In addition to making the election, the partnership must attach a statement to its tax return that reports the name and taxpayer identification number of the transferee partner, the basis adjustment computation, and the allocation of the basis adjustment to the partnership's properties. Reg. § 1.743-1(k)(1). The transferee partner has an obligation to provide written notice to the partnership of the information needed to compute the basis adjustment, as listed in Reg. § 1.743-1(k)(2). Once that notice is given, the partnership can rely on that information in preparing the adjustment, as long as no partner who is responsible for federal income tax reporting has any knowledge that the information is clearly erroneous. Reg. § 1.743-1(k)(3).

[205] The partner's share of income in respect of a decedent under Code § 691 (including unrealized receivables) does not receive a basis step-up. Reg. § 1.755-1(b)(4).

[206] Code § 743; Reg. § 1.742-1.

For additional rules regarding Code § 754 elections, see text accompanying footnotes 390–394.

The partnership and the transferee partner, including a decedent's estate, should consider extending their income tax returns so that any IRS adjustments to basis, including the value of assets in the decedent's gross estate, can be reflected in the transferee partner's income tax returns; ignoring the interplay of these statutes of limitations can cause the taxpayer to lose the benefit of the basis step-up.[207] For example, suppose decedent died December 1, 2004, and the partnership sold assets December 31, 2004. The estate tax return is due August 1, 2005 (nine months after death) and may be audited as late as August 1, 2008. The estate's income tax return for calendar year 2004 is due April 15, 2005 and may be amended only as late as April 15, 2008. Thus, audit adjustments on the estate tax return might be made between April 15, 2008 and August 1, 2008, but the estate could not amend its income tax return to reflect any increase in basis due to the audit. The partnership should extend the due date of its return.[208] Additionally, the estate could file an extension for its initial income tax return, so that the return is filed timely between August 1, 2005 and October 15, 2005 (six months being the latest date for an extension). An alternative to extending the estate's income tax return might be for the estate to choose a fiscal year ending on or after April 30, 2005; note that a § 645 election would be required if the decedent's partnership interest were held in a revocable trust.

## II.H Choice of Entity Hypothetical

Alice, Ben and Connie want to form a business manufacturing and selling widgets. They have been friends for many years. Even though they consider themselves family, technically they are not related to each other.

Alice is a natural at sales. She has many contacts and could sell any product that she believes is beneficial to the customer. Alice is terrific at selling not only to potential customers but also potential investors.

Ben is great at putting together and running organizations. He always knows what is going on in the business, tracking current progress, making short-term and long-term financial projections, and keeping everyone focused on the company's goals. Ben is talented at securing financing and making investors feel comfortable that they are receiving accurate information.

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[207] In *Malm v. U.S.*, 420 FSupp 1040 (DC ND 2005), the court stated:

> Harry Malm died on August 5, 1998. His estate included shares of Medtronic stock. The IRS disputed the estate's valuation of that stock. The dispute wound up in court, and on July 23, 2003, this Court ruled that the IRS' stock valuation was correct….As a result of this ruling, the Medtronic stock had a higher fair market value than reported by the estate on its federal estate tax return. Therefore, the estate's federal income tax return overstated the amount of the gain on the sale of this stock….The estate filed its income tax return on November 14, 1999. Since the estate did not file a claim for a refund on that return until February 12, 2004, its claim is barred by the statute of limitations.

[208] The partnership will need to make any Code § 754 election no later than the extended due date of the return. If the election does not look worthwhile but upon audit it starts looking worthwhile, the IRS will not grant Code § 9100 relief. Letter Ruling 200626003. However, if the partnership's assets are included in the decedent's gross estate under Code § 2036, the partnership's assets will receive a basis adjustment. *Id.*

Connie is a creative genius. She has scientific knowledge, engineering skills, and a keen mind for how to make machines and manufacturing and packaging processes work. Connie will enable the company to be a low cost producer for generic products and to efficiently tailor manufacturing processes to fit special customer needs.

**Initial Formation - Year 1**

Connie came up with a revolutionary widget that every household should have, and Alice has informally discussed with various retailers how they might help market the product. Ben has arranged a $1,000,000 bank loan, but the bank is going to make Alice, Ben and Connie personally guarantee loan repayment. Alice, Ben and Connie have agreed to take no compensation the first year, $50,000 each the second year, and then see where the business is headed. The business requires a $500,000 machine, as well as five employees to run it, initially under Connie's supervision. The business leases its space.

How should they set up their deal in Year 1?

Types of entities: sole proprietorships, partnerships, C corporations and S corporations. Business ownership and management structure. Tax on formation. Allocating gain when entity later sells contributed property. Ability to deduct losses: basis and at-risk limitations; net operating losses at entity vs. shareholder level; Code § 1244 stock. Allocating gain and loss from ongoing operations; tax distribution clauses. Self-employment/FICA tax: partnership vs. limited partnership vs. S corporation vs. C corporation.

**Outside Investors - Year 2**

Due to additional capital needs to take the business to the next level, Alice has been working on securing two investors who would put up capital of $250,000 each. They seek an annual preferred return of 20%, as well as one-fifth each of the business' residual value.

How should they bring in the investors? What governance/approval mechanisms would the investors want to protect themselves?

Tax on later contribution to entity. Allocation of income from operations, including preferred returns and, if taxed as a partnership, disguised sale issues. Restrictions on shareholders (S corporations).

**Buying Out Outside Investors - Year 5**

In Year 5, the business is earning $600,000 per year net profit, after paying $100,000 annual compensation to each of Alice, Ben and Connie. Alice, Ben and Connie are not getting along with the outside investors and want to buy them out. They believe the business will continue to expand and do not wish to share this growth with the investors when the company is later sold, and they are tired of paying a 20% return to the investors.

How should Alice, Ben and Connie go about buying out the investors? How would the form of organization affect this?

Structurally, it would require an agreement on the part of the investors to be bought out. The founders could have an option built into the original financing arrangements allowing them to buy back at certain formula, or upon certain triggers. Discuss dispute resolution mechanisms as well as buy-out options. Contrast S corporation or C corporation buy-out with after-tax dollars with LLC buy-out with pre-tax dollars under Code § 736, which can eliminate capital gain tax on part or all of the complete liquidation of an LLC member's interest.

**<u>Bigger Workforce; Family Business Succession Planning - Year 10</u>**

In Year 10, the business is earning $2,000,000 net profit, after paying $250,000 annual compensation to each of Alice, Ben and Connie. It has full sales and manufacturing forces and excellent office support, for a total of 50-100 employees. Everyone loves these new widgets; Connie keeps finding ways to improve the product; and Alice keeps finding new customers. Ben, however, is tired of trying to keep up with their unbridled energy. Ben's son, George, just received an MBA from a leading business school. Ben thinks that George should take over Ben's job and would like to transfer some of his equity to him. Alice and Connie agree to let George work his way into the business, getting experience in various office functions and eventually moving up to Ben's job in five years if George works out well.

How should they handle George's new role and Ben's phasing out of his own role? What if George turns out to be a slacker?

Estate planning issues: tax rates and exemption levels, ability to make gifts, transferring business opportunities or leveraged businesses, asset protection planning using trusts, passing to spouse and children, fair vs. equal, dividing into voting and nonvoting ownership interests, need for single class of equity interest (consider nonvested stock), and estate tax issues with related party buy-sell agreements. Alice, Ben and Connie want to institute some kind of nonqualified deferred compensation plan for themselves. Develop simple performance bonus for George, payable within 2½ months after close of year with no option for deferral. Important to set goals based on where Alice, Ben and Connie want George to be in five years. If George turns out to be a slacker, he gets no bonus. When Ben wants to transfer some of his shares to George, consider the issues of restrictions on transfer, rights of first refusal, etc.

**<u>Purchase of Retiring Founder's Interest; Business Succession Planning to Current Key Employee - Year 15</u>**

In Year 15, Alice gets bored. She wants to sell her share of the business to Ben, George and Connie and retire to a tropical island, along with the main characters in John Grisham's first two books. Sally, an employee who has been a top salesman for years, wants to take Alice's job. However, Sally has no money to invest to buy out Alice. Furthermore, Sally wants some financial incentives based on the company's sales and profitability.

Should the company, the other owners, or Sally buy out Alice? What kind of incentives should Sally be given?

Availability of capital gain rates when entity sells assets. Tax on splitting up or dissolving. Code § 736 payments. Consider phantom shares or restricted stock for Sally. George needs to be ahead of Sally because he is the son of the founder and, in his mind, the heir apparent. Include George in same plan developed for Sally. Also see issues from Year 10.

**Purchase of Deceased Founder's Interest, Including Possible Sale of Business - Year 20**

In Year 20, Connie dies. The stresses of keeping up with changing technology and foreign competition left her exhausted.

How should the remaining owners handle buying out Connie's ownership interest, which under her estate plan would pass to her husband, Herman?

Instead, should they sell the business? To the employees or to outside investors? Possible merger?

What if the remaining owners prefer to retire, turning the business over to the employees?

Estate tax deferral. Restricted stock (or phantom stock) immediately vested. Also see issues from Year 15.

## III. Estate Planning Implications

The first section of this portion deals with drafting and administering trusts, including income taxation and fiduciary responsibility. The second section deals with transfer tax issues, including transfers during life, estate tax issues, and special valuation issues (including the effect of buy-sell agreements). The third section discusses fairness within families, including allocating assets when businesses are involved and potential conflicts of interest involved in those allocation decisions.

## III.A Drafting and Administering Trusts

Drafting trusts to hold business interests involves melding the grantor's wishes with the related income tax consequences, especially when holding stock in S corporations. Trustees need to consider diversifying, but when a special purpose of the trust is to hold a business interest, the trustees will want to make sure that the businesses are professionally run in a manner that is both economically sound for the beneficiaries but also minimizes the trustees' liability.

### III.A.1 General Benefits of Trusts

Increasingly, people are becoming aware of the need to protect their assets from claims by creditors or spouses. Clients can do a big favor for your surviving spouse or children by leaving assets in trust instead of outright. The trust agreement can provide them with virtually complete control over the trust. Or, if clients wish, the trust agreement could be very restrictive. It all depends on what they want.

For example, a wife leaves her entire estate outright to her husband upon her death. They orally agree that he will leave her remaining assets to their children at his death. Unfortunately, that's a moral, not a legal, agreement. Suppose the husband remarries after the wife's death. Under Missouri law, upon his death, his new spouse would have the right to about 1/3 of his estate. This would be contrary to the clients' originally agreed goal of having all of your assets pass to your children at her death.

What about estate taxes? In 2005, each person can leave only $1.5 million to his or her children free from estate taxes (the "exclusion amount"). Suppose the clients have a $2 million estate (with insurance and property, many people have estates this large). If each leaves everything outright to the surviving spouse, the first spouse's exclusion amount is wasted. When the surviving spouse dies, the children will pay estate tax on the $500,000 excess over the surviving spouse's $1.5 million exclusion amount.

Clients can avoid these problems by leaving their property in trust for the surviving spouse. If they wish, the surviving spouse can be the sole trustee, take distributions for support as the surviving spouse determines, and change how the trust's assets pass at the surviving spouse's death to take into account changes in their children's family circumstances. Because the assets are in a trust the first spouse created, if the second spouse remarries, the new spouse would not have a claim on them upon the second spouse's death. Because the first spouse used his or her estate tax exclusion amount to create the trust, it will be excluded from the surviving spouse's estate at the surviving spouse's death, and the surviving spouse can use his or her exclusion amount to cover the assets that the surviving spouse owned outside of that trust.

What about leaving assets to children? Even adult children may need protection from creditors and spouses. Suppose a child starts a new business. The child's creditors will demand personal guarantees. If the client leaves assets to the child outright, they would be at risk. Likewise, if the child marries, the child's spouse might persuade the child to put the money in a joint account. If the child later divorces, the child will need to split this account with the soon-to-be ex-spouse.

When I asked a client whether he liked the idea of trusts for his children, he told me about his neighbor. The neighbor bought a house for his daughter and her husband. The house was titled jointly in their names. When the daughter divorced, the neighbor bought his ex-son-in-law's half so that the daughter could own the house outright. In other words, the neighbor paid for his daughter's house one and a half times!

Clients can avoid these, and other, problems by leaving your property in a separate trust for each child. If the client wishes, his or her child can be the sole trustee of the child's trust, take distributions to support the child as the child determines, and change how the trust's assets pass at the child's death. The child might even be able to pass the trust's assets free from estate tax, even if the child's separate assets use up the estate tax exclusion amount.

Missouri law was changed in 2001 to allow trusts to last forever. However, flexible drafting can let each generation change the rules for the next.

By using trusts, we can help clients protect their families from predators. We can also build in flexibility to allow them to react to changes that nobody can foresee, so that we can help clients give their families a legacy that they might enjoy forever.

## III.A.2 Liability Issues

In most states, trusts may hold interests in general partnerships or sole proprietorships only if the governing instrument or a state statute grants the trustee authority to do so, because of the liability risks involved. Even investments in limited liability entities may be considered too risky unless they have a proven track record. The propriety of an authorized investment in a closely-held business is determined by applying the same standard of care as for other assets.[209]

Under the Uniform Prudent Investor Act (UPIA),[210] a trustee "shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust;" and in making such decisions, the trustee "shall exercise reasonable care, skill and caution."[211] Additionally, a trustee's investment and management decisions regarding individual assets are to be evaluated with respect to the trust portfolio as a whole and "as part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[212] While making investment decisions and managing trust assets, the trustee should consider factors such as general economic conditions, tax consequences, the role of the asset in the overall trust portfolio, and the expected return from the asset.[213] Perhaps the most important factor to be considered is the asset's special relationship or value to the purposes of the trust or to one or more of the beneficiaries, when the special purpose of the trust is to hold a business interest.[214] This factor ties in with the UPIA's other requirement that the trustee diversify the trust investments unless there are special circumstances that indicate the trust's purposes would be better served without diversification.[215] Thus, when the trust's specific purpose is to hold a business interest, a lack of diversity in the assets of the trust will not run afoul of the UPIA's requirements. Finally, the UPIA imposes a "duty of impartiality" when the trust has more than one beneficiary. The trustee is to act impartially in performing his or her duties and in doing so should take into account any differences in the beneficiaries' interests. For example, the trustee has to consider any potential conflicts between the interests of beneficiaries interested in trust income versus those interested in trust principal.[216] This duty of impartiality will affect the trustee's investment and management conduct with regard to principal and income allocations – especially with regard to tax burden allocations.

The Uniform Trust Code (UTC)[217] provides default rules governing the trustee's duties and powers, but allows for many of those rules to be modified by terms of the trust.[218] Among those

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[209] See generally, Bogert, *The Law of Trusts and Trustees*, §679 (Rev. 2d. Ed. 1982).
[210] Citations to the Uniform Prudent Investor Act ("UPIA") are to the version adopted in 1994, published April 18, 1995, by the National Conference of Commissioners on Uniform State Laws.
[211] UPIA §2(a).
[212] UPIA §2(b).
[213] UPIA §2(c) .
[214] UPIA §2(c)(8).
[215] UPIA §3.
[216] UPIA §6.
[217] Citations to the Uniform Trust Code are to the version adopted in 2004, as amended or revised in 2005, published March 7, 2005, by the National Conference of Commissioners on Uniform State Laws.
[218] UTC §105.

duties are the duty of loyalty and the duty of impartiality among beneficiaries, a duty identical to the UPIA's duty of impartiality.[219] With regard to the duty of loyalty, the trustee must act in furtherance of the best interests of the beneficiaries. Specifically, when the trust holds a business interest, the trustee has a duty to vote shares and use proper care to promote beneficiary interests; and when the trust is the sole owner of an entity, the trustee should elect or appoint a director or manager to manage the entity in the best interests of the beneficiaries.[220] In a corporate context, the trustee must vote for corporate directors who will follow policy consistent with the trustee's duty of impartiality. The UTC also emphasizes that when a trustee has special skills or expertise in an area, he or she should use those skills in managing the trust.[221] In recognition of the trustee's ability to hold business interests, the UTC gives the trustee the power to continue business and take actions that would be taken by shareholders, members, or property owners and allows the trustee to exercise rights of an absolute owner with respect to stocks or other securities.[222]

With regard to partnership interests specifically, National Banks may find it difficult to hold a partnership interest. The Office of the Comptroller of the Currency (OCC) regulates these banks and has stated that, as a general partner, a bank's liability is not limited to the principal of a particular account, but that it would object to a bank investing in general partnerships unless local law limited the bank's liability.[223] As a limited partner, a bank usually would not have a say in the management of the assets. When a bank does hold a limited partnership interest, the OCC will not object if such investment is authorized by the governing instrument, local law or by written consent of account beneficiaries. Additionally, the bank would still be subject to the prudent investment standard, and the investment would have to meet the objectives of the account.[224]

Although trust agreements can seek to absolve trustees from liability, state law frequently imposes duties of at least some level of good faith.

Even if a trust specifically authorizes a trustee to take certain actions, such as holding a particular risky stock, it has been argued that a trustee has a duty to go to court to modify the trust to take a wiser course of actions.

### III.A.3 Income and FICA Tax Issues

After a modest run up in brackets, trusts quickly become subject to tax at the highest marginal tax rate. However, to the extent that a trust distributes its income, its beneficiary is taxed on that income instead of the trust being taxed on that income.

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[219] UTC §802, §803.
[220] UTC §802(g).
[221] UTC §806.
[222] UTC §816(6), (7).
[223] Note that a partnership may register as a limited liability partnership (LLP) to limit the general partner's liability. When a limited partnership registers as an LLP, it might be called a limited liability limited partnership (LLLP).
[224] Office of the Comptroller of the Currency, Comptroller's Handbook for Fiduciary Activities, July 1998, pg. 42.

Absent an abusive situation, trusts are not subject to FICA tax.

### III.A.4 Estate and Gift Tax Issues

Generally, irrevocable trusts are not included in the grantor's estate for estate tax purposes. However, certain advanced planning techniques and/or certain mistakes can cause inclusion in the donor's estate for estate tax purposes.

Also, trusts can be structured to avoid inclusion in the beneficiary's estate for estate tax purposes. Again, certain advanced planning techniques or certain mistakes can cause inclusion in the beneficiary's estate for estate tax purposes.

Gift planning typically involves special features that allow gifts to trusts to qualify for the $11,000 annual exclusion for each current beneficiary. This amount can be doubled if the donor's spouse elects to split gifts with the donor. It is not unusual for larger gifts to be made, and sometimes gifts of the $1 million applicable exclusion amount are appropriate.

### III.A.5 Trusts Holding Stock in S corporations

#### III.A.5.a Generally

The following trusts may be shareholders:

(1) <u>A trust all of which is treated under the grantor trust rules as owned by an individual who is a citizen or resident of the United States</u>.[225] The owner could be a grantor or beneficiary and is treated as the owner for purposes of the 100-shareholder limitation.[226] As we will discuss in more detail later, a beneficiary may be treated as the owner either by the way the trust is designed or if the beneficiary makes a "QSST" election[227] to have the grantor trust rules apply.

(2) <u>A trust that was a grantor trust immediately before the death of the deemed owner and which continues in existence after such death</u>.[228] Generally, such a trust is an eligible shareholder only for the 2-year period beginning on the day of the deemed owner's death. However, if the trust is subject to an election under Code § 645, then the trust is taxed as an estate and can hold the stock during the entire period during which the trust is taxable as an estate.[229] In either such case, the grantor's estate is treated as the owner for purposes of the 100-shareholder limitation.[230]

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225 Code § 1361(c)(2)(A)(i).
226 Code § 1361(c)(2)(B)(i).
227 Code § 1361(d)(1).
228 Code § 1361(c)(2)(A)(ii).
229 Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii); Letter Ruling 200529006.
230 Code § 1361(c)(2)(B)(ii).

Note that, if the grantor's gross estate (for federal estate tax purposes) might be subject to estate tax, it is common for the trustee to hold the S stock for more than two years after the grantor's death. This is done to avoid the trustee incurring personal liability under the tax laws, because a final determination of estate tax might not be made until after the two-year period has expired. Therefore, the trustee should consider making a Code § 645 election, by filing IRS Form 8855. The form is due by the time of the first income tax return filed for the grantor's estate (or grantor's revocable trust, if there is no probate estate). After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the § 6166 election.[231]

(3) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it.[232] In such a case, the testator's estate is treated as an owner for purposes of the 100-shareholder limitation.[233] Because a revocable trust that has made a Code § 645 election is treated as an estate, any transfer from that estate by reason of termination of the election or by bequest under that revocable trust is treated as transferred pursuant to the terms of a will.[234]

(4) A trust created primarily to exercise the voting power of stock transferred to it.[235] In such a case, each beneficiary of the voting trust is treated as the owner for purposes of the 100-shareholder limitation.[236]

(5) An electing small business trust.[237] In such a case, each potential current beneficiary of the trust is treated as the owner for purposes of the 100-shareholder limitation.[238] If any of the surviving spouse and the grantor's descendants are shareholders themselves, double counting does not occur.[239] In the next section of this article, we will discuss trust drafting techniques and a comparison between this type of trust and a QSST.

Again, the shareholder agreement does not need to specify these trusts, as the reference to causing the corporation not to be a "small business corporation" as defined in Code § 1361(b)(1) should be sufficient to limit which kinds of trusts may be owners without going into all the detail described above. However, when preparing shareholders' estate plans, make sure the beneficiaries of the estate plans qualify.

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[231] Reg. § 1.645-1(f)(2)(ii). Jonathan Blattmachr suggested this idea.
[232] Code § 1361(c)(2)(A)(iii).
[233] Code § 1361(c)(2)(B)(iii).
[234] Reg. § 1.1361-1(h)(1)(iv)(B).
[235] Code § 1361(c)(2)(A)(iv).
[236] Code § 1361(c)(2)(B)(iv).
[237] Code § 1361(c)(2)(A)(v).
[238] Code § 1361(c)(2)(B)(v).
[239] For the 100 shareholder limit, see Reg. section 1.1361-1(m)(4)(vii)(third complete sentence). For the family attribution rule, see 2004 Blue Book (General Explanation of Tax Legislation Enacted in the 108th Congress), p. 189, footnote 321.

Retirement plans are trusts, so let's discuss those for a moment. First, IRAs are qualified under Code § 408, not § 401(a). Therefore, IRAs are not eligible shareholders, as they are not trusts that qualify under these rules. Second, qualified retirement plans are taxed on unrelated business taxable income,[240] including income from S corporations.[241] However, employee stock ownership plans (ESOPs) are not subject to this tax.[242]

### III.A.5.b Trusts as Shareholders: QSST vs. ESBT, Including How to Fix a Late Election and Regulations Dealing with ESBTs

This section focuses on irrevocable trusts, including trusts created by bequests under a revocable trust. Revocable trusts are taxed as grantor trusts,[243] so they automatically qualify as S shareholders[244] whose grantors are treated as the shareholders for all tax purposes,[245] including the 100-shareholder limitation.[246]

To qualify as S corporation shareholders for any length of time,[247] generally[248] an irrevocable trust must either be a grantor trust or an electing small business trust (ESBT). An irrevocable trust may qualify as a grantor trust under the normal rules of Code §§ 671-678 or may be treated as a grantor trust through a QSST election made by the beneficiary.[249] If a beneficiary has a withdrawal right with respect to all gifts to the trust (a *Crummey* trust), the trust might be taxable to the beneficiary under Code § 678.[250] The rest of this section focuses on the features of QSSTs and ESBTs.

A QSST may have only one beneficiary who may receive income or corpus during the beneficiary's lifetime, and all of its income must be distributed currently to that beneficiary (who also must be a U.S. citizen or resident).[251] However, a trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a

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[240] Code § 511(a)(1), 501(a).
[241] Code § 512(e)(1).
[242] Code § 512(e)(3).
[243] Code § 676.
[244] Code § 1361(c)(2)(A)(i).
[245] Code § 671. Grantor trusts may use their deemed owners' social security numbers as their taxpayer identification numbers. Reg. § 1.671-4(b)(2)(A). However, a QSST must file Form 1041 and attach a statement of the items treated as having been received directly by its beneficiary. Reg. § 1.671-4(b)(6).
[246] Code § 1361(c)(2)(B)(i).
[247] Trusts can qualify as S shareholders by electing to be taxed as an estate under Code § 645 (which election has a limited duration under Code § 645(b)(2)), by being a continuation of a grantor trust under Code § 1361(c)(2)(A)(ii), or a testamentary trust under Code § 1361(c)(2)(A)(iii) (see text accompanying footnotes 232-234).
[248] A voting trust does not have time limits on how long it is an eligible shareholder under Code § 1361(c)(2)(A)(iv).
[249] See text accompanying footnotes 225-227.
[250] See discussion of IRS Letter Rulings in 730-2nd T.M., *S corporations: Formation and Termination*, II.E.1.b(3) and in *Federal Income Taxation of S corporations* ¶ 3.03[10] (4th ed., Warren, Gorham & Lamont). A trustee-beneficiary's power to make distributions to himself under an ascertainable standard might make the trustee-beneficiary a Code § 678 owner to the extent of that distributions would be authorized under that standard. Letter Ruling 8211057.
[251] Code § 1361(d)(3).

QSST with respect to each separate share.[252] For example, a grantor sets up an irrevocable trust for the benefit of his four children. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust. This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion.[253]

An ESBT may have more than one beneficiary.[254] However, each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[255] A potential current beneficiary means any person who at any time during a particular taxable year may receive a distribution of principal or income from the trust, whether the distribution was mandatory or discretionary.[256] Regulations provide that an open-ended inter vivos power of appointment violates the 100-shareholder limitation;[257] however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period.[258]

ESBT income taxation is complicated. The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate.[259] Very few deductions are allowed against this income, and the income distribution deduction is not available.[260] Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction, to name some of the most common problematic areas.

A QSST is best used when:

1. The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust

[252] Code § 1361(d)(3). Although the statute cites to the separate share rules under Code § 663(c), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds that remote possibilities *are* considered.

[253] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[254] For all of the ESBT requirements, see Code § 1361(e)(1).

[255] Code § 1361(c)(2)(B)(v).

[256] Code § 1361(e)(2).

[257] Reg. § 1.1361-1(m)(4)(vi)(A).

[258] Code § 1361(e)(2).

[259] Code § 641(c)(1).

[260] Code § 641(c)(2).

rules,[261] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[262]

2. The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[263] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

Neither a QSST nor an ESBT is a flawless tool for purchases made out of earnings. In QSSTs, all income must be distributed to the beneficiary rather than being used to repay the principal on a promissory note; an exception should apply when the note is secured by the stock and by all distributions with respect to the stock,[264] but that risks income tax uncertainty about interest deductions.[265] In ESBTs, interest on the promissory note is not deductible.[266] A better solution is a trust taxable to its beneficiary under Code § 678.[267]

The beneficiary must make a QSST election no later than fifteen days and two months after the trust received the stock.[268] The trustee of an ESBT must file the ESBT election within the same time framework. A late ESBT or QSST election may be made within 24 months of the original due date of the election, without the $10,000 fee required for letter rulings under Code § 9100.[269] The late election requires the consent of all the shareholders.

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[261] Code §§ 2056(b)(1) and 2523(b).

[262] Code § 651.

[263] Code § 1(e)(2).

[264] Letter Ruling 200140046. Compare Sections 502(b) and 504(b)(4) of the Uniform Principal And Income Act (last amended or revised in 2000; see http://www.law.upenn.edu/bll/ulc/upaia/2000final.htm); in Missouri, see RSMo §§ 469.453.2 and 469.457.2(3). Thus, a QSST should be able to repay principal of a promissory note if properly secured; however, if the QSST has other assets or later sells the stock, it might be required to distribute the other assets or sale proceeds to make up for the income that was used to pay principal on the promissory note.

[265] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." Notwithstanding that argument, the principle behind the ESBT regulation quoted in fn 266 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B).

[266] Reg. § 1.641(c)-1(d)(4)(ii) provides, "(ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion."

[267] See fn 250.

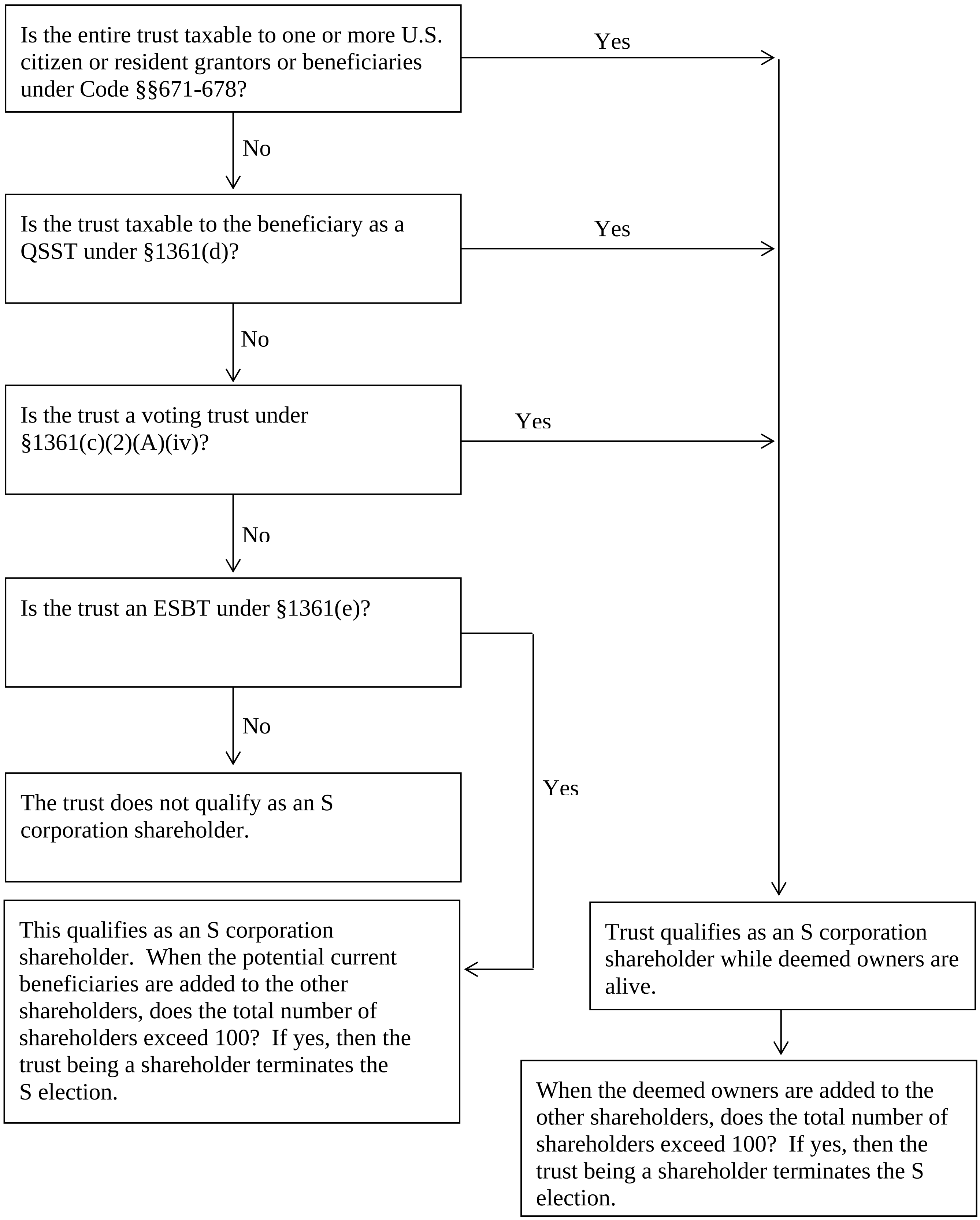
[268] Reg. § 1.1361-1(j)(6)(ii)(C).

[269] Rev. Procs. 2003-43, 2006-1.

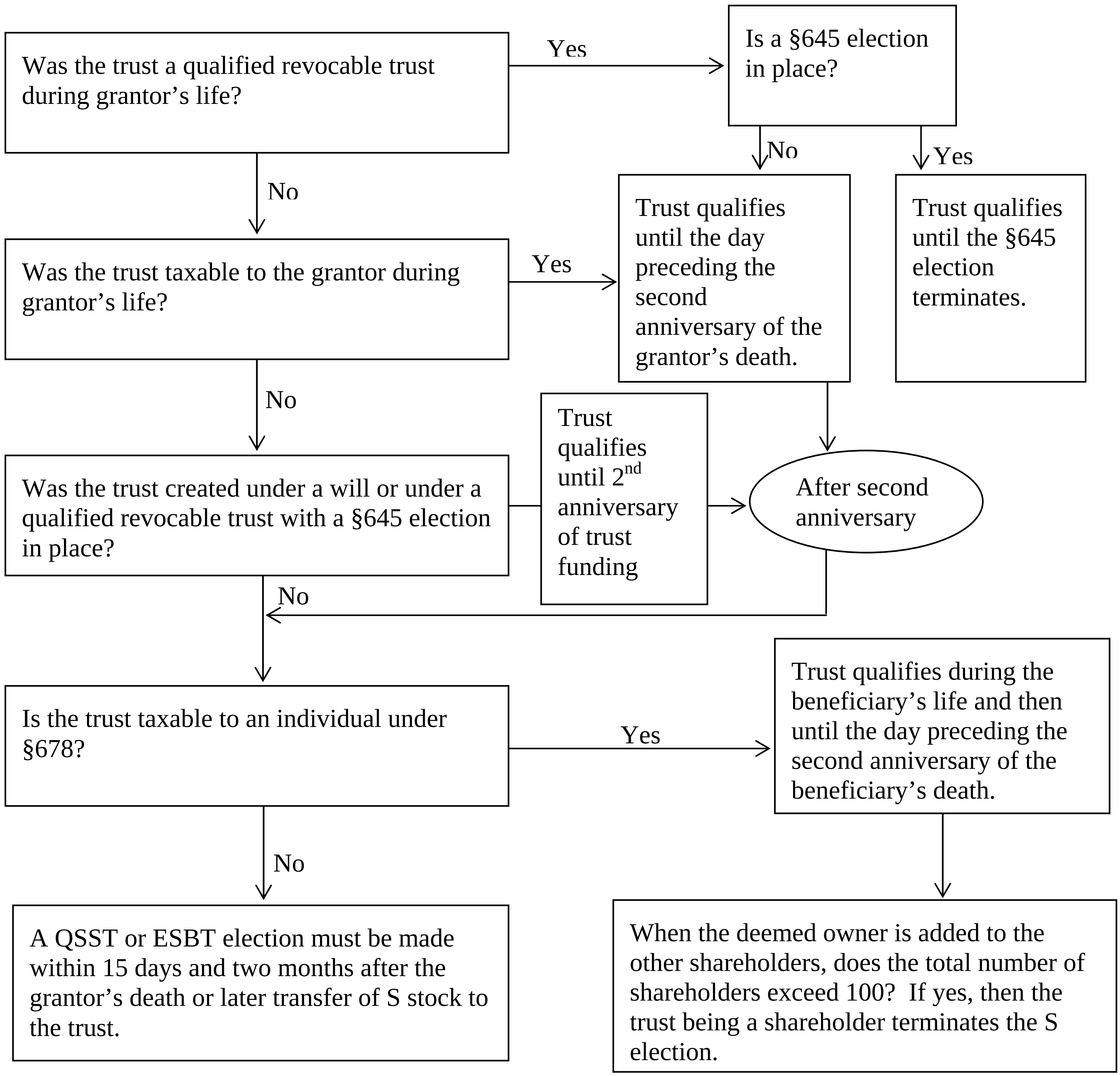
### III.A.5.c Flowcharts

Below are some flowcharts illustrating trust qualification as a shareholder of an S corporation. The flowcharts do not consider trusts that are tax-exempt.

**III.A.5.c.i Flowchart of Inter Vivos Trusts (Trusts Created while Grantor is Alive)**



### III.A.5.c.ii Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death)



### III.A.6 Trust Accounting Income Regarding Business Interests

When a trust holds a business entity interest, complicated accounting and tax issues can arise. One of the main reasons for these complexities is the difference between accounting income and taxable income. Accounting income helps determine the amount of distributions a trust is required to make, under the governing instrument or state law, which in turn may determine how much taxable income is carried out to the beneficiaries of the trust. The Code defines "income required to be distributed currently" as the fiduciary accounting income that must be distributed currently pursuant to the governing instrument or state law. Because fiduciary accounting income is determined by state law or the governing instrument, there will likely be differences between taxable income and accounting income. An example of such a difference would be capital gains. Capital gains are usually principal for fiduciary accounting purposes, but are taxable income for income tax purposes.

A similar problem can arise when a trust holds a partnership interest. Often times a partnership may report significant earnings on its K-1s, but may distribute a much smaller amount in cash to its partners. For example, a trust could receive a partnership K-1 with $100,000 of taxable income, but may only receive $60,000 of cash as a distribution. The $60,000 is all the accounting income, because the amount distributed does not exceed the amount of income attributable to the trust.[270] When this happens, the trust will have distributable income equal to $60,000, but will be unable to distribute the additional $40,000 of "phantom income" from the K-1, meaning the trust will be taxed on the $40,000. This can lead to cash flow problems when the trust has no other income, since once the trust distributes the $60,000 to the beneficiary it will have no available cash to pay the taxes. The Uniform Principal and Income Act[271] provides a solution to this problem. Under §505(c)(1), a tax that is required to be paid by a trustee on the trust's share of an entity's taxable income is proportionally divided between principal and income based on the receipts allocated to each.[272] Thus, the trustee will be able to keep some of the cash to pay the taxes on the trust's undistributed income.

### III.B Transfer Tax Issues

Transfer tax issues include transfers during life, estate tax issues, and special valuation issues.

### III.B.1 Transfers During Life

Transfers during life include many ways of transferring equity to one's loved ones. The simplest way is shifting a business opportunity. Gifts without consideration can appear straightforward, but then valuation issues complicate matters, and designing trusts to hold stock in S corporations can be tricky. More advanced tactics include transfers to grantor retained annuity trusts and various sale techniques, including self-canceling installment notes and private annuities.

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[270] Uniform Principal and Income Act, §401(b). See footnote 271.

[271] Citations to the Uniform Principal and Income Act are to the version adopted in 1997, as amended or revised in 2000, published August 21, 2003, by the National Conference of Commissioners on Uniform State Laws.

[272] See also RSMo §469.459.3(1).

## III.B.1.a Business Opportunities

A business owner who plans to add new locations or new products or services may be able to use some basic techniques to let family members participate in the business' growth. These techniques involve shifting these business opportunities to the family members.

New businesses often have speculative value. Even a successful business may have difficulty expanding into new locations or adding products or services. When starting a new business, consider giving most of the ownership to family members through nonvoting ownership interests. For example, the client owns 1% of the company and all of the voting rights, and the client's children own 99% of the company without any voting rights. The 99% that the client gives his or her children has little value if the new business has an uncertain future. Because the client controls the business, the client can use the business techniques that the client has mastered to make sure it is managed correctly. However, the children own 99% of the profits that the client creates.

A retailer used this concept to make his children rich. He would identify the location for a new store. Then his children or their spouses would buy the land, build a store, and lease it to the retailer. The lease payments enabled the children and their spouses to build equity in the real estate. This happened repeatedly, and the children and their spouse became multi-millionaires.

Another businessperson has special knowledge of a leasing business. He helps his family and close friends arrange financing to buy equipment. The financing is a combination of bank loans and loans from himself to them at the applicable federal rate (AFR – interest rates promulgated by the IRS monthly). He may make a gift to the family member or friend so that the recipient will be able to contribute equity to the project. However, no commitment is made to finance and buy the equipment until he finds someone willing to commit to lease the property for long enough for the buyer to use the lease payments to repay the loans. Although he is the moving force behind the transactions, his family and close friends own most of the business from inception and therefore receive most of the benefits of the equity.

Making long-term loans to a client's children at today's low interest rates is an easy way to help them acquire investments, whether a privately-owned business, real estate, or marketable securities.

Whatever form the gift may take, as it stands, the Code does not mention the term "gift of opportunity." This, naturally, has not stopped the IRS from pursuing these "gifts" as taxable transfers. The gift tax was initially devised as a backstop to the federal estate tax; however, this purpose was seemingly broadened by the decision in *Dickman v. Commissioner*.[273] In *Dickman*, the Supreme Court established that the gratuitous gift of the use of property constituted a taxable gift.[274] In holding such, the court stated that, "Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property."[275] The court goes further by adding,

[273] Dickman v. Commissioner, 465 U.S. 330 (1984).
[274] *Id*. at 333.
[275] *Id*. at 334.

"the gift tax was designed to encompass all transfers of property and property rights having significant value."[276] Several past cases highlight the extensive grasp of the gift tax provisions. "Gift," as Congress intended the word, means all of the "protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech."[277] The gift tax is "broad enough to include property, however conceptual or contingent,"[278] and may "reach every kind and type of transfer by gift."[279] Suffice it to say, the Supreme Court has supported a broad interpretation of what may fall under the purview of the gift tax statutes.

That being said, the IRS has encountered limited success in its efforts at reaching gifts of opportunity. The following discussion outlines some of these successes, and, likewise, some of its failures.

Loaning money to a child or other family member, under the holding in *Crown v. Commissioner*[280] did not produce gift tax liability should the lending parent fail to charge or collect interest on the loans. The court stated that interest-free demand loans were not transfers of property within the meaning of the gift tax statutes, as the borrowing child had no legally protected right against the lending parent.[281] Furthermore, the child's use of the money was not an interest with an exchangeable value.[282]

In certain respects, *Dickman* changed this. The Supreme Court, as previously mentioned, held that the right to use the loaned money represented a valuable, taxable gift because it represents a transfer of property by gift.[283] The Court softened this blow by recapping the merits of the gift tax exclusions available to individuals and families, such as the annual exclusion, gift splitting, exemptions, and the (then) unified credit.[284] However, *Crown* should apply in particular circumstances. For instance, a parent who allows his or her adult child to use the family vacation home rent-free should not engender any gift tax liability, as the child doesn't have a legally enforceable right, against the parent, to stay in the home.[285] *Dickman* involves loans and other arrangement where the borrower does have a legally protected interest to use the loaned funds or property, i.e. a formal loan.

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276 *Id*.
277 *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).
278 *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943).
279 *Robinette v. Helvering*, 318 U.S. 184, 187 (1943).
280 585 F.2d 234 (7th Cir. 1978).
281 *Id.* at 239.
282 *Id*.
283 *Dickman*, 465 U.S. at 333.
284 *Id.* at 341-42.
285 The *Dickman* Court expressly reserved for future cases adult children's use of cars or vacation cottages. *Id.* at 336.

### III.B.1.a.i Interest-Free and Below-Market Loans

Interest-free or below-market loans are governed by Code § 7872, which generally requires imputation of interest of such loans.[286] Each month, the IRS publishes a revenue ruling that prescribes interest rates to be used for federal tax purposes. These Applicable Federal Rates (AFRs) provide short-, mid-, and long-term government rates of interest.

These loans break down into two categories: term loans and demand loans. A term loan, as the name implies, is a loan for a specific term, i.e. it has a defined start date and end date. A demand loan is a loan that is immediately callable at any time.

Code § 7872 does allow for certain exceptions to the general rule of imputing interest. For instance, gift loans between individuals may qualify for a de minimis exception. If the outstanding aggregate amount of loans between individuals is less than $10,000, then the general rules of Code § 7872 will not apply.[287] The same rule holds true for compensation-related and corporate shareholder loans.[288] Also, Code § 7872 provides for an income tax (but not gift tax) exclusion of accrued interest where aggregate loans do not exceed $100,000.[289]

#### (a) Term Loans

Term loans with an interest rate below the AFR immediately result in a completed gift of the difference between the amount of proceeds and the value of the repayments using the AFR. For instance, the July 2005 mid-term monthly AFR was 3.79%. On a five-year loan of $100,000, the monthly payment would be $1,832. An interest-free loan, however, would generate a monthly payment of only $1,667. The monthly difference between the two payments is $165. The present value of five year's worth of $165 monthly payments is $9,006 (at the AFR), a figure which also represents the completed gift.

If an interest-free or below-market term loan is made, the lender is treated as having transferred an amount equal to the money loaned, less the present value of all payments due under the loan.[290] The present value is calculated using a discount rate equal to the AFR for the term of the loan.[291]

The loan will be considered to have original issue discount ("OID") in an amount equal to the excess of the money loaned over the present value of the payments due on the loan.[292] The lender will accrue interest income in each year of the loan. The borrower's tax treatment on the loan depends on whether he or she can deduct the interest. If deductible, it must be deducted in each year of the loan.

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[286] *Dickman* has been superseded and codified as Code § 7872, which provides for short-term (under three years), mid-term (three to nine years), and long-term (over nine years) AFRs.
[287] Code § 7872(c)(2)(A).
[288] Code § 7872(c)(3)(A).
[289] Code § 7872(d)(1).
[290] Code §§ 7872(b)(1), 7872(d)(2).
[291] Code § 7872(f)(1).
[292] Code § 7872(b)(2)(A). Added to this OID amount is any OID that the loan would carry. Code § 7872(b)(2)(B).

#### (b) Demand Loans

Demand loans, i.e. those immediately callable at any time, are valued annually for gift tax purposes. The short-term AFR is used, assuming that on the last day of the year, the amount of interest was paid to the lender, who in turn made a gift back to the borrower.[293]

### III.B.1.a.ii Gift of Services

The IRS, traditionally, has not tracked gifts of services. Before *Dickman*, the courts generally concluded that the gift tax only applied to transfers of title or interest in property. This is clearly no longer true, considering how the court chose to define "property." "[It] is more than just the physical thing – the land, the bricks, the mortar – it is also the sum of all the rights and powers incident to ownership of the physical thing. Property is composed of constituent elements and of these elements the right to *use* the physical thing to the exclusion of others is the most essential and beneficial."[294]

However, if the IRS decides to pursue gifts of services, it will not necessarily be on strong footing. Rather, the holding in *Crown* seems to support the opposite conclusion. "The opportunity cost of either letting one's money remain idle or suffering a loss from an unwise investment is not taxable merely because a profit could have been made from a wise investment."[295] Likewise, donating one's own services should not create gift tax liability merely because profit could have been made by working for wages or profit. "The taxpayer is not under any duty to cultivate the fruits of his capital (or labor) and will not be taxed as if he had when he hasn't."[296] Also, *Dickman* states that the gift tax is an excise tax on transfers of property.[297] *Dickman* did not address gifts of services.

### III.B.1.a.iii Family Partnerships

Take, for instance, a scenario in which a parent real estate entrepreneur makes a capital contribution to become the general and managing partner of a family partnership. The children all make capital contributions, as limited partners, in amounts greater than or equal to the parent's. The lion's share of the capital necessary to finance the project is borrowed from banks, presumably on the basis of the parent's good credit and standing in the financial community. If the transaction succeeds, the banks are paid back and the children are rewarded in proportion to their capital contributions. If the transaction fails, however, the banks and the parent, as general partner, are left holding the bag. These are similar facts, in certain respects, to those of *Carriage Square, Inc. v. Commissioner*.[298]

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[293] Code § 7872(a)(1); *See generally* Kathryn Henkel ¶ *28.02, Section 7872: Imputed Interest on Below-Market Loans*, Estate Planning and Wealth Preservation (June 2005).
[294] *Dickman*, 465 U.S. at 336, quoting *Passailaigue v. U.S.*, 224 F.Supp.682, 686 (MD Ga. 1963).
[295] *Crown*, 585 F.2d at 236.
[296] *Id*.
[297] *Dickman*, 465 U.S. at 340.
[298] 69 TC 119 (1977).

In *Carriage Square*, the father, through his corporation, Carriage Square, Inc., contributed funds to a partnership (10% of total funds), while five trusts, for the benefit of his wife and children, each contributed the remainder (90%). The father became the general partner, while the trusts became limited partners. The father would then purchase land with borrowed money and sell the land to the partnership, with the partnership borrowing the necessary capital from the same bank on a guarantee by the father. The partnership would also take out a construction loan, again guaranteed by the father. Once the real estate development became successful, the five trusts received 90% of the profits.

The *Carriage Square* majority held that the borrowed capital was not a material income-producing factor.[299] Code § 704(e)(1), a non-exclusive safe harbor, states that a person shall be recognized as a partner for income tax purposes if he or she owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. However, whether capital is a material income-producing factor in a partnership is for the fact finder to determine on a case-by-case basis. Essentially, the court believed the bank would not have loaned the money to capitalize the venture without the secured guarantees by the father.

The court held that the partnership was a sham, a façade designed to transfer tax-free income streams to the children. Because capital was not a material income producing factor, Code § 704(e)(1) did not apply. Also, the court held, the partners did not have a valid business purpose for forming the partnership, considering the 90% share of profits the trusts earned in light of their limited capital contributions and consequential limited risk (since they did not guarantee the loans). Because the partnership could borrow whatever amounts it needed based on the guarantees by the father, their capital contributions were not material. Further, because the father, through the general partner corporation, performed all the services necessary to operate the business, assumed all the risk of business failure, and used his contacts and community goodwill to secure the loans, the court held that the trusts were not partners.[300] Judge Tannenwald, in his dissent, instead of discounting the partnership interests of the trusts, raised the specter of the trusts' partnership interests having been acquired by gift under Code § 704(e)(2).[301]

A family partnership in which capital is not a material income-producing factor may still be recognized as a valid entity and the persons within it as valid partners under the *Culbertson* standard.[302] Partners must show they had a good faith business motive for entering into the partnership. However, for income tax purposes, failure to satisfy Code § 704(e)(1) will preclude the partnership from passing the *Culbertson* hurdle.[303]

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[299] The court believed that Reg. § 1.704-1(e)(1)(i) prohibited the borrowed capital from being considered as an income producing factor because it was not contributed by a partner. *Id*. at 127. "The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners." Reg. § 1.704-1(e)(1). Here, the capital was guaranteed by a non-partner, the father.
[300] *Carriage Square,* 69 TC at 128.
[301] *Id*. at 140-41.
[302] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).
[303] Howard Zaritsky, ¶ *10.09 The Family Partnership Rules,* Tax Planning for Family Wealth Transfers: Analysis With Forms.

Commentators have long questioned the *Carriage Square* holding.[304] The case, as the Tax Court admitted, was an egregious example of tax avoidance.[305] Today, it is readily distinguishable and, with proper planning, should cause little concern for the gift of opportunity described above. One reason for this is the IRS' change of attitude regarding loan guarantees.

### III.B.1.a.iv Loan Guarantees

Private Letter Ruling 9113009 held that loan guarantees conferred "valuable economic benefits" to the grantee that constituted a gift. If the grantee, without the guarantees, would pay a higher interest rate on the loan, or otherwise be unable to obtain the loan altogether, then the grantee has received a valuable property interest.[306] The grantor had assumed a legally enforceable obligation for less than full consideration. Thus, when a loan guarantee became binding, the grantor had made a completed gift.[307]

At least one commentator, at the time, noted the foolishness with which loan guarantees were taxed.[308] The folly came by way of comparison of the effects of a parent loaning a child funds (possibly using a "back-to-back" loan) versus a parent guaranteeing a child's loan. Code § 7872, which superseded *Dickman*, controls below-market demand loans. Thus, at the July 2005 short-term AFR,[309] a parent could lend his or her child funds at 3.40% without incurring gift tax liability. If the parent has wonderful credit, he or she may be able to borrow funds for himself or herself at the prime lending rate, which, as of July 2005, was 6.00%. Thus, using a back-to-back loan, a parent who could borrow at the prime lending rate can essentially gift 2.60% per year tax-free. However, if the parent simply chose to guarantee the child's loan, under PLR 9113009, this would incur gift tax liability.

The IRS withdrew Private Letter Ruling 9113009 in 1993.[310] Thus, a parent should be able to make his or her credit standing available to his or her children without creating an income or gift tax event.[311] What is essentially a loan of creditworthiness, though it may enable a child to obtain a loan at a more favorable interest rate or a loan that would have otherwise been unavailable to him or her, should not factor into gift of opportunity analysis. Thus, one of the more troublesome aspects of *Carriage Square* has been superseded. Furthermore, in Letter Ruling 200534014,[312] the IRS did not appear to be troubled by a parent providing his

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[304] W. McKee, W. Nelson, R. Whitmire, Federal Taxation of Partnerships and Partners, ¶ 14.02 (3d ed. 1997) (stating that establishing a recognizable capital interest is less onerous under Code § 704(e)(1) and Reg. § 1.704-1(e)(1)(iv) than *Carriage Square* believes).

[305] *Carriage Square*, 69 TC at 131.

[306] Private Letter Ruling 9113009 (Dec. 21, 1990).

[307] *Id*.

[308] *See* Randall J. Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395, 409 (1991-1992).

[309] Rev. Rul. 2005-38.

[310] Private Letter Ruling 9409018.

[311] William P. Streng, *Estate Planning,* 800-2d T.M. VII.D.2.

[312] In addition to the fact that letter rulings are not precedent, this particular ruling dealt with the effect of a child conveying to the parent stock in the company that borrowed the money. Thus, the loan of credit-worthiness was not the true issue; rather, the parent was deemed to have held the stock in trust for the child. The author does not recommend intentionally creating the facts present in that ruling.

creditworthiness to his child, pointing to some cases that seem to have been decided under state law where parents loaned collateral to their children.

If one is concerned that a loan guarantee is a gift, one should structure the loan as a back-to-back loan. If that is impractical, consider paying the parent a guarantee fee, possibly by looking at what banks would charge to maintain a letter of credit in your area.

#### III.B.1.a.v Sending Business

In *Crowley v. Commissioner*,[313] a father owned a savings and loan. In addition to the traditional sources of income, the business generated income by means of appraisal fees, insurance fees, and title commissions. He created a partnership for his four children to handle these ancillary income streams for the S&L. One son was trained as an appraiser and insurance agent, handling the S&L's appraisal and insurance needs. The profits from this work were shared between the S&L and the partnership. The Tax Court held that the income was all taxable to the partnership and not to the father.[314] Having determined that no income was attributable to the father, the court held that there were no gift tax issues.

Assuredly, the son could not have obtained the amount of appraisal work he did without the aid of his father. This was a business opportunity that the son (and his siblings) had not earned on the basis of individual ability. Such nepotism, however, would be extraordinarily difficult to tax, and the IRS does not regularly pursue it.[315]

#### III.B.1.b Gifts Without Consideration, Including Restructuring Before Gifts or Other Transfers

For smaller companies, consider gifts either outright or in trust.

For corporations, the author frequently recommends that clients create nonvoting stock, doing a 19-for-1 nonvoting-for-voting stock dividend. The parent keeps the voting stock, which represents all of the voting rights, but only 5% of the distribution rights, the parent then transfers part or all of the nonvoting stock. This restructuring may also be a prelude to the more advanced techniques.

For an S corporation, a simple way to protect the principal from the donee's creditors (including the IRS through estate taxes) would be to use a qualified subchapter S trust (QSST).[316] A QSST has only one beneficiary, and all of its income must be distributed to that individual. A QSST's income is taxed to its beneficiary,[317] which means that the trust's fiduciary income tax returns simply report the trust's income on a statement, which the beneficiary then uses to prepare his or

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[313] 34 TC 333 (1960).
[314] *Id*. at 345-47.
[315] Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395, 410 (1991-1992).
[316] Code § 1361(d)(3).
[317] Code § 1361(d)(1)(B).

her own individual income tax returns.  In III.A.5, this article will more fully discuss the merits of QSSTs compared to other alternatives.

### III.B.1.c Valuation Issues

Because S corporations are not publicly traded, they are inherently difficult to value.

S corporations that engage in a Code § 162 trade or business are likely to be valued based on their projected net cash flow, with earlier years' results being used to determine whether projected earnings are reasonable.

See III.C. for a further discussion of valuation.

### III.B.1.d Self-Canceling Installment Note

A self-canceling installment note (SCIN) involves a sale of property to a buyer in exchange for an installment note that expires upon a certain cancellation event.  Typically, an older family member sells to a younger family member and the cancellation event is the seller's death.[318] When the obligation to make payments on the SCIN ceases upon the seller's death, there is nothing of value to be included in the seller's gross estate.  Thus, the unpaid purchase price and future appreciation in the property are excluded from the gross estate.[319]

Other advantages of a properly structured SCIN include: the avoidance of gift tax, possible increased liquidity for the seller, the ability to completely secure the property, the ability to use capital losses and possibly give the buyers an increased basis in the transferred property (compared with a gift), and the seller's ability to spread income out over time.

Disadvantages of using a SCIN include: no stepped-up basis at death, a finite term of payments, restrictions on alienability,[320] and potential income from discharge of indebtedness.

For the arrangement to be characterized as a SCIN, buyers and sellers have to maintain the form and substance of a SCIN.  Since SCINs are transactions between family members, strict scrutiny applies and the transactions are presumed to be gifts.  To rebut this presumption, taxpayers must show a genuine intent and expectation that payment be made.[321]  To avoid inclusion of the value of the property in the gross estate under §2036, the seller cannot retain an interest in the property.[322]  Also, the loan's terms must cancel the note at death; a bequest of a note is not a SCIN.[323]  Most importantly, the buyer has to pay a premium to the seller as compensation for the

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318 The cancellation event could also be the buyer's death, the first to die of the buyer and seller, or the death of a 3rd party.

319 However, any delinquent payments will be included in the gross estate.

320 Code §453(e) (accelerates income if the buyer sells the property within two years after an installment sale; if the property is marketable securities, income may be accelerated on sales during or after the two-year period).

321 *Estate of Costanza v. Comm'r*, 320 F.3d 595, 597 (6th Cir. 2003).

322 *See Cain v. Comm'r*, 37 T.C. 185, 187-188 (1961) (stock not included in gross estate where the seller "divested herself of all title to and control over the stock"), *acq.* 1962-2 C.B. 4.

323 *Estate of Buckwalter v. Comm'r*, 46 T.C. 805, 816-817 (1966).

chance that the seller may die before full payment is received.[324] If this risk premium is too low, the IRS might re-characterize the transaction as a bargain sale or part gift.[325] Lastly, although the SCIN term need not be the seller's life, the chosen term cannot exceed the seller's life expectancy; if it does, the SCIN might be re-characterized as a private annuity.[326]

A properly structured SCIN will pre-empt inclusion of the property in the seller's gross estate. Gift tax will also be averted if the SCIN's value - including the premium for self-cancellation - equals the value of the property transferred.[327] Also, Chapter 14 should not apply to a properly structured SCIN.[328]

For the buyer's income tax purposes, since a SCIN is an installment sale, the buyer can deduct whatever part of each payment represents deductible interest. The buyer's basis should be the property's full stated price.[329] A more complicated issue is whether buyers recognize gain based on cancellation of indebtedness under §61(a)(12) when the seller dies. Although it seems unfair to tax both the buyer and seller (as discussed below) on this gain, to date there has been no decision on this issue; however, the better view is that the buyer does not recognize income. In addressing the issue of the buyer's basis, courts and the IRS assumed that the buyer's basis would increase without a corresponding income recognition unless the seller or seller's estate recognizes income.

The seller of property for a SCIN pays income tax on the receipt of payments according to the installment method (unless the seller opts out of it).[330] The more complicated income tax issue for the seller is whether any gain is realized upon death. That issue was resolved in *Estate of Frane v. Comm'r*,[331] where the Eighth Circuit affirmed that cancellation upon death is treated as a transfer by the estate. Thus, under §691(a)(2), the estate must pay income tax on the amount of

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[324] *See Estate of Moss v. Comm'r*, 74 T.C. 1239, 1246-47 (1980) (full consideration for SCIN includes consideration for the cancellation provision), *acq.* 1981-2 C.B. 2. Although the IRS has not provided guidance on how to calculate this premium, it is usually calculated using the actuarial likelihood that the seller will die during the term of the trust using IRS life expectancy tables as indicated in Reg. §20.2031-7.
[325] *See Estate of Berkman v. Comm'r*, 38 T.C. Memo 1979-46 ("[T]he difference between the amount of each transfer and the fair market value of each promissory note given in exchange constitutes a taxable gift.").
[326] GCM 39503 (1986).
[327] *See Wilson v. Comm'r*, T.C. Memo. 1992-480 (1992). The premium for the cancellation feature is based on §7520 rules and IRS actuarial tables if the seller is not terminally ill. *See* note 338.
[328] *See* Priv. Ltr. Rul. 9436006 (1994) (neither §2701 nor §2702 applied to a note because debt is not a retained interest in a trust).
[329] GCM 39503 (1986). S*ee Frane v. Comm'r*, *supra* note 331 at 570-71. It has been suggested that regulations on contingent payments indicate that basis in a SCIN builds as payments come due because one cannot rely on the scheduled payments (Regs. §§1.483-4(b), 1.1275-4(c)(5)(iii)). However, under Reg. §1.1272-1(c)(2), an alternative payment schedule applies only if, based on all the facts and circumstances as of the issue date the alternative payment schedule is significantly more likely than not to occur. Because a properly structured SCIN has a term that is less than life expectancy, it would be practically impossible for an alternate payment schedule to be significantly more likely than not to occur.
[330] Code § 453. Interest on deferred tax may apply to transactions aggregating over $5 million. Code § 453A(c). The seller's gain is accelerated if the buyer is a related party and re-sells the property within two years. Code § 453(e).
[331] 998 F.2d 567 (8th Cir. 1993). *Accord* Rev. Rul. 86-72.

the installment obligation cancelled. The dissent in the Tax Court claimed that income should not be realized because there are no payments due after death that can be cancelled.[332] The dissent further suggested a way around the holding by phrasing the exchange as a contingent sale,[333] but that technique has not been tested in court.[334]

A SCIN is a good planning technique when the seller wants security, the buyer has means to make payments, the buyer wants an interest deduction, the buyer plans to hold the property for at least two years, and the seller's income tax bracket is relatively low and estate tax bracket is relatively high.

### III.B.1.e Private Annuity

Generally, a private annuity is a transfer of property for the transferee's unsecured promise to make specific, periodic payments to the transferor for the rest of the transferor's life.

Private annuities[335] offer many of the same advantages as SCINs. The property and its future appreciation are excluded from the gross estate, probate is avoided, gift tax is avoided, the transferor acquires increased liquidity, wealth is kept in the family, and capital losses can be utilized. Unlike SCINs, the transferor is paid for life, though the payments will be lower since no risk premium is included.

Private annuities also have disadvantages. Private annuities do not allow a step-up in basis at death. Unlike SCINs, the transferee cannot deduct interest payments, and private annuities also have a default risk since they are unsecured. Moreover, private annuities bear the risk that the transferor could outlive actuarial life expectancy, though it may be drafted to cap payments so that they do not extend for more than a short time after life expectancy.

Like a SCIN, certain rules have to be followed to have an exchange properly characterized as a private annuity. Because the exchange is between family members, strict scrutiny applies. In order to have the transfer characterized as a private annuity and not as a gift or part gift, the annuity's actuarial value should equal the fair market value of the property.[336] The annuity's

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

[333] THE PARTIES INTEND THIS TO BE A CONTINGENT PAYMENT SALE. The purchase price of the stock is variable, and will be somewhere between $0 and $141,050, depending upon how long seller lives. A condition precedent to each contingent payment is that seller be alive on the scheduled potential payment date. Consequently, if seller dies before any scheduled potential payment, the obligation to such payment does not come into existence.

[334] Another possible route to avoid *Frane* is to use an irrevocable grantor trust as the transferee and argue that death cannot be a cancellation event since no realization event occurs during life. This proposition is controversial.

[335] There are three types of private annuities. The normal private annuity, or private annuity for life, requires payment for the transferor's life (or transferors' joint lives). A private annuity for a stated term ends at the earlier of the transferor's death or the stated term (which cannot exceed the transferor's life expectancy). A private annuity with a maximum payout ends at the earlier of the transferor's death or at the maximum payout amount. *See* GCM 39503 (1986).

[336] *Estate of Cullison v. Comm'r*, T.C. Memo. 1998-216 (1998), *aff'd*, 221 F.3d 1347 (9th Cir. 2000) (unpublished decision). *See also 212 Corp. v. Comm'r*, 70 TC 788, 798 (1978) (reviewed decision).

actuarial value is based on the §7520 rate of interest and the transferor's life expectancy.[337] To determine life expectancy, the actuarial tables should be used unless the transferor is terminally ill or has a 50% chance of death within one year.[338] To avoid re-characterization of the private annuity as a transfer with a retained life interest, which would be included in the transferor's gross estate under §2036(a), the transferor cannot retain an interest in the property.[339] Hence, as long as the private annuity is properly structured, gift tax will be avoided on the exchange, and the property will be excluded from the transferor's gross estate.

For income tax purposes, if the annuity is unsecured,[340] then the transferor is treated as though the property were sold in a deferred recognition event for a term equal to the transferor's life expectancy.[341] Each annuity payment consists of a capital component (including return of basis and capital gain) and an annuity component. An exclusion ratio determines how much of each payment is excluded from income as recovery of capital. The exclusion ratio is the transferor's investment in the contract (adjusted basis in the property) divided by the expected return from the annuity (life expectancy multiplied by annuity payments).[342] The capital gain portion is the difference between the seller's basis in the property and the seller's expected return. The remaining amount is the annuity portion, which is taxed as ordinary income.[343] Regulations govern how an annuity contract can avoid the original issue discount rules that impute interest on uneven payments; careful attention must be paid if the annuity is not a flat payment for life.[344]

The transferee in a private annuity transaction is treated like the purchaser of an annuity, with the distinction that amounts paid in excess of the purchase price are non-deductible annuity payments, not deductible interest.[345] The transferee's basis varies for different circumstances.[346] For depreciation purposes during the transferor's life, the unadjusted basis is the present value of

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[337] *Id.* (holding that the transitional rules of Reg. § 25.7520-4 required the use of §7520 actuarial rules). Section 7520 regulations require the use of Code § 72 tables for annuities. Valuation is complicated if the annuity is to be paid from a trust or other limited fund and it might be exhausted before the annuitant attains age 110. Reg. §§ 25.7520-3(b)(2)(i), 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i).

[338] Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3). If the transferor survives for 18 months, the transferor is rebuttably presumed not to have been terminally ill.

[339] *See Greene v. U.S.*, 237 F.2d 848, 852-853 (7th Cir. 1956) (transferred securities included in gross estate where transferor retained the right to all income generated by the securities); *Estate of Holland v. Comm'r*, 47 BTA 807 (1942) (transferred stock included in life estate where transferors retained voting rights, transferees could not divest the stock, and the annuity payments were tied to stock value), *acq.* 1942-2 C.B. 9.

[340] If the annuity is fully secured, gain is recognized immediately (although the interest portion is deferred). GCM 39503 (1986); *Bell v. Comm'r*, 60 TC 472 (1973) (reviewed decision, *aff'd per curiam* 668 F.2d 448 (8th Cir. 1982)), *followed by 212 Corp. v. Comm'r*, 70 TC 788, 802 (1978) (reviewed decision).

[341] An installment sale has limitations on deferral, which limitations do not apply to annuities. See fn. 330.

[342] Code § 72(b); Rev. Rul. 69-74.

[343] Rev. Rul. 69-74.

[344] Reg. § 1.1275-1(j). Reg. § 1.1275-1(j)(2) generally excludes an annuity from OID treatment if the contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals) and does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

[345] Rev. Rul. 55-119.

[346] *Id.*

the annuity promise on the date of the agreement. For calculating tax on a disposition of the annuity property for a gain during the transferor's life, the transferee's unadjusted basis is the sum of annuity payments made plus the prospective payments owed at the date of disposition. If the sale is for a loss during the transferor's life, the transferee's unadjusted basis is the sum of the annuity payments made to the date of disposition. If the transferor outlives life expectancy—causing the transferee to pay more than the original present value of the annuity—the transferee's unadjusted basis increases accordingly. Upon the transferor's death, the transferee's unadjusted basis—for future disposition and depreciation purposes—becomes the sum of annuity payments made.

When a private annuity involves a trust, the transaction might be characterized as a gift to a trust instead of a sale. In a reviewed decision, the Tax Court held that it will look at several factors to make this determination, including: (1) the relationship between the creation of the trust and the transfer of property to the trust; (2) the relationship between the income generated by the transferred property and the amount of the annuity payments; (3) the degree of control over the transferred properties exercisable by the transferor; (4) the nature and extent of the transferor's continuing interest in the transferred properties; (5) the source of the annuity payment; and (6) the arm's-length nature of the annuity/sale arrangement.[347] Courts have upheld properly structured annuity sales to trusts.[348]

A properly structured private annuity should not implicate chapter 14, with the exception of private annuities transferred to a trust, which may involve Code § 2702 issues. Code § 2702 applies to gifts in trust where the transferor or an applicable family member retains a qualified interest.[349] Thus, Code § 2702 can be avoided where there is no gift (the fair market value of the property equals the actuarial value of the annuity) or where neither the transferor retains an interest in the trust after the transfer nor the transferee had an interest before the transfer.[350]

A private annuity is a good planning technique when the transferor has a shorter actual than actuarial life expectancy (yet will live beyond 18 months), the transferee has means to make payments, and the transferor wants a source of retirement income. The trade-off is that the basis of the purchased property will be relatively small. If one is using high basis property and would like to avoid a basis step–down, then one might consider placing the asset in an entity so that the asset's basis is preserved and only the basis in the entity itself is decreased.

[347] *Weigl v. Comm'r*, 84 T.C. 1192, 1225-26 (1985) (reviewed decision) (income tax case holding that a transfer to trust does not create an annuity where the transferor effectively controls the trust).

[348] *Estate of Fabric*, 83 T.C. 932 (1984); *Stern*, 747 F.2d 555 (9th Circ. 1984), rev'g 77 T.C. 614 (1981). However, the Tax Court has openly expressed hostility towards private annuity sales to trusts when not required by the appellate court to uphold them. *Melnik*, TC Memo 2006-25, responding to a taxpayer's attempt to rely on *Fabric* and *Stern*.

[349] Code § 2702(a), (b).

[350] See Priv. Ltr. Rul. 9253031 (1992) (Code § 2702 applied to an annuity where the taxpayer sold marketable securities to a preexisting trust in exchange for an unsecured private annuity).

### III.B.2 GRAT vs. Sale to Irrevocable Grantor Trust

### III.B.2.a General Description

For a company whose value is so high that its stock cannot be transferred merely by annual exclusion gifting, we often transfer S stock to irrevocable grantor trusts – trusts whose assets are, or will be later, excluded from the grantor's estate, but whose income is currently taxable to the grantor. Two types of transfers most commonly used are:

- Gift to Grantor Retained Annuity Trust (GRAT).[351] The grantor gives property (nonvoting stock) to the trust and receives an annuity for a fixed term of years in exchange for the gift. Usually, the annuity is expressed as a specific percentage of the initial value of the trust's assets.[352] This initial value is the value determined for federal tax purposes,[353] and adjustments to payments are required if the initial value is incorrectly determined.[354] The amount of the gift is the excess of the gifted property's value over the present value of the retained annuity, determined using Code § 7520 interest rates.[355] If the IRS increases the initial value, the annuity also increases, allowing the grantor to report a gift that is either zero or close to zero. GRATs have become more popular since a 2000 court decision on valuing retained annuities.[356]

- Sale to Irrevocable Grantor Trust. The grantor establishes an irrevocable trust that is excluded from the grantor's estate for estate tax purposes but treated as owned by the grantor for income tax purposes. The grantor makes a gift[357] equal to at least one-ninth of the value of the property the grantor is going to sell. The grantor sells property (nonvoting stock) to the trust and receives a promissory note.[358]

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[351] This is just a summary of certain features of a GRAT that help determine its financial success. The technical requirements are beyond this article's scope.
[352] Code § 2702(b)(2).
[353] Reg. § 25.2702-3(b)(1)(ii)(B).
[354] Reg. § 25.2702-3(b)(2).
[355] Code § 2702(a)(2)(B).
[356] Reg. § 25.2702-2(a)(5), giving credit for an annuity payable to an estate, amended in response to *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq.* IRS Notice 2003-72.
[357] The trust should not grant withdrawal rights (*Crummey* rights) to the beneficiaries. To do so may call into question whether the grantor owns all of the trust for all purposes. Code § 678(b) provides that a grantor's rights to income supersede a beneficiary's right to income for grantor trust purposes, and many tax advisors are concerned whether a grantor's rights to principal supersede a beneficiary's right to principal for grantor trust purposes. However, one might be able to obtain a letter ruling. See Letter Rulings 200603040 and 200606006.
[358] If somehow the IRS successfully recharacterizes the note described below as equity, then the Code § 2701 rules come into play. Code § 2701 assigns at least a 10% minimum value to the junior equity, which would be represented by the initial gift to the trust. For example, if the property to be sold is worth $9M, then the gift would be $1M, so that the junior equity would be worth 10% ($1M divided by the $10M total in the trust). This 1/9 funding also provides more substance to the trust. Finally, the trust should make all interest payments on time, and the 1/9 funding provides funding in case corporate cash flow to the shareholders is insufficient (due to a temporary downturn in business, for example).

The gift to a GRAT is safer than a sale to an irrevocable grantor trust, in that the grantor can ensure that the gift is close to zero, even if the IRS tries to adjust the property's value.[359] It also does not require an up-front gift, which can be a problem when the grantor tries to move more than $18M in stock.[360] Finally, GRATs have a 105-day grace period in the event of a late payment;[361]

A sale to an irrevocable grantor trust has several advantages over GRATs, if one is willing to take gift tax audit risks. Payments back to the grantor are lower and more flexible than in a GRAT.[362] Also, if the grantor dies during the term, the assets in the trust should not be brought back into the grantor's estate.[363] The grantor can apply GST exemption up front on a highly leveraged basis (in other words, using a small amount of GST exemption relative to the property transferred to the trust), whereas to make a GRAT exempt the grantor would apply GST exemption at the end of its term, based on the trust's asset's values at that time.[364]

S corporation stock can work very well for a GRAT or sale to an irrevocable grantor trust over a 5-10 year period. Frequently, S corporation stock is valued at 4-5 times earnings, so it is easy to pay for the sale. For example, suppose an S corporation generates $200,000 of net cash flow per-year and distributes $90,000 each year to the shareholders so that they can pay their taxes. The corporation is worth $1 million (5 times earnings). In the first year, the promissory note payments from the trust to the grantor are $90,000, which the grantor uses to pay taxes as usual. The $90,000 payments are $60,000 interest (using a 6% AFR) and $30,000 principal. If the corporation distributes all of its earnings to get estate tax matters taken care of, then it distributes $200,000 in the first year, which the trust could use to pay $60,000 interest and $140,000 principal. In the second year, the trust could use the $200,000 distribution to pay $51,600 interest and $148,400 principal. The note could easily be paid off in 5-10 years, even if the corporation's earnings do not increase.

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[359] A sale to an irrevocable grantor trust can include a price adjustment clause, but it is unsettled whether the IRS and courts would respect such a clause. *McCord*, 120 TC 358 (2003 reviewed decision), *rev'd* by 5th Circ. in 2006, http://www.ca5.uscourts.gov/opinions/pub/03/03-60700-CV0.wpd.pdf.

[360] If the stock to be transferred is worth $18M, then the gift would be $2M, which will be the gift tax applicable exclusion amount for the foreseeable future for a married couple that splits gifts. Any larger initial gift would trigger gift tax. However, when an irrevocable grantor trust starts building equity, the grantor can make additional sales to the trust, so long as the trust always has at least 10% equity.

[361] Reg. § 25.2702-3(b)(4).

[362] A sale uses the applicable federal rate (§ 1274), and a GRAT uses the § 7520 rate, which is 120% of the annual mid-term rate (rounded to the nearest 0.2%). A sale can have interest-only payments with a balloon payment upon maturity, with optional principal prepayments. A GRAT must have relatively even payments, with any year's payment no greater than 120% of the prior year's payment. Reg. § 25.2702-3(b)(1)(ii). Thus, a GRAT requires higher payments up-front, which leaves less in the trust to grow.

[363] If the promissory note is considered an interest in the trust and is worth less than the stock sold, the IRS could argue that the sale was not for adequate and full consideration and attempt to include the trust in the grantor's estate under Code § 2036(a)(1). If the grantor dies while receiving payments from a GRAT, then all or part of the GRAT will be included in the grantor's estate under Code 2036(a)(1). In FSA 200036012, the IRS took the position that all of a GRAT is included under Code § 2039, but the better view is that Code § 2039 should not apply.

[364] Code § 2642(f).

## III.B.2.b Tax Allocations Upon Change of Interest

Both S corporations and partnerships are flow-through entities. The grantor trust rules treat a grantor as owner of the trust for federal income tax purposes. As such, the income generated by the grantor's business, through the trust, is imputed back to the grantor. This income, naturally, generates tax liability.

In the case of either a GRAT or sale to an irrevocable grantor trust, generally the grantor is taxed on all of the trust's income, and payments back to the grantor have no income tax consequences.[365] A GRAT can be disastrous to the grantor if the company is very successful and the grantor has to pay income tax in excess of the grantor's payments, so GRATs should allow the grantor to be reimbursed for income taxes on part or all of the GRAT's income. This generally is not necessary for an irrevocable grantor trust, which is usually drafted so that the grantor trust taxation can be turned off. The trust agreement may authorize an independent trustee to reimburse the grantor's income tax so long as the decision to reimburse is made in the trustee's absolute discretion and cannot be legally compelled by the grantor.[366]

This issue is only magnified by the sale of the business. Now, instead of just the imputed income generated by the business, the grantor must pay taxes on any gain from the sale. Ideally, the grantor would like to "turn off" the grantor trust features, essentially making the trust the owner for income tax purposes. The following discussion details the tax allocations upon a change of interest in S corporations and partnerships.

### III.B.2.b.i S Corporations

#### Transfer of Less Than Shareholder's Entire Interest

A grantor who transfers only a portion of his or her interest in the S corporation has no choice of tax allocation method. He or she must use the daily proration method, as outlined in Code § 1377(a)(1).

#### Daily Proration

Should the grantor transfer less than his or her entire interest in the S corporation, the transferor and the transferee will be allocated a pro rata portion of S corporation items based upon the daily proration formula in Code § 1377(a)(1). This pro rata share is determined by a two-step process:[367]

(1) each corporate item is assigned, in equal portion, to each day of the taxable year.

(2) that portion is divided pro rata among the shares outstanding on that day.

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[365] For the lack of income tax on payments using appreciated property, see Rev. Rul. 85-13.
[366] Rev. Rul. 2004-64, Situation 2.
[367] Code § 1377(a)(1).

The grantor is treated as a shareholder for the day of disposition, including the day of his or her death.[368]

**Transfer of Shareholder's Entire Interest**

When a grantor transfers the entire S corporation interest, he or she uses the daily proration rule of Code § 1377(a)(1) unless an election is made to apply the special rule of Code § 1377(a)(2), described below.

A grantor who terminates his or her entire interest, in conjunction with the remaining shareholders, may elect to terminate the corporation's tax year.[369] To effect this interim closing of the corporation's books, each of the affected shareholders and the corporation must consent to the election. An affected shareholder is defined as:[370]

(1) the shareholder whose interest is terminated; and

(2) all shareholders to whom such shareholder has transferred shares during the taxable year (if such shareholder has transferred shares to the corporation, the affected shareholders include all persons who are shareholders during the taxable year).

Subsequently, the books will be treated as if the taxable year consisted of two taxable years, the first of which ends on the close of the day in which the grantor's entire interest in the S corporation is terminated.[371]

However, it is doubtful that the grantor will be able or willing to divest himself or herself of his or her entire interest in the S corporation to effect this result. More likely, the grantor has structured the transfer so that he or she retains the voting shares of the company, while transferring the vast majority of corporate stock to the trust as non-voting shares. A conventional structure might have the grantor retaining 5% of the company shares as its only voting stock, while transferring 95% of the remaining non-voting stock to the trust. By terminating grantor trust status in such a situation, the grantor will not be able cut off his or her entire interest in the S corporation. Instead, the grantor should consider turning off the grantor trust powers before the tax year of sale to avoid this concern.

**Death of a Shareholder**

The death of a shareholder (grantor) is treated as if the grantor had sold his or her entire interest in the S corporation. As such, the applicable tax allocation rules upon the death of the grantor are similar to those of a transfer of the entire interest, as enunciated above.

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[368] Reg. § 1.1377-1(a)(2)(ii).
[369] Code § 1377(a)(2).
[370] Code § 1377(a)(2)(B).
[371] Reg. § 1.1377-1(b)(1).

***General Rule (Default Rule) —* Daily Proration**

As above, the default rule of daily proration applies absent the corporation and shareholder's joint election for an interim closing of the books.

***Special Rule (By Agreement)* — Interim Closing of the Books**

The executor or administrator of the deceased grantor's estate may consent to the termination election on behalf of the deceased grantor and his estate.[372] As before, all affected shareholders must consent to the election.

### III.B.2.b.ii Partnerships

#### (a) Transfer of Less Than a Partner's Entire Interest

Generally, the partnership's taxable year does not close with respect to a partner who sells or exchanges less than his entire interest or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise).[373] However, the sale or exchange of at least 50% of a partnership terminates the partnership, closing the books.[374]

Because the partnership did not terminate, but a change occurred in the varying partners' interests during the taxable year, all partners' distributive shares are determined by taking into account their varying interests in the partnership during the year.[375] These distributive share rules apply not only to the partner whose interest is transferred, but also to any other partner whose interest is increased as a consequence.[376]

Likewise, the special rule for determining a partner's share of the partnership's allocable cash-basis items also applies.[377] *See* Modified Accrual Method below.

#### (b) Transfer of Partner's Entire Interest

The taxable year of a partnership closes "with respect to a partner whose entire interest terminates (whether by reason of death, liquidation or otherwise.)"[378]

If the transfer terminates the partner's entire interest in the partnership, the books for both the transferor partner and the transferee partner must be treated as two separate taxable years. The first taxable year ends on the date of transfer, while the second year begins the following day.[379] The terminating partner, upon the day of partnership termination, shall no longer be treated as a

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[372] Reg. § 1.1377-1(b)(5)(ii).
[373] Code § 706(c)(2)(B).
[374] Reg. § 1.708-1(b)(3).
[375] Code § 706(d)(1); Reg. § 1.706-1(c)(4).
[376] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* ¶11.01
[377] Code § 706(d)(2).
[378] Code § 706(c)(2)(A).
[379] Reg. § 1.706-1(c)(2)(ii).

partner. As such, partnerships, unlike S corporations, default to the ideal position, an interim closing of the books without the necessity of complete termination. The partners, if they so choose, however, may avoid this interim closing of the books by agreeing to the special pro rata rule outlined below.

The partnership's taxable year, with respect to the remaining partners, shall not close, unless the partnership is otherwise terminated, such as under Code § 708(b), which provides that the sale or exchange of a partnership interest which, by itself or aggregated with sales or exchanges in the preceding 12 months, transfers an interest of 50% or more of the total partnership capital or profits will effectively terminate the partnership.[380]

To avoid the interim closing of the books, the partners may agree to estimate their distributive shares of § 702(a) items according to each individual partner's pro rata portion of those partnership items, based on a formula.[381] This formula may be based on: (1) the number of days the individual (or entity) is a partner and the partner's percentage interest in the partnership; or (2) any other reasonable method.[382] The partners must agree, either by contemporaneous agreement or by provision detailed in the partnership or operating agreement, to allocate their individual portions based on the chosen formula.

Despite, however, an agreement by the partners to allocate partnership items on a pro rata basis, it may still be necessary to utilize the interim closing of the books method to comply with other sections of the Internal Revenue Code. For instance:

(1) Because determination of the adjusted basis and fair market value is necessary to comply with Code § 755 allocations, a Code § 754 election by the partnership to adjust the basis of partnership assets for the benefit of a transferee partner[383] or in the case of a liquidation[384] will require an interim closing of the books; and

(2) To apply Code § 732(d), special partnership basis, to a transferee; and

(3) If under Code § 708(b), the partnership is terminated due to the sale of 50% or more of the partnership's capital and profits within a 12-month period.

Furthermore, if there is a change in any partner's interest in the partnership, each partner's distributive share of any allocable cash basis items shall be determined:[385]

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[380] Reg. § 1.708-1(b)(3).
[381] Reg. § 1.706-1(c)(2)(ii).
[382] *Id.*
[383] Code § 743(b).
[384] Code § 734(b).
[385] Code § 706(d).

(1) by assigning the appropriate portion of such items to each day in the period to which it is attributable; and

(2) by allocating the portion assigned to any such day among the partners in proportion to their partnership interests at the close of such day.

This is, in effect, a daily interim closing of the books. The modified accrual method must be applied with respect to the following allocable cash basis items, as paid or received by the partnership:[386]

(1) interest; or

(2) taxes; or

(3) payments for services or for the use of property, for example, rent; or

(4) any other item specified by regulation.

**(c) Death of a Partner — Treated Like a Sale of a Partner's Entire Interest**

The death of a partner is treated as if the partner had sold his or her entire interest in the partnership. As such, the applicable tax allocation rules upon the death of the partner are similar to those of a transfer of the entire interest, as enunciated above. This was not always the case.

Previously, the deceased partner's estate received all of the deceased partner's income for the partnership taxable year in which the death occurred. Under Code § 706(c)(2)(A), this is no longer true, and the taxable year closes with respect to a partner whose entire interest in the partnership has terminated.[387] Thus, the death of a partner is treated as a transfer of the deceased partner's entire partnership interest to his or her estate.[388]

As above, subject to Reg. § 1.706-1(c)(2)(ii), the partners may opt away from the interim closing of the books method and adopt a pro rata allocation method based upon a formula. As before, the partners must agree to adopt this method, subject to provisions in the partnership or operating agreement. Although this seems a reasonable interpretation of Code § 706 and the applicable Treasury Regulations, the Treasury Regulations have not yet been amended to reflect the changes made to Code § 706(c)(2)(A). Thus, it is possible that an election to use the pro rata method, as outlined above, upon the death of a partner may be disallowed.

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[386] Code § 706(d)(2)(B)(i-iv).
[387] Code § 706(c)(2)(A).
[388] The Treasury Regulations do not currently reflect this recent change in the Internal Revenue Code.

### (d) Code § 754 Elections

Generally, Code § 754 election adjusts the basis of a partnership's assets when an event occurs that changes the basis of any interest in that partnership.[389] The idea is that the value of the partnership's assets was reflected in the change of basis in the partnership interest; therefore, some element of the basis in the partnership's assets should reflect the change of basis in the partnership interest.

The American Jobs Creation Act added three new mandatory basis adjustment rules that can cause serious problems if a partnership does not have a Code § 754 election in effect.[390] The first rule applies to limit the transfer of built-in losses on property contributed to a partnership after October 22, 2004.[391] The second rule applies when a partnership distributes cash or property after October 22, 2004 that results in the transferee either recognizing a loss or receiving a stepped-up basis in the property greater than $250,000.[392] The third rule applies when a partner dies or transfers an interest in a partnership after October 22, 2004 and the partnership has built-in losses greater than $250,000.[393] Limited exceptions apply to certain electing investment partnerships and securitization partnerships.[394]

For more details on Code § 754 elections, see the text accompanying footnotes 203–207.

### III.B.2.b.iii Income Tax Reimbursement Clause

If the grantor cannot achieve accounting cut off or cannot terminate his grantor trust powers to escape the dire tax consequences of an exploding GRAT or irrevocable grantor trust, an income tax reimbursement clause may be a valuable tool to remedy this problem. In its simplest form, the income tax reimbursement clause authorizes the trustee with a discretionary power to reimburse the grantor for income taxes incurred in excess of the annuity or note payments.<

An income tax reimbursement provision will cause inclusion of the trust assets in the grantor's gross estate if it constitutes a transfer with a retained life estate interest in the trust assets.[395] Any retention of a right to apply the trust property towards the discharge of a legal obligation merits inclusion under Code § 2036.[396] GRATs should include income tax reimbursement clauses, which potentially makes them includible in the grantor's gross estate under Code § 2036. Often, this is not a concern, because GRATs are often fully included in the grantor's estate if the grantor

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389 Code §§ 734, 743.
390 Reg. § 1.701-2(d), Ex. 8 also considers failure to make a Section 754 election to be an abuse.
391 Code § 704(c)(1)(C).
392 Code § 734(b).
393 Code § 743(a) and (b), as amended.
394 Code §§ 734(e), 743(e), (f).
395 Code § 2036(a)(1-2). The right to be reimbursed for tax liability over the annuity or note amount, presumably, could be deemed as "the possession or enjoyment of, or the right to the income from, the property" or "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."
396 Reg. § 20.2036-1(b)(2). The grantor is legally obligated to pay his or her income taxes, thus any right to reimbursement for this legal obligation may be included in the grantor's gross estate.

dies during the annuity term. However, in the case of a sale to the irrevocable grantor trust, only the note is included under Code § 2036; therefore, avoiding estate inclusion due to tax reimbursement clauses is particularly important.

Rev. Rul. 2004-64 provides specific guidance on this point.[397] When trust language provides the trustee discretionary power to reimburse the grantor for excess income taxes, the reimbursement clause will not cause estate inclusion.[398]

However, if the grantor has an enforceable right to reimbursement, the reimbursement right will cause estate inclusion.[399] Furthermore, applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust in the grantor's gross estate. This raises the issue of whether or not the availability of self-settled trusts (spendthrift trusts in which the grantor is the beneficiary) to the grantor's creditors subjects the trust to inclusion under Code § 2036.

The general rule is that the grantor's creditors can require distribution of self-settled trust assets to the extent which the trustee had discretion to make distributions.[400] As such, self-settled trusts are generally includible under Code § 2038 due to the grantor's retained power to terminate the trust by consigning his or her creditors to the trust assets.[401] However, some states permit self-settled trusts to be protected from the grantor's creditors.[402]

The Bankruptcy Abuse and Prevention Act of 2005, however, has raised apprehensions about the efficacy of domestic asset protections trusts ("DAPTs"), to prevent creditors from gaining access to trust assets. Of particular concern is the 10-year lookback provision, which states that transfers to self-settled trusts by the debtor in which the debtor is a beneficiary of the trust within ten years before filing for bankruptcy.[403] However, the language of the Act included a scienter requirement indicating that the grantor, by means of the transfer, intended to hinder, delay, or defraud any party to which the debtor was indebted.[404] In other words, the burden would lay on the bankruptcy trustee to show that the filer had the necessary fraudulent intent. Thus, DAPTs formed for legitimate purposes, such as transfer tax minimization, will retain their usefulness as estate planning tools.[405] However, at least one commentator has noted that it would be difficult for a filer to argue that the transfer of assets to a DAPT was not intended to delay or hinder a

[397] *See also* William S. Forsberg & James C. Worthington, *Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them*, PROB. & PROP., Vol. 19 No. 3, May/June 2005.
[398] Rev. Rul. 2004-64, Situation 3.
[399] Rev. Rul. 2004-64, Situation 2.
[400] Rev. Rul. 76-103; Forsberg & Worthington, *supra* note 27 at 7 (citing 2A Austin W. Scott, Trusts § 156).
[401] Rev. Rul. 76-103; Code § 2038(a)(1).
[402] Alaska, Delaware, Missouri, and Rhode Island have endorsed self-settled trust creation by statute, while other states, such as Indiana, Maryland, and New York have case law supporting self-settled trusts. Forsberg & Worthington, *supra* note 27 at 7.
[403] 11 U.S.C. § 548(e)(1)(A-C).
[404] *Id*. at § 548(e)(1)(D).
[405] David G. Shaftel & David H. Bundy, *D.A.P.T. 2005: The Report of My Death Was an Exaggeration*, Steve Leimberg's Asset Protection Planning Newsletter #68 (May 23, 2005), available at http://www.leimbergservices.com.

creditor.[406] As such, some uncertainty remains as to whether a grantor will be required to wait the full ten years before the hole in the DAPT is plugged so that creditors will be unable to reach the trust assets. With this lingering uncertainty about the new bankruptcy bill, it will be difficult for practitioners to definitively say that these self-settled trusts are free from creditor claims, and subsequently, not includible in the grantor's gross estate.

### III.B.3 Estate Tax Issues

Estate tax issues include general valuation problems, deferral under Code § 6166, and marital deduction considerations and related planning.

#### III.B.3.a General Valuation Problems

[reserved for discussion of projected operating cash flow and its reliability given the subject stockholder's ability to cause distributions to occur.]

#### III.B.3.b Estate Tax Deferral or Financing

##### III.B.3.b.i Overview of Discretionary Extensions Under Section 6161

Use IRS Form 4768 to request the extensions of time to pay described below.

(a) <u>Tax Shown on Return</u>

Code § 6161(a)(2) provides for tax reported by the executor:

> The Secretary may, for reasonable cause, extend the time for payment of—
>
> > (A) any part of the amount determined by the executor as the tax imposed by chapter 11, or
> >
> > (B) any part of any installment under section 6166 (including any part of a deficiency prorated to any installment under such section),
>
> for a reasonable period not in excess of 10 years from the date prescribed by section 6151(a) for payment of the tax (or, in the case of an amount referred to in subparagraph (B), if later, not beyond the date which is 12 months after the due date for the last installment).

[406] Jay Adkisson & Chris Reiser, *Bankruptcy Act Impact on Life Insurance and Domestic Asset Protection Trusts*, Steve Leimberg's Asset Protection Planning Newsletter #66 (May 3, 2005), available at http://www.leimbergservices.com.

Reg § 20.6161-1(a)(1) provides a "reasonable cause" extension for tax shown on the return:

> [An] extension of time beyond the due date to pay any part of the tax shown on the estate tax return may be granted for a reasonable period of time, not to exceed 12 months by the district director or the director of a service center, at the request of the executor, if an examination of all the facts and circumstances discloses that such request is based upon reasonable cause.

Below are examples of "reasonable cause" under Reg § 20.6161-1(a):

> Example (1). An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence.
>
> Example (2). An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate.
>
> Example (3). An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due.
>
> Example (4). An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.

Reg § 20.6161-1(a)(2)(i) provides an "undue hardship" extension for tax shown on the return:

> [I]n any case where the district director finds that payment on the due date of any part of the tax shown on the return, or payment of any part of an installment under section 6166 (including any part of a deficiency prorated to an installment the date for payment of which had not arrived) on the date fixed for payment thereof, would impose undue hardship upon the estate, he may extend the time for payment for a period or periods not to exceed one year for any one period and for all periods not to exceed 10 years from the date prescribed in section 6151(a) for payment of the tax.

Reg § 20.6161-1(a)(2)(ii) defines "undue hardship" relating to tax shown on the return:

> The extension provided [for] undue hardship … will not be granted upon a general statement of hardship or merely upon a showing of reasonable cause. The term "undue hardship" means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate. The following examples illustrate cases in which an extension of time will be granted based on undue hardship pursuant to this paragraph:
>
> > Example (1). A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.
> >
> > Example (2). The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.

Reg § 20.6161-1(b) explains the procedural issues when filing the appropriate form, highlights of which include:

> …. An application for an extension of time for payment of the tax, or of an installment under section 6166 … will not be considered unless the extension is applied for on or before the date fixed for payment of the tax or installment…. The granting of the extension of time for paying the tax is discretionary with the appropriate internal revenue officer and his authority will be exercised under such conditions as he may deem advisable. However, if a request for an extension of time for payment of estate tax under this section is denied by a district director or a director of a service center, a written appeal may be made … to the regional commissioner with authority over such district director or service center director within 10 days after the denial is mailed to the executor…. When received, the appeal will be examined, and if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified.

(b) <u>Deficiencies Resulting from IRS Audit</u>

Code § 6161(b)(2) provides for tax assessed by the IRS:

> Under regulations prescribed by the Secretary, the Secretary may, for reasonable cause, extend the time for the payment of any deficiency of a tax imposed by chapter 11 for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency.

Reg § 20.6161-2 is much more stringent for tax arising from a deficiency. An extension may be granted for "undue hardship" only. Furthermore, Reg § 20.6161-2(b) provides for a more stringent definition of "undue hardship":

> The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the estate. It must appear that a substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the estate from making payment of the deficiency at the date prescribed therefor. If a market exists, a sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. No extension will be granted if the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade the tax.

Reg § 20.6161-2(c) procedural requirements include:

> … When received, [the application for extension] will be examined, and, if possible, within thirty days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. The district director will not consider an application for such an extension unless it is applied for on or before the date prescribed for payment of the deficiency, as shown by the notice and demand from the district director…. The granting of the extension of time for paying the deficiency is discretionary with the district director.

IRM 5.5.5.5(1) requires a denial of an extension to notify the taxpayer:

> "A written appeal may be made to the Examination Area Director within 10 days from the time the denial is mailed." Show the CSCO address for the Appeals office address unless the liability was created by an examination.

Whether the extension is for tax shown on the return or for a deficiency, the IRS grants the extension only one year at a time.

Internal Revenue Manual ("IRM") 5.5.5.8 provides:

> (6) In addition to establishing reasonable cause, these cases require an analysis of the progress of efforts being made to borrow or liquidate assets or to otherwise pay the amounts to be extended. Some suggested additional information required in this analysis include:
>
> > a. Balance sheets listing all assets, disbursements, liabilities and earnings for the estate and relating to the prior extension period. Real estate should be listed with the value and location identified (city, county, and state).

b. An accounting of the actions taken during the past extension period to resolve the indebtedness. Examples include marketing property, resolving suits, or seeking loans.

c. Information on the executor's proposal to make partial payments during the extension being requested.

(7) Contact the executor within 30 days of the date of the extension request to

a. advise them that you are reviewing the request,

b. gather information to support your determination, and

c. estimate the date of completion.

….

(10) Most requests for an extension to pay are necessary because the estate representative or executor needs additional time to liquidate what are often very valuable properties that cannot be marketed within the 9 month period following the death of the taxpayer. Provided the executors verify that all steps necessary to sell property to pay the tax are being taken in an expeditious manner, and that all liquid assets not needed for the payment of anticipated administrative expenses are paid over, extensions to pay should generally be granted….

(12) When evaluating extension to pay requests bear in mind that denial of the request may have adverse financial ramifications to the estate far in excess of the failure to pay penalty which will begin to accrue if the request is denied….

(c) Additional Extensions; Miscellaneous Rules

For additional extensions, IRM 5.5.5.3 instructs, "Evaluate progress of efforts made by the executor to borrow, liquidate assets, or otherwise pay the amount to be extended."

Code § 6161(d) provides additional rules:

(1) Period of limitation. For extension of the period of limitation in case of an extension under subsection (a)(2) or subsection (b)(2) , see section 6503(d).

(2) Security. For authority of the Secretary to require security in case of an extension under subsection (a)(2) or subsection (b) , see section 6165.

(3) Postponement of certain acts. For time for performing certain acts postponed by reason of war, see section 7508, and by reason of Presidentially declared disaster or terroristic or military action, see section 7508A.

Code § 6503(d) suspends the statute of limitations while an extension is in effect.

Code § 6165 provides:

> In the event the Secretary grants any extension of time within which to pay any tax or any deficiency therein, the Secretary may require the taxpayer to furnish a bond in such amount (not exceeding double the amount with respect to which the extension is granted) conditioned upon the payment of the amount extended in accordance with the terms of such extension.

However, bonds generally are not practical.

### III.B.3.b.ii Code § 6166 Deferral

Code § 6166 allows the payment of estate tax to be deferred for certain closely-held businesses. Generally, interest is paid on the 1st through 4th anniversary of the estate tax return due date, and interest and one-tenth of the principal are paid on the 5th through 14th anniversary of the estate tax return due date.

### III.B.3.b.iii *Graegin* Loans: Overview

In Rev. Rul. 84-75, the IRS ruled:

- If a loan is obtained to avoid a forced sale of assets, the loan is reasonably and necessarily incurred in administering the estate. Therefore, interest incurred on the loan is deductible as an expense of administration under Code § 2053(a)(2).

- However, in situations where the estate's obligation to make installment payments may be accelerated, the amount of future interest that will be paid is indefinite because a premature repayment will stop the accrual of interest. Therefore, for purposes of Code § 2053, a deduction is not allowable for the estimated amount of interest that will accrue upon funds borrowed by an executor on behalf of an estate to pay the federal estate tax if repayment of the loan could be accelerated. The interest is deductible as an administrative expense only to the extent it has accrued.

In *Estate of Graegin v. Commissioner*, TC Memo 1988-477, a related corporation loaned money to the estate to pay estate tax, because the estate did not have sufficient liquidity to pay estate tax. It was a balloon note, payable in 15 years, which was the decedent's widow's life expectancy. The loan was not prepayable, so the Tax Court allowed the estate to deduct the entire 15-years' interest, which was payable at the then-15% prime rate.

In Litigation Guideline Memorandum TL-65 (1989), the IRS stated that it will challenge deductions for balloon payments:

- when there is doubt as to the bona fide nature of the indebtedness,

- where the liability for interest is not certain or for a reasonably estimable amount, or

- when a convincing argument can be made that there is no necessity for the borrowing.

Letter Rulings 199903038 and 199952039 allowed deductions for interest, but each qualified the deduction:

> Accordingly, in view of the terms of the loan, we conclude that a deduction may be claimed on the Form 706 for the entire amount of the post-death interest expense to be incurred by the estate, provided the expense is necessarily incurred in the administration of the estate within the meaning of section 20.2053-3(a) and is allowable under local law. Whether the interest expense will be necessarily incurred in the administration of the estate is a factual determination and we are specifically not ruling on this issue.

On the other hand, Technical Advice Memorandum 200513028 disallowed deductions for interest on a loan from a family limited partnership that held marketable securities (57.6%), real property (24.7%) and personal notes on the partnership's prior sale of real estate (24.7%).

**III.B.3.b.iv Liens**

IRM 5.1.19.1 points out:

> [Code §] 6502 provides that the length of period for collection after assessment of a tax liability is ten years. The collection statute expiration ends the government's right to pursue collection of a liability.

IRM 5.5.7.2 explains:

> (1) The key to successfully collecting delinquent estate tax is a thorough understanding of the estate tax lien under [Code §] 6324(a)…. [T]he estate tax lien arises immediately upon the death of any United States citizen or resident, and attaches to all assets that comprise the gross estate of the decedent, i.e., those assets which must be reported on Form 706 and, the value of which on date of death, are the basis for the estate tax liability.
>
> (2) The [Code §] 6324(a) lien has an absolute life of 10 years beginning on the date of death. Although the lien may be foreclosed if accomplished within the 10-year period, no event can extend the lien. Notice of the lien cannot be recorded nor is any recording necessary in order for it to become choate. The lien has priority over all subsequent interests in the assets of the gross estate but for the exceptions detailed at IRM 5.5.8.2.

IRM 5.5.7.4(1) explains how strong the Code § 6324(a) lien is:

> The estate tax lien comes into existence upon death. No recording is necessary in order to perfect the estate tax lien, nor is recording possible since no form exists for this purpose. (See Revenue Ruling 69-23). Locally authored notices purporting to be notices of the estate tax lien should not be recorded.

When estate tax might be due, executors of probate estates cannot grant clear title when selling assets. IRM 5.5.7.5.2 provides some information that is shocking when one first learns of it:

(1) But for the exceptions detailed at IRM 5.5.8.2, probate assets distributed without having been discharged from the estate tax lien, are subject to administrative levy or seizure and/or litigation to foreclose the lien.

Example: An estate owes unpaid tax in the amount of $100,000. 5 years remain on the [Code §] 6324(a) lien. An asset check reveals that the decedent's residence, which was titled in her name at time of death and valued at $150,000, was sold 3 years after death. The purchaser obtained a mortgage for $140,000 to finance the purchase. The sale was not done at the direction of a court and the executor had not received a discharge of liability under [Code §] 2204 prior to the sale. The estate tax lien has priority over the interests of both the purchaser and the mortgagee and can be administratively seized from the purchaser and sold.

Note: This example is common. Unless the seller of the property is the estate, and sometimes even then, title insurers frequently do not consider the possibility that an unrecorded estate tax lien may be attaching to the property for which the purchaser is paying them to insure title. When title to property is conveyed by the personal representative to an heir who then sells the property, the chance that the title insurer will not recognize the presence of the lien is greatly increased. In practice, a title insurer can only indemnify itself against an unrecorded estate tax lien by performing a 10-year deed search, looking to see if an estate conveyed the property during that period. If so, the title insurer should contact the representative of the estate that conveyed the property and obtain verification that any estate tax that may have been due has been paid, or that the personal representative transferred title to an heir only after first receiving a discharge of liability. As an alternative, some title insurers have a clause in their title insurance policies excluding coverage for unrecorded liens. Because of the cost involved in performing a 10-year deed search, title insurers normally perform searches only as far back in the chain of title as the last occasion when a title company insured title. If seizure of property from a purchaser is proposed, it is usually necessary for the purchaser to file a claim with the title insurer before the title company will pay over the government's lien interest. Direct contact by the Revenue Officer with the title company informing them of the existence of the estate tax lien and demanding payment, is rarely effective.

(2) Under [Code §] 6324(a)(3), if a personal representative has received a discharge from liability under [Code §] 2204 and then distributes property to an heir who subsequently sells the property to a valid purchaser, the property is divested of the [Code §] 6324(a) lien. However a "like lien" then attaches to the consideration received from the purchaser and the consideration is subject to enforcement action. This lien does not attach to any other property of the heir unless it can be shown that the property was acquired with the consideration.

Note: This provision for sale of property free of the [Code §] 6324(a) lien after the personal representative has been discharged from liability, does not apply if the personal representative, in that capacity, is the seller of the property.

Nonprobate assets are not subject to the same hazards. However, those who receive nonprobate assets, including the trustees of revocable trusts, are in peril. IRM 5.5.7.6.1 explains:

> (1) [Code §] 6324(a)(2) provides that when estate taxes are not paid when due, any recipient of non-probate assets becomes personally liable for the taxes to the extent of the value at the time of the decedent's death, of such property. If the recipient transfers any of the non-probate property to a purchaser or holder of a security interest, the property is divested of the [Code §] 6324(a) estate tax lien. However, a like lien, in other words a lien with all of the attributes of the [Code §] 6324(a) estate tax lien, then attaches to all property owned by the recipient except that which is subsequently transferred to a purchaser or holder of a security interest.
>
> (2) The like lien remains in effect until the estate taxes are paid or until the [Code §] 6324(a) estate tax lien expires.
>
> (3) As with the [Code §] 6324(a) estate tax lien, no recording is necessary in order to perfect the like lien, nor is recording possible since no form exists for this purpose. Locally authored notices purporting to be notices of the like lien should not be recorded.
>
> (4) It is not necessary to obtain a separate assessment against the recipient of the non-probate property in order to enforce the like lien.

For Code § 6166 elections, IRM 5.5.5.8 requires:

> (11) …. [T]he granting of an extension to pay an annual installment should always be conditioned upon the estate posting a bond under [Code §] 6165, or agreeing to the recording of a special estate tax lien (Form 668-J) under [Code §] 6324A, if a bond was not previously posted or a lien recorded. Before securing a bond or a lien, verify that Estate & Gift has made a final determination regarding the acceptability of the [Code §] 6166 election. (See IRM 5.5.8.4 for procedures)…..

The taxpayer can choose the security to be offered. IRM 5.5.8.5(4) comments:

> **Note**: Even though the property offered by the estate as security for the lien may be, if necessary, difficult to enforce against (such as stock in a closely held corporation), distrainability is not a factor in determining the adequacy of the value of the property offered. As long as the requirements under [Code §] 6166A(b) as to the value of the property are met, and there are no indications that the property will not survive the deferral period, whatever property the estate offers as security for the lien is acceptable.

Let's take a moment to compare liens resulting from Code § 6166 to Code § 6324(a) liens:

- The Code § 6324(a) lien is very strong. However, as an unrecorded lien, it is not likely to impair assets as a practical business matter until creditors request a representation that no liens are on property included in the decedent's gross estate. When switching from a lender who made a loan before death to refinance with a new lender after death, one should have the first lender assign its loan to the new lender, hoping that the underlying security interest's priority over the Code § 6324(a) will survive the change.

- Code § 6324A liens on Code § 6166 property cause the Code § 6324(a) lien to be released from that particular property.[407] Procedurally, this occurs when the property is listed on a recorded IRS Form 668-J.[408] Recording the § 6324A lien also discharges the executor or other fiduciary.[409] Code § 6324A liens are not valid against a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice of the lien is filed.[410] IRM 5.5.8.5.1(2) points out:

> **Note**: If property that was part of the gross estate is offered as security, it is important to verify any encumbrances that may have arisen since the date of death. Although the general estate tax lien under IRC § 6324(a) may have priority over these encumbrances, after the property is listed on the Form 668-J, the property is attached by the IRC § 6324A lien, but released from the effects of the IRC § 6324(a) lien. Therefore, any encumbrances that may have been junior to the IRC § 6324(a) lien, would now have priority over the IRC § 6324A lien.

IRM 5.5.8.1.1 offers the following comparison of federal estate tax liens:

| Code Section | How Created | Attributes | Form Title |
|---|---|---|---|
| 6321 | Assessment, balance owed, notice and demand | Attaches to all right, title and interest of the decedent in any probate property undistributed at time lien arises - 10 year life can be extended. | Form 668 Notice of Federal Tax Lien |
| 6324(a) | At death | Attaches to estate assets listed on the F706 the value of which are the basis of the tax liability; recording not required to be choate; absolute life of ten years; follows the probate assets if transferred or liquidated, a lien of comparable value | No form |

[407] Code § 6324A(d)(4); IRM 5.5.8.5(4)(d).
[408] IRM 5.5.8.1(4)(b).
[409] Reg. § 20.2204-3; IRM 5.5.8.5(4)(e).
[410] Reg. § 20.6324A-1(c)(2). Once filed, the notice of lien remains effective without being refiled. *Id.*

| Code Section | How Created | Attributes | Form Title |
|---|---|---|---|
| | | arises upon any property of the party who received proceeds from sale or encumbrance of non-probate property. | |
| 6324A | Upon election by the estate and signed agreement by all parties with an interest in the property on the lien | Attaches the specific property shown on the lien; must be recorded. Recorded notice lists all parties of interest and the specific property that is subject to the lien. | Form 668J, Notice of estate Tax Lien under Internal Revenue Laws |
| 6324B | Upon election by the estate of the special use 2032A or qualified family owned business interest 2057 | Pertains to farm or business real estate only (2032A) or family owned business property. Notice must be recorded. Recorded notice lists all qualified heirs and has a complete legal description of the subject real property. | F668H, Notice of Federal Estate Tax Lien under Internal Revenue Laws |

### III.B.3.c Marital Deduction Considerations and Related Planning

#### III.B.3.c.i Qualifying for the Marital Deduction

In most cases, a marital trust should authorize the surviving spouse to direct the trustee to make the property productive.

Buy-sell agreements can ruin the marital deduction if they have the effect of transferring property away from the surviving spouse for less than adequate and full consideration.

#### III.B.3.c.ii Related Planning

Marital trusts are included in the surviving spouse's gross estate at the surviving spouse's death. A QTIP trust is included under Code § 2044; however, their assets are not aggregated with the surviving spouse's other assets.[411] For example, suppose a QTIP trust owned 30% of the voting stock of a corporation, and the surviving spouse owned 40% of the voting stock outright. Even

[411] See part II.B.2, footnote 71.

though 70% of the voting stock is included in the surviving spouse's gross estate, each block is valued separately as stock that lacks control.

Contrast this with a general power of appointment trust, which is included in the surviving spouse's gross estate under Code § 2041. Assets included under Code § 2041 are aggregated with other assets. In the example above, if the marital trust were a general power of appointment trust instead of a QTIP trust, the surviving spouse's gross estate would be deemed to own a controlling 70% voting block.

If the spouses have a high degree of trust in each other, the author tends to include in a QTIP trust a 5% withdrawal right exercisable only during a limited duration each year (two weeks, for example). The enables the surviving spouse to withdraw stock and make gifts without having to justify a principal encroachment. If the surviving spouse dies during the period in which the surviving spouse can withdraw 5%, the withdrawal right is considered a general power of appointment, with all the negative consequences described above, but only with respect to 5% of the trust. If the withdrawal right lapses, the lapse is not treated as a release of a general power of appointment, and the entire trust retains its QTIP segregation for estate valuation purposes.

Another strategy a surviving spouse can use is to sell a voting interest to a credit shelter trust. If the surviving spouse is a beneficiary of the credit shelter trust, consider having the trust overpay for the voting stock, documenting the transaction as part sale, part distribution. This should preclude the IRS from successfully arguing that the surviving spouse made a gift to the trust (if the IRS were to successfully revalue the stock as worth more than what the surviving spouse thought it was worth); such a gift could create future Code § 2036 inclusion issues.

An irrevocable inter vivos QTIP trust can also come in handy when one spouse wants to leave the business directly to children instead of to the other spouse. Suppose Husband has $1 million in cash or marketable securities, and Wife owns the closely-held business.. Husband transfers that to an irrevocable inter vivos QTIP trust for wife where Wife is the trustee and has a special power of appointment. After recapitalizing the corporation into voting and nonvoting stock, Wife sells voting stock with an estimated fair market value for $600,000 to the trust in exchange for $1 million. The sale should not be not subject to income tax.[412] The $400,000 excess of value over purchase price is a distribution from the trust to Wife. If the IRS audits the transfer, it can increase the voting stock's value to as much as $1 million before considering any adverse estate tax consequences under Code §§ 2036 and 2038.[413]

### III.B.4 Chapter 14

Congress enacted much of Chapter 14 to avoid perceived abuses in valuing transfers of family-controlled business entities. Below this portion considers how retained equity interests are valued (and how to avoid such valuation), and the circumstances under which agreements to

[412] The irrevocable inter vivos QTIP trust is a grantor trust taxable to the husband under Code § 677, since all of the income and principal are distributed or accumulated for the grantor's spouse. Code § 1041 provides that sales between spouses are not taxable.

[413] An adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust.

require or restrict transfers are considered in determining the value of what is transferred. We will focus on how Chapter 14 might affect the beneficial equity structures and deferred compensation techniques described in the "General Income Tax" discussion above. After focusing on this interaction, the portion further below after this one brings the Code §409A overlay into play and tries to find some "sweet spots" which one might seek in structuring businesses.

### III.B.4.a Overview of Chapter 14 Rules Regarding Family-Controlled Business Entities

Generally, Code § 2701 values transfers from older family members to younger family members. Code § 2703 allows the IRS to disregard buy-sell and transfer restrictions in many situations. Code § 2704 allows the IRS to disregard restrictions on liquidating an entity in certain situations.

### III.B.4.b Code § 2701 Overview

Code § 2701(a)(1) values "transfers" when a transferor or "applicable family member" (the older generation) holds an "applicable retained interest" (a preferential distribution or liquidation right) after making a transfer of an interest in a corporation or partnership to a "member of the transferor's family" (a younger generation). Let's examine the meaning of these quoted terms and consider exceptions to these rules.

"Transfer" generally includes a contribution to capital, a capital structure transaction such as redemption, recapitalization, or other change in the capital structure of a corporation or partnership, or certain terminations of an indirect holding in the entity.[414]

For most purposes of Code § 2701, "applicable family member" means "the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor."[415] "Member of the family" means "the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant."[416]

"Applicable retained interest" includes the following:

- A "distribution right," but only if, immediately before the transfer, the transferor and applicable family members "control" the entity:[417]
    - o A "distribution right" is a right to distributions from an entity with respect to stock in a corporation or a partner's interest in a partnership.[418] However, it does not include:[419]

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[414] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i).
[415] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).
[416] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).
[417] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).
[418] Code § 2701(c)(1)(A).
[419] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).

- a right to distributions with respect to an interest that is of the same class or subordinate to the transferred interest,

- an extraordinary payment right (a liquidation, put, call, or conversion right), or

- a right to receive guaranteed payments from a partnership of a fixed amount.

o "Control" means:

- In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[420] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[421] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[422] Permissible recipients of income from the equity interest and other beneficiaries, rather than the trustee, are considered to hold voting rights that are in trust.[423] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[424]

- In the case of a partnership:[425]

  - At least 50% of the capital or profits interests, or

  - In the case of a limited partnership, any interest as a general partner.[426]

  The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[427]

- Solely for purposes of this "control" test, "applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[428]

• <u>An extraordinary payment right</u>.[429] Generally, an extraordinary payment right includes a liquidation, put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the transferred interest's value.[430] A "call right" includes any warrant, option, or other right to acquire one or more equity interests.[431]

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420 Code § 2701(b)(2)(A).
421 Reg. § 25.2701-2(b)(5)(ii)(B).
422 *Id.*
423 *Id.*
424 *Id.*
425 Code § 2701(b)(2)(B).
426 Reg. § 25.2701-2(b)(5)(iii).
427 Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 435.
428 Code § 2701(b)(2)(C).
429 Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).
430 Reg. § 25.2701-2(b)(1)(i), (b)(2).
431 Reg. § 25.2701-2(b)(2).

Notwithstanding the above, certain rights are not applicable retained interests:[432]

- A mandatory payment right.[433] This is a right to receive a payment at a specific time (including a date certain or the holder's death) for a specific amount.

- A liquidation participation right.[434] This is a right to participate in a liquidating distribution. However, generally the right to ***compel*** liquidation is treated as if it did not exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.

- A right to a guaranteed payment of a fixed amount under Code § 707(c).[435] The time and amount of payment must be fixed. The amount is considered fixed if determined at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate.

- A non-lapsing conversion right.[436] This is a non-lapsing right to convert an equity interest:

  - Into a fixed number or fixed percentage of shares in a corporation that are the same class as the transferred interest.

  - Into a specified interest in the partnership (not represented by a fixed dollar amount) that is the same class as the transferred interest.

  In both cases:

  - Differences in voting rights are ignored.

  - The conversion right must be subject to proportionate adjustments:

    - For a corporation, such adjustments must be made with respect to splits, combinations, reclassifications, and similar changes in capital stock.

    - For a partnership, the equity interest must be protected from dilution resulting from changes in partnership structure.

### III.B.4.c Code § 2701 Interaction with Income Tax Planning

How does Code § 2701 inform the discussion further above on ways to plan for entity transfers? Below is a qualitative analysis; quantifying these amounts using the complicated subtraction method set forth under Reg. § 25.2701-3(b) is beyond the scope of these materials.

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432 Reg. § 25.2701-2(b)(4).
433 Reg. § 25.2701-2(b)(4)(i).
434 Reg. § 25.2701-2(b)(4)(ii).
435 Reg. § 25.2701-2(b)(4)(iii).
436 Reg. § 25.2701-2(b)(4)(iv).

### III.B.4.c.i Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer.

- Suppose a parent transfers a profits interest to a child and retains the parent's capital account. The parent's capital account generally would be an applicable retained interest, valued at zero, so that the transfer to the child will be treated as a transfer of the parent's capital account as well. However:

  - This rule will not apply if the following, added together, are less than 50% of the partnership's income and less than 50% of the partnership's capital:

    - The parent's and child's interests, and

    - Interests of any combination of:

      - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor), and

      - Descendants of the parents of the parent or the parent's spouse (in other words, the parent's and parent's spouse's siblings and the descendants of the parent, of the parent's spouse, or of such siblings).

  - The parent may reduce the gift based on the discounted present value of the right to receive the capital account if either:

    - The partnership must pay the capital account to the parent at a "specific time," such as a specific date or the parent's death, or

    - Liquidation (at which time the capital account would be paid to the parent) cannot be compelled by any combination of:

      - The parent,

      - Members of the parent's family (the parent's spouse, a descendant of the parent or the parent's spouse, and the spouse of any such descendant), and

      - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor).

The parent can enhance the retained capital account's present value by retaining a cumulative distribution right with respect to the capital account. For example, if the partnership were required to pay the parent annually 7% of the parent's capital account and that right either was not contingent on profits[437] or was cumulative,[438] then the parent could also reduce the gift on account of the present value of that payment right.

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[437] Thereby constituting a guaranteed payment right under Reg. § 25.2701-2(b)(4)(iii). Instead of using 7% (arbitrarily selected for this example), one could use the prime rate or some other market rate.

The value of a junior equity interest cannot be valued at less than 10% of the sum of the total value of all equity interests in the partnership and the total amount of the partnership's indebtedness to the parent and other applicable family members.[439] In a partnership, "junior equity interest" means any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.[440] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[441] Thus, generally the 10% minimum value rule would not apply to profits interests. However, as a practical matter, often appraisers of qualified retained interests require junior interests to be worth at least 20% of the entity to give full valuation effect to the stated payments, so avoiding the 10% minimum value rule would not necessarily be helpful.

On the other hand, if one needs to go through all of this complexity, one might consider abandoning the profits interest idea and instead using a GRAT.[442] If the parent wants to transfer only a small portion, the parent could transfer a vertical slice (described further below) of what the parent owns and place a ceiling on the amount that is ultimately transferred to the child. If the parent's goal in transferring a profits interest is to incentivize the child, the GRAT's ceiling could be based on objective business performance measures.

- The issuance of a pure profits interest[443] does not have Code § 409A implications.[444] The Code § 409A analysis is not affected by whether the profits interest is junior to another interest.

- Suppose the partnership issues the interest to the child, instead of the parent transferring the interest. Code § 2701 applies to a "change in the capital structure" of a partnership or

[438] Thereby constituting a qualified payment under Code § 2701(c)(3)(C)(i) (first sentence) and Reg. § 25.2701-2(b)(6)(ii). The transferor or an applicable family member who holds a distribution right that does not qualify may nevertheless treat the right as a qualified payment if he or she makes a special election under Code § 2701(c)(3)(C)(i) (second sentence) and Reg. § 25.2701-2(c)(4). Finally, additional gift tax may be imposed under Code § 2701(d) if the qualified payment is not made within the four-year grace period allowed under Code § 2701(d)(2)(C).

[439] Code § 2701(a)(4); Reg. § 25.2701-3(c). Such indebtedness does not include short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services); indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity; or a qualified lease. Reg. § 25.2701-3(c)(3). A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

[440] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).

[441] However, if the parent retained a cumulative distribution as recommended above, then the profits interest would be junior as to income, and presumably the 10% minimum value rule would apply.

[442] The author thanks Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.

[443] By "pure profits interest" the author means a partnership interest that would be allocated nothing if liquidation were to occur at the time of transfer of such interest.

[444] See text accompanying footnote 53.

corporation in certain situations.[445] However, Code § 2701 applies to a change in capital structure only if:[446]

(1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

(3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

In this variation, the parent does not hold an applicable retained interest before the transaction. Thus, we look to paragraph (1) and not to paragraphs (2) or (3). Because the parent has retained the capital account that he had before the transaction, rather than receiving a capital account,[447] has the parent "received" an applicable retained interest in the transaction?

**III.B.4.c.ii Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest.**

- Suppose a parent is buying a partnership owned by an unrelated third party. The unrelated third party retains all of his capital interest and receives preferred payments of income in liquidation of the value of his interest in excess of his capital account. The parent is entitled to 100% of the profits in excess of the preferred payments. As discussion further above, preferred payments of income to the third party can be very beneficial to the parent who is buying the business, if the preferred payments are taxed to the third party as a distributive share of income under Code § 736(a) so that the parent is using pre-tax dollars to buy out the third party.
    - o Initially establishing this capital/income structure will not have Code § 2701 implications, because the parent is not a member of the third party's family.
    - o The partnership's capital/income structure could have Code § 2701 implications if the parent transfers an interest to his child or any other member of the parent's family.
        - ➢ Does the parent own at least "50% of the profits interests" that would be required for Code § 2701 to be considered (since the parent has no capital account yet) if the partnership is a general partnership? The statute and

[445] Code § 2701(e)(5).
[446] Reg. § 25.2701-1(b)(2)(i)(B).
[447] This approach cannot be taken if done in conjunction with a contribution to capital.
Reg. § 25.2701-1(b)(2)(i)(A).

regulations do not clearly answer the question.[448] If the partnership is a limited partnership and the parent is a general partner, then Code § 2701 must be considered no matter what the parent's economic interests are.[449] If the partnership is a manager-managed limited liability company, and the parent is a manager, would that be the same as being a general partner in a limited partnership?

- Even if one assumes that the parent's partnership interest is sufficient to make one consider Code § 2701, if the parent transfers a vertical slice of the parent's right to income and the same vertical slice of the parent's right to capital to his child, Code § 2701 should not apply to that transfer.[450] Suppose, for example, that the parent owns 60% of the income and 10% of the capital and wants to give a vertical slice of 1/10 of his interest to his child.[451] In that case, the parent would give the child a 6% income (60% multiplied by 1/10) and 1% capital interest (10% multiplied by 1/10) and would retain a 54% income and 9% capital interest. The vertical slice should be structured so that the child succeeds to 1/10 of every item of the parent's rights to distributions and financial obligations. For example, if the parent is obligated to leave a portion of his share of income in the partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[452] constitute a contribution to capital, triggering Code § 2701,[453] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

### III.B.4.c.iii Deferred Compensation.[454]

- Suppose a parent is 55 years old and wants to retire in 10 years. The business entity (same analysis whether partnership or corporation) agrees to make the following series of payments:

448 Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).
449 Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).
450 See Reg. § 25.2701-1(c)(3),(4).
451 In the example, the parent starts with a pure profits interest and no capital. However, the parent is likely to leave some income in the partnership, especially since the reinvested income might be used to buy the third party's capital account. The cumulative effect would be to decrease the third party's capital account and increase the parent's capital account until the third party's capital account and income interest have decreased to zero.
452 The next paragraph of text suggests a difference between the parent transferring a partnership interest and the partnership issuing a partnership interest. Therefore, the author's concern about leaving profits in the partnership could be creating an issue where there is none, because the parent is not transferring property to the child. Thus, this recommendation is an attempt to be very conservative.
453 Reg. § 25.2701-1(b)(2)(i)(A).
454 Although this is not equity, it reduces the entity's value for many purposes and makes it easier to sell. It is realistically available only if the entity earns sufficient income.

- Retirement Payment. $100,000 per year for life,[455] but only if the parent continues to work for the entity until the parent attains age 65.[456] This should not violate Code § 409A; of course, to satisfy other tax issues, the retirement payment must, when combined with other compensation, constitute reasonable compensation for future services.[457] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[458] whether or not the IRS attempts to classify it as equity.

- Disability Payment. The parent receives $100,000 for life if the parent becomes disabled before attaining age 65. If disability is defined consistent with Code § 409A(a)(2)(A)(ii) & (a)(2)(C) and the pronouncements thereunder, the payment would not violate Code § 409A. Unfortunately, this definition is more stringent than most good disability policies, and one might consider paying a bonus to the parent so that the parent can buy disability insurance instead.[459]

- Death Benefit. A death benefit to replace the disability and retirement payments would not violate Code § 409A.

  The discussion below of creative bonus arrangements convinces the author that none of the above would constitute an equity interest. Therefore, such arrangements would

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[455] If instead the payment were for a fixed period of years instead of for life, more planning opportunities are acailable if the arrangement provides at all times that the right to the series of installment payments is to be treated as a right to a series of separate payments. Prop. Reg. § 1.409A-2(b)(2)(iii).

[456] When the parent reaches 65, the present value of the retirement payments vests for FICA purposes, and a lump-sum FICA tax payment is due. Although this might sound onerous, it is actually quite beneficial. FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB. See http://www.ssa.gov/OACT/COLA/cbb.html for the current TWB ($94,200 in 2006). Most of the FICA tax on the present value will be at the lower 2.9% rate. When payments are made in future years, they will not be subject to FICA tax. This could save over $11,680 of FICA tax each year ($94,200 TWB multiplied by the 12.4% spread between 15.3% and 2.9%).

[457] In this example, the requirement that the parent work for 10 years is an attempt to spread the period of "earning" the compensation for the purposes of determining reasonable compensation.

[458] Reg. § 25.2701-2(b)(4)(i)(in the case of a corporation) or (iii) (in the case of a partnership).

[459] A good disability policy will provide benefits if the disabled person cannot work in his or her ***own occupation***. Contrast this with Code § 409A(a)(2)(C), which provides (emphasis added):

> For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant—
>
> (i) is unable to engage in ***any substantial gainful activity*** by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or
>
> (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

not constitute an "applicable retained interest" that would taint a transfer by the parent to a child.[460]

### III.B.4.c.iv Stock Options

- Stock options exercisable at a price that is at least the underlying stock's value on the date of exercise generally are not subject to Code § 409A. Similar rules apply to partnerships. For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[461]

  > Until the options are exercised, the holder of the option has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code.

  Income tax cases have held than an option to acquire a partnership interest does not constitute an equity interest in the partnership.[462] The author has not discovered Code § 2701 cases addressing that question.

  However, options are subject to Code § 2703, which deals primarily with buy-sell agreements.[463]

### III.B.4.c.v Creative Bonus Arrangements

- Suppose an employee who is a family member is entitled to receive a bonus based on the entity's profitability. If the bonus is required to be paid on March 15 following the calendar year the results of which are being measured, the bonus plan generally would not be subject to Code § 409A. If this bonus is based on the entity's income, would the bonus plan constitute an equity interest?

  The author is not aware of Code § 2701 cases addressing this issue, so the author has summarized selected income tax cases.

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[460] Code § 2701 applies only when the parent or a member of the parent's family holds an applicable retained interest. An applicable retained interest includes only a right to equity. See Code § 2701(b), (c)(1), (c)(2).

[461] Letter Ruling 199952012 and CCA 199927002; see Letter Ruling 9616035. The IRS also compares the stock with respect to which the option is granted with the stock that the transferor retained. See Letter Ruling 9725032 (option related to publicly traded stock, and such stock is not subject to Code § 2701) and 9722022 (stock subject to option was same class as stock the transferor retained, so Code § 2701 did not apply).

[462] *Dorman v. US*, 296 F2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. US*, 498 F2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too speculative] nor a partnership interest); *Mayhew*, TC Memo 1992-68 (option and right to bonus did not constitute a profits interest).

[463] See text accompanying footnotes 118-122.

As in other areas, state law determines rights, but tax law determines the effect of those rights; whether a partnership exists depends on a weighting of several factors.[464] The most commonly cited factors, none of which is conclusive, are:[465]

- [t]he agreement of the parties and their conduct in executing its terms;
- the contributions, if any, which each party has made to the venture;
- the parties' control over income and capital and the right of each to make withdrawals;
- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
- whether business was conducted in the joint names of the parties;
- whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers;
- whether separate books of account were maintained for the venture; and
- whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[466]
- Developed a new product line, not only thinking of the idea but also reducing it to practical application and sales to the general public, receiving a percentage of sales.[467]

The above tests all assume that the service provider is an employee. In a corporate setting, a shareholder who works in the business has two different capacities: an owner and an employee. The author is aware of only one situation in which the IRS combined the two concepts, and that was a clearly abusive situation.[468] The discussion further

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[464] *Commissioner v. Culbertson*, 337 US 733 (1949), clarifying *Commissioner v. Tower*, 327 US 280 (1946).
[465] *Luna*, 42 TC 1077-78 (1964). Although this case dealt with an insurance agent, it has been cited in many other situations.
[466] *Friednash v. Commissioner*, 209 F2d 601 (9th Cir 1954); *Duley*, TC Memo 1981-246.
[467] *Luna*, 42 TC 1067 (1964). This is one of many cases in which insurance agents unsuccessfully attempted to treat as the sale of a capital asset payments commuting their future commissions or similar contract rights.
[468] In TAM 9352001, son-in-law was given an employment contract that paid him cash of at least three or four times the market value of his services, for a management position for which he was not qualified, as well as issuing him a

above about S corporations compensating employees with stock options provide insight about when, for income tax purposes, an option constitutes equity in the corporation. Absent guidance in a Code § 2701 setting, the author suggests relying on the income tax principles, possibly requesting a private letter ruling in appropriate situations.

Contrast that with a partnership setting: For income tax purposes, all partner compensation is considered in conjunction with the partner's equity interest. Although Code § 707(a) provides that a partner may be considered as dealing with a partnership other than in his/her capacity as a partner, under Code § 707(c) fixed payments to a partner for services constitute guaranteed payments. Such payments are reported on the Schedule K-1 that the partnership issues to the partner; issuing Form W-2 that applies to employees violates the regulations governing FICA. Whether a particular compensation arrangement is a guaranteed payment or a distributive share of profits is a fluid concept.[469] Generally, a payment based on gross income constitutes a guaranteed

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control block of voting stock as part of his compensation. The IRS ruled that the stock was cumulative preferred stock, with the excess compensation constituting the preference.

[469] Reg. § 1.707-1(c) provides:

> Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of §1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:
>
> *Example (1).* Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).
>
> *Example (2).* Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.
>
> *Example (3).* Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner

payment (such as a fixed percentage of gross rent), whereas a payment based on net income constitutes a distributive share (such as rental income net of all allocable expenses).[470] The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the service provider's Schedule K-1.[471] If the IRS audits an applicable family member's estate tax return and obtains partnership income tax returns, an agent is likely to argue that the service provider's guaranteed payments are part of the service provider's total equity interest and might argue that a testamentary or prior transfer of equity to the service provider should have been valued considering this additional compensation. One should carefully consider the extent to which the service provider has the <u>right</u> as a partner to make these payments to himself/herself.

- Contrast this to a corporate setting, where these incentive payments are reported on Forms W-2. The IRS' main inquiry is likely to be whether the incentive payments constituted reasonable compensation. Although the IRS might argue that the payments were part of the service provider's rights as a shareholder, in most corporate settings the shareholder would need to elect a director to protect his/her interest, and then prove that the director would have conspired with the other directors to order the corporation's president to pay such compensation.[472]

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X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

*Example (4).* Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

[470] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶13.03: "Partners Acting in Their Capacities as Partners: Section 707(c) Guaranteed Payments," discusses that the Tax Court held that a management fee equal to 3% of gross rents constituted a distributive share rather than a guaranteed payment. The treatise states that the IRS disagreed with the Tax Court's ruling, both citing the Revenue Ruling and providing details in footnote 144:

> Rev. Rul. 81-300, 1981-2 CB 143. The legislative history of the Deficit Reduction Act of 1984, however, states that the transaction described in Rev. Rul. 81-300 should be governed by § 707(a), not § 707(c) . Moreover, it seems that § 707(a) treatment is dictated by the fact that the services rendered (real estate management) are traditionally compensated by fees that are a percentage of gross income, thus triggering § 707(a)(2)(A). 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Prt. No. 169, at 229, 230 (Comm. Print 1984). See supra ¶ 13.02[4].

[471] See footnote 469.

[472] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities. Furthermore, a shareholders' agreement can purport to lock-in such arrangements; however, the general rule is that no agreement can legally bind future directors to a particular course of action.

### III.B.4.d Code § 2703 Overview

See discussion in II.G.1.b.

### III.B.4.e Code § 2704 Overview

In a family-controlled business, Code § 2704(a) treats as a transfer the lapse of any voting or liquidation right in a corporation or partnership. Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults.

In the context of an affirmative transfer of an equity interest, regulations do not apply these rules regarding liquidation restrictions to the ability to liquidate one's equity interest.[473] Thus, Code § 2704 generally will not be significant in most cases involving incentive compensation or the transfer of an equity interest.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

## III.C Fairness Within Families; Valuation

A succession plan can be one of the most important factors contributing to the long-term success of a family business, yet the importance of these plans is often overlooked until it is too late. In many cases, the plans are technically sufficient, but the drafters have failed to consider the relationships that drive the business itself – the family. While the technical issues underlying family business succession plans are usually similar from case to case, the family issues – the "human context" – are unique in every case. No two families are the same, and successful business succession plans have to take into consideration those human differences. The stakeholders in the business have to be treated equitably for the plan to succeed; thus, the plan has to consider the interests of family, non-family owners, and the employees.

The starting point for any business succession plan is determining an accurate valuation of the business. If the plan involves keeping the business in the family, it is important to have an accurate determination of its value in order to allocate wealth fairly among family members involved in the business and those who are not involved. Or if the plan involves some sort of sale, accurate valuation will ensure the sellers receive fair compensation for their interests. And regardless of whether the business stays in the family or is sold, an accurate valuation can help parties estimate the biggest expense of the succession process – the transfer tax cost of the succession.

The general principle underlying business valuation is the "willing buyer – willing seller test". Regulations define fair market value in the context of estate transfers as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under

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[473] *Kerr*, 292 F.3d 490 (5th Cir. 2002); *compare* Reg. § 25.2704-2(b) (for a transferred interest, an "applicable restriction" is a limitation on the ability to liquidate the entity") *with* Reg. § 25.2704-1(a)(2)(v) (for a lapse, liquidation right means fight to compel the entity to redeem the interest).

any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[474] The test is easy to apply when dealing with publicly traded stock - one simply takes the mean between the highest and lowest quoted sales prices on the valuation date. In the context of non-publicly traded securities, there is no ready-made market for the stocks, so valuation is more challenging. The Code states that the value of such stocks should be determined by examining numerous factors, including the value of stocks of corporations "engaged in the same or a similar line of business which are listed on an exchange".[475] Regulations expand on the factors to be considered, mentioning the company's net worth, prospective earning power and dividend paying capacity and list other relevant factors, including the good will of the business, the economic outlook in a particular industry, the company's position in the industry, the degree of control of the business represented by the block of stock to be valued, and the value of stock of other corporations engaged in similar lines of business which are listed on a stock exchange.[476] Revenue Ruling 59-60 mirrors the Regulations and lists eight fundamental factors that should be considered in valuation cases: the nature of the business and the history of the enterprise; the general economic outlook and the business' specific industry outlook; the book value of the stock and the company's financial condition; the company's earning capacity; the company's dividend paying capacity; goodwill; sales of the stock and the size of the block of stock to be valued; and the market price of companies in similar lines of business with actively traded stock.

In applying these factors, three methods are commonly used in business valuations: the net asset method, the market value method, and the earnings method. These methods are often used in conjunction with one another to come up with the best possible valuation of the business.

The net asset method (or the "underlying asset" method) is based on the accounting concept of net book value. Net book value of a company is the historical cost of the company's assets less its liabilities. Under this method, each asset and liability must be analyzed to determine if the historical balance sheet treatment needs to be restated. This approach is not always accurate when valuing operating companies, since the method does not consider the company's goodwill, so this method is usually considered to give a picture of the minimum value of a company and may be useful where a company is in financial distress with liquidation in its future. However, this method can be quite useful in valuing companies with little goodwill, like holding companies.

The market value method involves an analysis of the value of similar, publicly traded companies or of similar companies that have been recently acquired in private transactions. The comparison values are based on stock prices or transaction prices, which are then divided by a specific earnings parameter or balance sheet parameter. That multiple is then applied to the subject company's same parameter to get an estimated company value. Because the valuation's accuracy depends on the level of similarity between the two companies, this valuation method becomes less appropriate as the subject company becomes more unique and will be hard to apply in many cases.

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[474] Reg. §20.2031-1(b) and §25.2512-1.
[475] Code §2031(b).
[476] Reg. §20.2031-2(f)(2) and §25.2512-2(f)(2).

The earnings method bases valuation on a company's cash flow capacity and earnings to determine the present value of the future economic benefits the company will bring to its investors. This valuation can be determined two ways, either through the discounted cash flow method or through the capitalization of earnings method. When a company has a past earnings stream that is not expected to indicate future earnings prospects, the discounted cash flow method is used. This entails projecting the business' future cash flows and discounting them to present value using an appropriate discount rate, usually the weighted average cost of capital (WACC), the rate of return the company's capital providers require on their investment. When a company has consistent historical earnings and expects that trend to continue, the capitalization of earnings method is often used. This method entails multiplying a normalized level of earnings by a capitalization factor, the inverse of the company's WACC.

Once the company's value has been established using any combination of the valuation methods, the value of the particular interest in the company has to be determined. In many cases, the value of the particular business interest will not be the proportionate share of the entire business value. Instead, adjustments often need to be made to get an accurate value of the interest. For example, a 51% interest may be just two percentage points larger than a 49% interest, but the 51% interest has more than just a two percentage point value advantage over the 49% interest, since the 51% interest is a controlling interest. Thus, controlling interests often are increased by a control premium, while minority interests are decreased by a minority interest discount. Other examples of valuation adjustments include a key employee discount, a non-voting stock discount or a blockage discount. When making these adjustments it is important to consider whether the discount has already been taken into consideration in determining the company value as a whole. If it has, then the discount should be ignored for the particular business interest valuation. For example, a controlling interest valued using earnings will be based on the company's dividend paying capacity. On the other hand, a minority interest tends to be valued using dividends paid, since a holder of a minority interest may have difficulty forcing dividends to be paid and keeping compensation reasonable.

Restrictive agreements can also play a role in determining interest values. Buy-sell agreements, by definition, involve setting a price at which a particular business interest will be purchased or redeemed. There are a number of ways that price is set: by using a formula, by agreement, or by an appraisal procedure.

The formula method usually involves applying some multiple to asset value or earnings, and the decision on whether to use asset value or earnings is usually dependent upon the particular business industry. The multiple applied to that factor will vary depending upon the company and the general business cycle, so finding the appropriate multiple can be challenging. Some of this difficulty can be eased if the company is similar to publicly traded companies, that would give the valuation expert a guideline in determining the multiple.

The agreed value method is exactly what one would assume – it involves the business owners agreeing to a buy-sell purchase price. The most important aspect of this method is the certificate of value itself. Owners must make sure the certificate is updated on a regular basis to ensure the agreed upon price is in fact fair. It is best if the agreement itself provides for an alternate method of valuation if the certificate is not kept up to date. Another potential problem with this approach comes into play where the relative bargaining power of the owners is not equal. In such a case, this method can lead to inequitable results.

The appraisal procedure is usually the most fair method of valuation, but many times it is not used because it can be very expensive. Additionally, because the method requires many judgment calls, no two appraisers are likely to come to the same conclusion about the company's value. Thus, results can be very uncertain, and a company and its owners need to be prepared to pay for multiple appraisals if the interested parties are not satisfied with the initial results.

Two other issues also need to be addressed in buy-sell agreements: whether the interest will be valued at fair market value or fair value, and whether contingent payments will be an option. These issues both address fairness to the parties involved in the transaction.

Fair value is usually the appropriate measure to be used in buy-sell agreements. The goal of fair value is to reach a fair result for the party whose interest is being cashed out involuntarily. On the other hand, fair market value derives from the "willing buyer, willing seller" test, and involves the previously discussed valuation adjustments. But many business interest disposals are triggered by involuntary events, like a family death, meaning the seller is often not the "willing seller" referred to in the fair market value context and applying valuation adjustments could lead to inequitable results.

A buy-sell agreement also should include a contingent payment provision. Such a provision will come into play when a company undertakes a sale or merger after the triggering event of the buy-sell agreement. In many cases, the sale or merger will be based on a significantly different value than the one used in the buy-sell agreement. If this happens, the party who is bought out in the buy-sell agreement could end up receiving inequitable compensation for his interest. A contingent payment provision can correct this inequity by providing for additional consideration to be paid to those whose interests were retired under the buy-sell agreement within a certain amount of time before the sale or merger.

The valuation issue is so important in family business settings because of the "human element" of a family business. The success of these businesses can depend on how well the older generation plans and how clearly they delineate those plans to the younger generation. This is especially critical when members of the family are active participants in the business. It is highly unlikely that all of those members involved in the business participate equally in the success of the business; and, when a patriarch dies, arguments may quickly break out about those contributions. The business owner has to recognize this reality and deal with it preemptively or the business may fail. The plan will usually be to have family members interested in the business take over and leave other non-business assets to those uninterested family members. This is the logical answer to the problem, but it is more complex than that. This is why valuation is so important. In order to divide assets fairly among family members, one has to know the value of those assets. And once the business has been valued, it is critical to appropriately value the worth of each family member's contribution to that business. But family members are not the only parties who need to be considered in a business succession plan. Non-related owners and employees are also critical to a company's success, and they need to be taken care of as well so that they will continue to be productive.

In addition to the valuation process discussed previously, a number of issues should be addressed in a fair and successful business succession plan. These include expansion of the professional and business team, employment agreements, compensation, life insurance, ways to reduce estate taxes, capital structure, voting control, and communication.

When developing a business succession plan, professionals might help deal with family dynamics. These professionals usually have training areas like cultural anthropology, psychology or organizational dynamics and can help the business owner prepare for situations he or she would otherwise fail to see coming.

A successful succession plan may also integrate increased depth at the management level. Common sense would tell you that a company is more likely to succeed when the managers taking over have business experience, and succession planning should take that into consideration. It can also be helpful to incorporate outside directors into the board of directors. These "neutral" parties can not only help family members make smart business decisions after the patriarch's death, but can also help reassure the employees. In addition to having non-family board members, it may also be helpful to have a board of advisors. These advisors would not assume any fiduciary duty to the company, but can provide an impartial review of the company's operations and can be a significant aide to new family members or outside management who take over the company after the patriarch's death.

Employment agreements can help ease the anxieties surrounding their futures after a business owner's death. Key employees may be concerned about being run out or demoted by new family members who take over the business. Employment agreements can help to lessen these concerns by including protection from "without cause" terminations and by allowing for compensation if the employee resigns for "good reason." These agreements may also include a clause similar to a "retention bonus" that gives the employee additional compensation for staying on after the death of an owner to help the business complete the transition period.[477]

In addition to addressing compensation in employment agreements, a succession plan should address compensation decisions. All parties involved need to know and understand who will make compensation decisions in the new management scheme and how abuses of the compensation system will be prevented.

Life insurance can help with liquidity issues that may arise at the time of an owner's death in two ways. First, the proceeds can assist in achieving fairness in the estate distribution process if the estate does not hold sufficient liquid assets. The proceeds can provide assets for family members who are not involved in the family business (or can provide liquidity for those who are involved so that they have a cushion if the business declines), while the business itself passes to interested family members. Additionally, if the estate does hold liquid assets, then the proceeds can provide liquidity for the business itself in the time of transition. Finally, life insurance payable to

[477] Deferred compensation agreements are subject to Code §409A (added by the American Jobs Creation Act of 2004), which accelerates an employee's recognition of income and imposes a 20% penalty when such agreements do not satisfy its requirements. Payments contingent on future performance of services frequently satisfy its requirements.

the company upon the death of key management can be used to help the company in retaining or recruiting management during the transition.

A business succession plan should include estate planning strategies to help preserve family wealth, thereby increasing the likelihood of continued success of the business. Some of these strategies are discussed elsewhere in these materials.

A business' capital structure can also be arranged to ensure fairness among owners. A plan needs to consider all owners' needs and determine what business structure gives the company and owners the most flexibility in meeting those needs. In addition, a business plan can use capital structure to segregate assets for estate planning purposes. For example, an LLC can be created to hold real estate, which it can lease to the operating company in exchange for rent. The real estate LLC can provide rental income to family members who are not active in the business. Long-term leases with inflation adjustments can provide stability for all interested parties.

Voting control allocation can also assist in the success of a fair business succession plan. A balance needs to be struck between giving the active family members enough power to fulfill their responsibilities and not giving them too much authority so as to enable abuse of power situations. A voting/non-voting interest dichotomy or a limited partnership structure can achieve this balance.[478] In both cases, active family members can take control of the company, regardless of how much of the company they actually own themselves. Family members who are not in control also need rights that give them some input into major company issues or at least some way to get out of the company if they are not satisfied with how management is running it. This could be accomplished by setting a level of performance of management, and if management falls below that performance level, then minority or non-controlling members would have the right to cash out their interest.

Essentially all of these issues come together under one theme – communication. Business owners need to address as many potential issues as they can and make sure all interested parties know and understand how those issues are to be resolved. This can be achieved through a clearly delineated business succession plan that is communicated to family members, non-family owners, key employees and the board of directors or advisors. Finally, when the plan involves keeping the business in the family under the control of certain family members, the client needs to make sure the family knows the reasoning behind the decisions, to minimize future conflict.

## III.D Hypothetical

### III.D.1 Facts

Harvey Decedent died in 2002, leaving four children by his first marriage and a second wife, Wanda.[479] All four children (Angie, Bob, Cindy, and Dan) are in their late thirties, and each has

[478] State law often restricts a plan's ability to dictate corporate directors' actions. LLC statutes provide much more flexibility. Statutory close corporation rules can provide a fair amount of flexibility if a corporate form is essential.
[479] This hypothetical is based on a presentation done by Steve Salley, Jonathan Lander, Steve Kirkpatrick, and the author at the 2004 ABA RPPT/Tax Joint Fall Meeting.

two children of his/her own. Harvey was diligent during his life in moving assets to his children, so that at his death all his business assets were held in family entities in which his children participated. Following estate administration virtually all the estate's assets ended up in a QTIP for Wanda with the remainder to Harvey's descendants per stirpes.

A) The Trust. The QTIP holds assets which include the following:

1) Approximately $5,000,000 in marketable securities.

2) An 80% interest in Cow Town LLC, an entity (taxable as a partnership) that owns the real estate and improvements of Cow Town Hotel, a well-known and valuable but aging urban hotel in Texas. The real estate is valued at $10,000,000 but is encumbered by a $4,000,000 mortgage that currently bears interest at 5% per annum. Payments are currently interest only for the next 3 years, until it balloons. The Hotel earns approximately $1.5 million per year in taxable income after management fees, but has been distributing only 50% of that amount to its members, the balance going to badly needed capital improvements. The remaining 20% of the LLC is owned in equal shares by the four children, two of whom are desperate for cash due to their wastrel ways and two of whom are the key employees of Cow Town, Inc., discussed below.

3) A 40% interest in Cow Town, Inc., an S corporation established by Harvey to manage the Hotel and, during his life, to provide cash flow to his kids from Hotel operations. The corporation has no assets other than a management agreement on the hotel which has 2 years to run before it must be renegotiated. The remaining 60% of the stock is held 15% each by the four children. To date the contract calls for a management fee equal to 50% of the Hotel's "profit", an amount deemed by dad to be equal to taxable income. Thus the corporation has enjoyed $1,500,000 /year in management fees, which after salaries and expenses of $500,000 annually, was distributed pro rata to the shareholders. The two key employees of the corporation and, indirectly, of the Hotel are Angie and Bob Decedent who have received the same $100,000/year salary since Harvey died. They complain about doing all the work for the benefit of their brother, sister, and Wanda and are demanding significant salary concessions to continue managing the hotel.

B) The Trustees. The QTIP has three trustees, Sam Tortte (Harvey's long-time lawyer), Tom Penny (Harvey's CPA), and FiDuc., a nationally known commercial trust company first nominated to serve under Harvey's will with no prior experience with the family.

C) The Problems.

1) The mortgage holder on Cow Town LLC has offered to extend the mortgage to a 15-year term with straight amortization and a 4.5% interest rate but only if the Trust, as the largest equity holder and source of liquidity, guarantees the mortgage.

2) FiDuc is requesting that the management agreement and the compensation of Angie and Bob be reviewed by an outside "expert" to determine reasonability; but the four kids threaten to stymie any efforts to change the ownership or cash flow for the benefit of Wanda, whom they believe is more than well taken care of from the trust's other assets.

3) The hotel is desperately in need of a new roof at a cost of $1,000,000, which will either have to come from the hotel's "profit" or a second mortgage. A second mortgage will require additional collateral beyond the guaranty of the Trust, including, perhaps, a pledge of a portion of the Trust's marketable securities.

4) FiDuc has demanded that any collateral or guaranty by the trust of Hotel debt must be accompanied by a loan agreement that assures the Trust control of the Board of Directors of Cow Town Inc. and the status of "sole managing member" of the LLC.

The trust is domiciled in a state that has adopted the most recent uniform trust-related laws. The trustees desire a "roadmap" of issues to be addressed in the upcoming negotiations.

## III.D.2 Trust Accounting and Taxation

The QTIP trust holds an 80% interest in a partnership. As a QTIP trust, it must distribute all of its income. The partnership earns approximately $1.5 million in the current year, but distributes only 50% of that amount to its partners. Thus, the trust receives a K-1 with $1,200,000 of income (80% of $1,500,000), but receives only $600,000 in cash (50% of $1,200,000). Initially, one might think the entire $600,000 is distributable net income and must be distributed to the beneficiary, since under §401 of the Uniform Principal and Income Act, a trustee must allocate money received from an entity to income.[480] However, if the trust does distribute the entire amount, it will be unable to pay the tax on the other $600,000 of "phantom" taxable income from the K-1 that it could not distribute. So the trust must retain some of the cash it received from the partnership. This withholding is supported by the language of §505(c) of the Uniform Principal and Income Act,[481] which states that taxes required to be paid by a trustee on a trust's share of an entity's taxable income are to be paid proportionately from income and principal based on the extent that receipts from the entity are allocated to each.

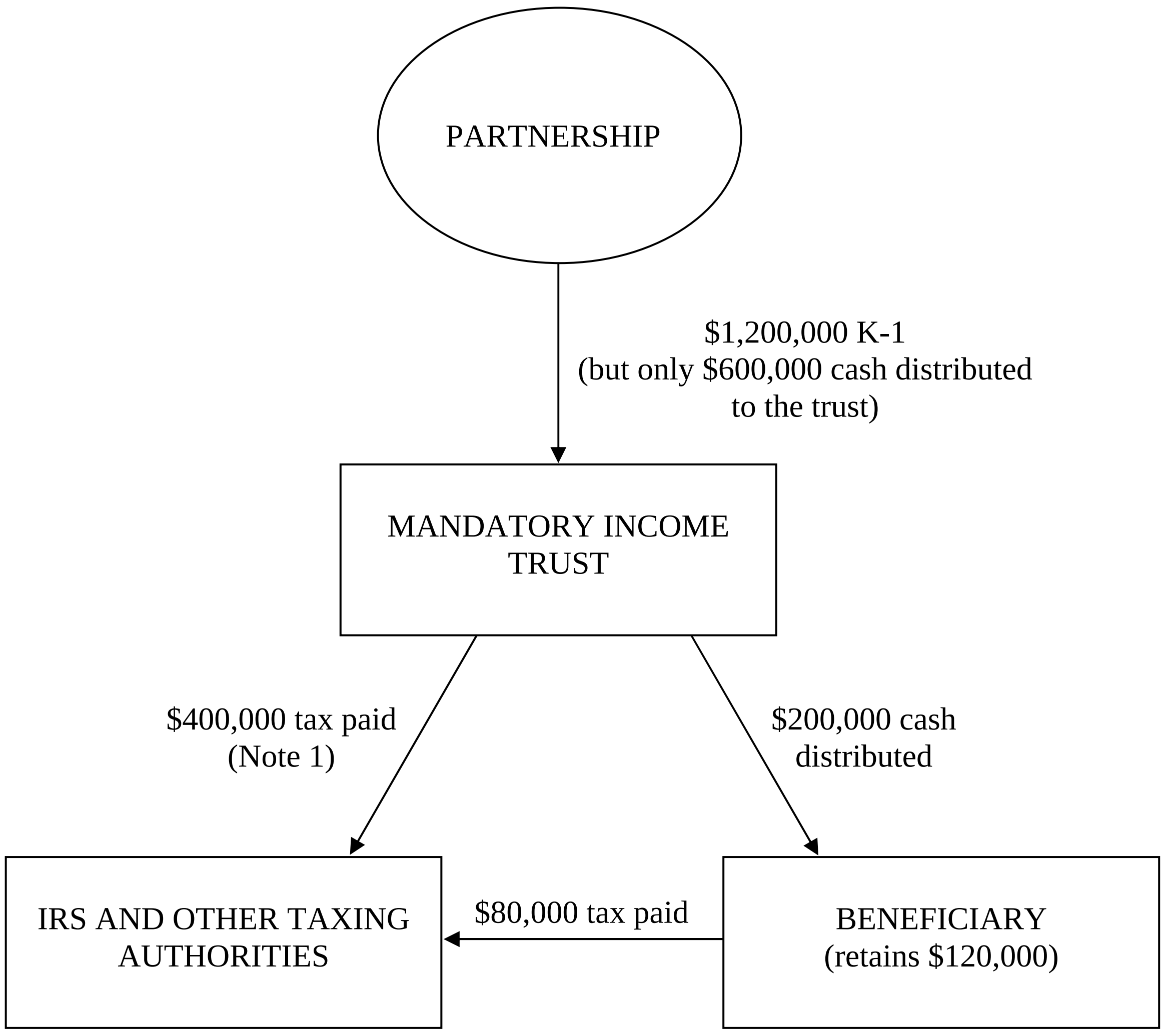
In this hypothetical, all $600,000 of cash received was properly allocated to income, so 100% of the tax due on the trust taxable income must come out of income. Thus, the trustee has to do a circular calculation to determine how much of the $600,000 must be withheld in order to cover the tax on that amount.

Assuming a 40% combined federal and state income tax rate, the trust will end up withholding $400,000 of the cash and distributing $200,000 to the beneficiary. This leaves the trust with $1,000,000 of taxable income ($1,200,000 K-1 income minus the $200,000 distribution deduction), resulting in a $400,000 tax due, which the trust will be able to pay with the $400,000 cash it retained. The beneficiary will receive $200,000 and pay $80,000 tax on that amount, leaving the beneficiary with $120,000.

Put another way, the K-1 income was $1,200,000, requiring $480,000 of tax to be paid by somebody, and $120,000 to be retained by the income beneficiary after tax ($600,000 cash distribution from the partnership minus $480,000 tax paid). Of the $480,000 tax to be paid,

[480] See also RSMo §469.423.2.
[481] RSMo § 469.459.3

$400,000 is paid by the trust and $80,000 by the beneficiary (out of the beneficiary's $200,000 distribution).




Note 1: $1,200,000 K-1 income minus $200,000 income distribution deduction equals $1,000,000 taxable income. Assumes a combined federal and state tax rate of 40%.