POST-MORTEM ACCESS TO FUNDS FROM CLOSELY HELD BUSINESS INTERESTS

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I. INTRODUCTION

When attorneys meet with clients to discuss estate planning, they need to consider the assets that will be available post-mortem to satisfy estate tax and administrative expenses, not to mention the beneficiaries' needs for living expenses. If the estate consists largely of a closely held business, the planner needs to seriously consider the decedent's business as one strong candidate for a source of cash.

This outline will provide a general discussion of tax issues when accessing funds from closely held business interests, while touching on considerations unique to cashing out upon death.

II. CORPORATE DIVIDENDS AND REDEMPTIONS

A. A dividend is a shareholder distribution out of a corporation's current or accumulated earnings and profits. Dividends are taxed to the recipient shareholder to the extent of the corporation's earnings and profits. Since the Job and Growth Text Relief Reconciliation Act of 2003 (JGTRRA), most corporate dividends are taxed at the same lower rate at which capital gains are taxed. If the amounts are greater than earnings and profits then they are treated as a return of basis; if the distributions are in excess of basis they receive sale/exchange treatment. § 301(c).

B. A corporate redemption is a purchase of a shareholder's stock by a corporation, which can be partially or totally redeemed by the corporation. § 302(b) controls whether the purchase of stock by the corporation would be subject to sale/exchange treatment and thus capital gains rates to the shareholder. If the § 302(b) tests are not satisfied, the recipient shareholder is subject to § 301 dividend treatment and would receive dividends to the extent of the corporation's earnings and profits. §§ 301(c)(1) and 316. Apart from the current favorable treatment of dividends under JGTRRA, redemptions have an advantage over dividends because shareholders can deduct their tax basis against any redemption proceeds.

C. If a shareholder sells all of his or her stock back to the corporation, the shareholder qualifies for a sale/exchange treatment and the preferential capital gains treatment pursuant to § 302(b)(3). This "complete redemption" approach is the easiest way to qualify for sale/exchange; the question of whether or not the shareholder held any stock after the transaction is fairly clear. However, be aware of the § 318 attribution rules discussed below.

D. If the shareholder is redeemed but does not give up all of his or her stock, the redemption still can fit within § 302(b) and create sale/exchange treatment to the shareholder if it constitutes a "substantially disproportionate distribution" under § 302(b)(2). To be considered a substantially disproportionate distribution, following the redemption the shareholder must own less than 50% of the total combined voting power of all the classes of voting stock. Furthermore, the redeemed shareholder's voting stock must be less than 80% of his or her voting stock prior to the redemption period.

E. If the shareholder fails the complete redemption test and the substantially disproportionate distribution test, he or she can still qualify for sale/exchange treatment if the distribution is "not essentially equivalent to a dividend." § 302(b)(1). This test is much more difficult to apply, given that there is no bright line rule but simply a facts and circumstances analysis of whether the redemption results in a "meaningful" reduction. *US v Davis*, 397 US 301 (1970); Rev. Ruls. 75-502, 75-512, and 78-401.

F. The attribution rules under § 318 must be given careful consideration when determining whether a shareholder fits into § 302(b). Under § 318, stock owned by family members, trusts, estates, corporations, or partnerships may be attributed to a shareholder, even if the stock is not owned by the shareholder. § 318(a).

G. § 318(a)(1) governs the family attribution rules, wherein stock owned by designated members of a taxpayer's family will be deemed constructively owned by the taxpayer. Attribution occurs with respect to stock owned by the taxpayer's spouse, children (to include legally adopted children), grandchildren, parents, and a spouse.

H. § 318(a)(2) covers the entity attribution rules, applying to partnerships, corporations, estates and trusts. Stock owned by an entity is deemed to be proportionately owned by the owners of the entity. Additionally, stock owned by those having an interest in the entity is generally attributed in full to that entity; however, with respect to corporations, § 318(a)(2)(C) holds that stock will not be attributed to or from a shareholder unless the shareholder owns 50% or more in value of the stock in a given corporation.

I. § 318(a)(2)(A) holds that stock owned (directly or indirectly) by an estate is considered as owned proportionately by the estate beneficiaries. An estate beneficiary will include any person entitled to receive property under the terms of the will or by the laws of descent and distribution. Treas. Reg. § 1.318-3(a).

J. Once an individual is no longer considered a beneficiary of an estate, the estate attribution rules no longer apply. An individual is no longer considered a beneficiary of an estate if the property to which he or she is entitled has been distributed and received; he or she no long has a beneficial claim against the estate; and there is only a remote possibility that the estate would seek contribution from her to satisfy claims against the estate. Treas. Reg. § 1.318-3(a). However, you will not be able to satisfy these elements if the beneficiary is a residuary beneficiary, as discussed below.

K. Because of the family attribution rules, stock ownership of family members that continues after the redemption prevents apparent "complete termination" unless a waiver of family attribution can be effected. IRC § 302(c)(2). The problem is that these waivers affect only family attribution, and not the estate or trust attribution rules, which creates particular concern in the estate or trust context. See *Crawford v. Comm.*, 59 T.C. 830 (1973); *Robin Haft Trust v. Comm.*, 62 T.C. 145 (1974).

L. The typical post-death redemption deals with all stock of the deceased owner, and it appears to be a "complete redemption." But where other related shareholders are involved, the attribution rules regarding estates and trusts still create problems. Thus, an estate is treated as if it "owns the stock" of its beneficiaries. IRC § 318(a)(3)(A).

1. If the estate's beneficiaries own stock, directly or indirectly, after the redemption, then ownership is attributable to the estate, and a redemption from the estate will not qualify as a complete redemption for tax purposes.

2 One way to avoid this attribution is to distribute the stock to the beneficiary prior to the redemption, but that won't work if the beneficiary is a residuary beneficiary.

3. Therefore, this needs to be considered in the planning stage, but that only works if the distribution is outright, rather than into a testamentary trust for beneficiaries who also own stock individually. See *Robin Haft Trust*, supra.

M. In *Crawford* cited above, the Court held that the family attribution rules could be waived if stock was redeemed from both the estate and his sole beneficiary and after the redemption the beneficiary's children were the only stockholders.

N. *Robin Haft Trust* held that family attribution rules could not be waived in connection with the estate beneficiary rules.

O. *Rickey v. U.S.*, 592 F.2d 1251 (5th Cir. 1979), responded by holding that estate-beneficiary rules could be waived, as well as family attribution rules.

P. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress essentially adopted *Crawford* and allowed waiver of family attribution rules, but not estate beneficiary rules, thereby overruling *Rickey*.

Q. Thus, from the planning standpoint, an estate beneficiary should receive not only stock, but the entire interest from the estate before the redemption takes place, which means that they cannot be a residuary beneficiary. If any portion of the estate remains to be distributed to the beneficiary, the estate beneficiary relationship continues, even though the stock has been distributed from the estate.

R. In the estate context, also consider the availability of IRC § 303 which is a taxpayer-friendly provision treating a stock redemption at the shareholder's death as a capital transaction. In order to qualify for § 303, two rules must be satisfied the redemption cannot exceed the total of all death taxes, funeral and administrative costs allowable under § 2053; and the value of the stock in the corporation as held by decedent must be at least 35% of the adjusted gross estate of decedent and the distribution must be within 90 days after the expiration of the three-year limitations period for the assessment of estate tax set forth in § 6501(a) (subject to extensions by Tax Court proceedings and §6166 elections).

III. ENTITIES TAXED AS A PARTNERSHIP

A. For entities taxed as partnerships, § 731 provides in general terms that neither the partner/member nor the entity recognizes gain or loss on a distribution of money or property to the partner/member; however, there is an exception when the distributed money or marketable securities treated as money exceeds a partner/member’s basis in his or her entity interest. In that case, the partner/member will recognize a gain from the sale or exchange of his or her entity interest (capital gain) to the extent of the excess. §§ 731(a)(1); 731(c)(1).

Generally, current distributions never result in a loss, although liquidating distributions can cause a partner/member to recognize a loss on the sale of an entity interest if the distributions consist solely of money, unrealized receivables, or inventory. § 731(a)(2).

B. While generally speaking there is no recognition of gain or loss on an in-kind distribution of property, property distributions will be treated as cash distributions in two instances:

1. if property distributions reduce a partner/member's share of entity liabilities, the reduction is to be treated as a cash distribution under § 752(b); and

2. a distribution of marketable securities will be treated as a distribution of cash in most cases under § 731(c).

C. Where the entity has debt, redeeming a partner/member's interest is going to force a reallocation of the partner/member's share of the entity's liabilities, which might entail immediate tax consequences. Under § 752(b) a reduction in a partner/member's share of a liabilities is a deemed distribution of money to that partner/member, and § 731(a) requires a partner/member to recognize gain to the extent the money distributed exceeds the adjusted tax basis of the partner/member's interest.

D. As mentioned above, all or some of distributed marketable securities may be treated the same as a money distribution under § 731(c); however, there are two common exceptions to the “marketable securities are money” rule of § 731(c).

1. § 731(c) does not apply to distributions of marketable securities if the security was contributed to the entity by the partner/member 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. § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i).

2. § 731(c) does not apply to distributions of marketable securities by investment partnerships to eligible partners. Treas. Reg. § 1.731-2(e)(1). An investment partnership is defined by § 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.

E. Be aware that § 704(c) requires that any gain from the sale of appreciated property contributed to an entity is to be allocated among the partners/members in a manner that takes into account the property's built-in gain and contribution. This built-in gain must be allocated to the contributing partner/member. Any gain in excess of the built-in gain can be allocated as the partner/members agree among themselves.

F. Be further aware of the 7 year Rule under § 704 (c)(1)(B). § 704(c)(1)(B) was devised to keep partners from avoiding their § 704(c) gain or loss by having the partnership distribute their contributed property to another partner/member within seven years of its original contribution. If § 704(c) property is distributed to any partner/member other than the contributing partner/member within seven years of the original contribution, the contributing partner/member must recognize gain or loss and the amount in character that such property would have been allocated under § 704(c)(1)(A) had it been sold to the recipient partner/member at its fair market value on the date of the distribution. The best option to avoid this result is to simply wait longer than seven years to distribute the property.

G. § 737 can also trigger gain (but not loss) to a contributing partner/member if within seven years of a contribution the contributing partner/member receives a distribution of property, other than the property he or she contributed. The partner/member is required to recognize gain equal to the excess distribution (meaning the excess of the distributed property's value over the partner/member's outside basis) or the partner/member's net pre-contribution gain or pre-contribution gain not previously recognized. Again, much like with § 704(c), §737 applies only to contributions made within seven years preceding a distribution.

H. Under § 736, when an entity redeems a partner/member's interest in full, IRC § 736(a) provides that payments may be deductible to the entity and ordinary income to the selling partner/member. Or, they may choose to apply IRC § 736(b) so that the payments are nondeductible to the entity and capital gain to the partner/member. Generally, the redemption agreement can provide that as much or as little of the redemption payments receive treatment under IRC § 736(a) or (b). However, capital gain payments:

1. cannot exceed the fair market value of the withdrawing partner/member's share of the entity property. Treas. Reg. § 1.736-1(b)(5)(iii); and

2. cannot include certain payments for goodwill, accounts receivable and inventory. § 736(b)(2).

I. § 754 can be very important to an estate, given the income tax consequences related to the step-up in basis of the decedent's entity interest. § 754 allows for the entity to equalize the inside basis (the entity's basis of the partner/member's pro rata portion of the underlying property) with the outside basis (the partner/member's basis in his entity interest). This § 754 election is particularly useful if the entity consists of depreciable property like rental real estate; the election allows the entity to depreciate the property once again using the higher basis for the deceased partner/member, making additional income tax deductions available to the estate and its beneficiaries.

J. If there is no § 754 election in place at the time of the partner/member's death, and the partnership will not make a § 754 election, the estate can still proceed under IRC § 732. A § 732(d) election can be made by the estate without the consent of the entity or of any of the partner/members. It does not affect the entity or the other partner/members; however, a § 732(d) election only applies to distributions of entity property to the estate and cannot be used for purposes of establishing the estate's share of any depreciation or gain or loss on the sale of the entity property by the entity.

IV. BUY-SELL AGREEMENTS AND § 2703

A. A buy-sell agreement provides for a controlled conveyance of a closely held business. The agreement details what will happen with the owner's interest upon specific events, such as retirement or death. However, if the buy-sell agreement is among family members, be wary of IRC § 2703.

B. For purposes of determining the taxable estate of a deceased business owner, the fair market value of the business interest will have to be established as of date of death. 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." Treas. Reg. § 20.2031-1(b). A buy-sell agreement, by its terms, would appear to satisfy the definition of fair market value, but §2703 could enter the picture.

C. For gift, estate and GST tax, IRC § 2703(a) provides that the value of any property shall be determined without regard to 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 any restriction on the right to sell or use such property.

D. Typically § 2703 attempts to address abuses involving a parent and child setting an artificially low buy-out price whereupon the surviving shareholder is allowed to purchase the interest for less than the fair market. Absent § 2703 the below-market price that the child would pay to the deceased parent's estate for the stock would establish the value for estate tax purposes due to the estate's legal obligation to complete the contract at the designated price. Under § 2703, the IRS can ignore the value established by such an agreement, even though it does not effect the contractual obligation of the decedent's estate to convey the stock at that price.

E. In the worst case scenario, the parent's estate could be obligated to sell at the lesser value, while still having to pay a much higher transfer tax based upon the IRS's determination of fair market value. If that discrepancy in value is large enough, the estate may be in a position where the sale price for the stock could fail to satisfy the estate tax liability stemming from the stock. For something like the worst case scenario see *Estate of True v. Comm*. 390 F.3d 1210 (10^{th} Cir. 2004).

F. § 2703 sets out the general rule that the property subject to a restrictive agreement is valued for transfer tax purposes without regard to such restrictions; however, there is an exception to the general rule. § 2703(b) provides that the general rule shall not apply to any option, agreement, right or restriction if it meets each of the following three requirements:

1. it is a b*ona fide* business arrangement;

2. the agreement is not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and

3. the terms of the agreement are comparable to similar arrangements entered into by individuals engaged in an arms length transaction.

While the first two requirements are hard to satisfy, the third requirement makes it very difficult to prevail, given that comparable arrangements could be impossible to find.

G. Further § 2703 is limited to arrangements between family members.

> "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 [Treas. 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 [Treas. Reg.] § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family." Treas. Reg. § 25.2703-1(b)(3) .

Accordingly, it could be that a non-family member would be considered a family member for the safe harbor purposes.