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BUSINESS ORGANIZATIONS AND ESTATE PLANNING

by
*Ethan B. Stroud**

IN EGYPT many years ago, Joseph told the taxpayers that: "And at the harvest you shall give a fifth to Pharaoh, four-fifths shall be your own, as seeds for the field and as food for yourselves and your household, and as food for your little ones."¹

Today, unfortunately for the modern taxpayer, that ratio has been reversed. The twentieth-century Pharaoh, acting through his collector of internal revenue, may take the four-fifths fraction for his own and the twentieth-century taxpayer in many cases, may keep only one-fifth for himself and his household. At the modern harvest time, on April 15th of each year, as much as ninety-one per cent of an individual's income may be collected and amounts up to seventy-seven per cent can be appropriated from the estate of a deceased person.²

Estate planning for business organizations is therefore most important if for no other reason than the reduction or legal avoidance of estate, income and gift taxes. Although today tax reduction and tax avoidance is not so easy a thing to accomplish as it was back in the days when irate taxpayers dumped tea into the harbor in Boston, there is certainly nothing sinister in arranging one's affairs in order to keep taxes as low as possible.³

Estate planning is, however, a good deal broader and more comprehensive than simply a plan of tax reduction (as important as that is). Estate planning for business organizations properly comprehends and includes all of those steps called for in connection with a person's property which anticipate the passing of such property, either during lifetime or after death, with a minimum shrinkage caused by gift, estate and income tax with maximum provision in favor of those whose welfare and financial security is of concern to the business owner. Estate planning is a continuing process during a person's life. It involves a lifetime of business planning and is therefore a continuing activity designed to achieve pragmatic and useful ar-

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¹ Genesis 47:24.

² Int. Rev. Code of 1954, §§ 1, 2001.

³ For example, as Judge Learned Hand commented in a recent case: "Over and over again, Courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: Taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

rangement of one's business enterprise and property and at the same time also provide advantageous post-death results. The plan should be designed to afford the greatest enjoyment to the whole family group commensurate with sufficient conservation.

It is puzzling why a person will spend a lifetime building his business and accumulating property and then spend only a few minutes attempting to dispose of it on, perhaps, one sheet of paper. This same business owner will think nothing of spending hours and even days in devising imaginative ways of avoiding income taxes on any particular business venture and yet will begrudge spending an hour or two on his entire lifetime estate plan. A businessman is never dismayed by a ten-page contract, but there seems to be frequent dismay and complaint over a ten-page will!

Estate planning for business organizations must necessarily begin with the desires, objectives and wishes of the business owner. A businessman is ordinarily most vitally interested in providing for the immediate and future needs of his family and dependents. Without weakening his own present financial status, an owner will ordinarily want to be assured that his family and dependents will be well taken care of through the medium of his business enterprise⁴—whether it be continued or liquidated. In the event of his death, he will want his death taxes avoided or reduced as much and in as great a degree as is legally possible under the prevailing rules of the tax game. He will want to utilize his business organization, where feasible, in payment of the death taxes, debts and other expenses which will be due on his death. Finally, he will want to be assured that the control of his business organization is in the hands of his selected beneficiaries.

The tax laws of our country have multiplied and proliferated the types of organizations and entities commonly utilized in today's business activities. Businessmen may operate through the medium of proprietorships, corporations, unincorporated business enterprises electing to be taxed as corporations, general partnerships, limited partnerships, syndicates, joint ventures, trusts, estates, tax haven corporations, Western Hemisphere trade corporations, China trade act corporations, associations which are taxable as corporations, tax exempt organizations, and corporations which elect to be taxed as partnerships.

This Article is concerned with estate planning for the small busi-

⁴ The businessman will usually include in his thinking other assets such as life insurance, stock, bonds and real estate.

ness owner who conducts his enterprise through the medium of a sole proprietorship, a small partnership or a closely held corporation.

I. GENERAL ESTATE PLANNING CONSIDERATIONS OF THE BUSINESS OWNER

In estate planning for business organizations one of the threshold questions is to determine whether the business enterprise should be continued or disposed of upon the owner's death. This fundamental decision, if not made during the owner's lifetime as an aspect of his estate plan, may have to be made during the administration of his estate when the opportunity to take remedial action may have been lost. The retention of a business interest after the owner's death simply means the continuation of that enterprise in the hands of the other members of the decedent's family or trustees for the benefit of the decedent's beneficiaries. Retention of a business interest may be accomplished by either inter vivos or testamentary direction and without a conversion for other consideration by the decedent's estate or his legatee.

Continuation or retention of a business organization will not necessarily be the goal in all situations. It may, on the other hand, be more feasible and desirable to bring about a complete liquidation and termination of the business organization. If it is determined that continuation of the business is desirable, then plans and action taken during the owner's lifetime are generally indispensable to accomplish this result in a reasonable and economic fashion.

A. *Reasons For Retaining Business*

The decision to continue a business after the death of the owner is ordinarily motivated by one or more of the following factors.

First, the business undoubtedly represents an attractive way of maintaining a high income for the owner and his beneficiaries. The income from such a business is frequently larger than that which might be obtainable from other types of investment. Even if the financial situation of the survivors or beneficiaries is such that they do not require high income, it might still be favorable to retain the business solely because of the future capital growth inherent in that business.

Second, the business owner may have a son, minor child or other close relative for whom the owner would like to have the business continued in the future. The business might continue to provide a substantial income for such beneficiaries.

Third, in many instances, the owner may have available successor

management who can take over and operate the business after the owner's demise. There may be employees with long and faithful service who will be forced to find employment elsewhere if the business is dissolved or sold. Therefore, the owner may feel morally obligated to these key men in his business and may desire to enable them to carry on the enterprise after his death.

Moreover, the continuance of the business organization may be the only means of ultimately realizing a fair price based on the true value of the business as a going concern. If the business is the kind which is not suitable to sell, the decision to retain it may be forced upon the owner. For example, even after a conscientious and long continued effort, there may be no purchasers available, or if available, the price which they are willing to pay is so niggardly that the owner is unwilling to sell.

If the owner has other non-business assets, such as stocks, bonds, real estate or insurance, which constitute a sufficient source of funds to provide the cash and liquidity which will be needed in the event of the owner's death, there may be no need to sell or liquidate the business in order to meet the claims of creditors and tax collectors.

In addition, there may be factors favoring retention of the business enterprise which are unrelated to financial considerations. For example, the businessman may have a certain pride of ownership in his enterprise and may be desirous of retaining and transmitting the organization as part of his estate. The business may have had a long family history with a background of tradition and sentimental attachments. The business may be a way of perpetuating the family or owner's name.

These factors which favor the retention of the business organization must be weighed and balanced against all of the reasons which favor its disposition. The owner must carefully examine with candor and perspicuity the reasons and factors for selling or disposing of the enterprise.

B. Reasons For Disposing Of Business

First, of course, the owner may be the only one available with sufficient stature and leadership to assure the future prosperity of the enterprise. The owner's death may eliminate any possibility of retaining the organization by virtue of the fact that there are no skilled or experienced persons to take over and operate the business organization. The owner may have no children, spouse or other close relatives that are interested in, competent or qualified to manage the business and it may not be feasible or practical for a trustee, such

as a bank, to succeed to his responsibilities in connection with managing and operating the business and carrying it on for the benefit of the owner's family. Thus, the business may have no going concern value after the owner's death.

Second, if the great bulk of the owner's net worth is invested in the business organization it may be absolutely necessary to sell either all or part of the business in order to raise the necessary cash and to have the necessary liquidity with which to meet the obligations of creditors and tax collectors. The federal estate tax is due within fifteen months after the death of an owner and the local inheritance tax may be due even sooner.⁵ To be added to this considerable financial outlay will be the debts and administration expenses of the owner.

In many instances the death of the business owner will cause a curtailment of the salary or net income to which the owner's family has become accustomed. Where the owner's beneficiaries are entirely dependent upon the owner's net estate remaining after the payment of administrative expenses, debts and death taxes, it may be imperative to arrange for a sale or other disposition of the business organization with the proceeds to be reinvested in a conservative portfolio of stocks and bonds. This portfolio should be designed to offer the owner's beneficiaries steady income, little capital risk, a ready market and if management is needed consideration should be given to the use of a trust. Moreover, the business organization may not be saleable except as a unit and therefore under circumstances of this kind the entire enterprise may have to be disposed of. This problem is an especially difficult one if the business organization constitutes a proportionately large part of the owner's net estate and has no existing market or only a very limited one.

Thus, depending upon which of these factors predominate, a business organization may be (1) retained as part of the estate, (2) sold by the estate, (3) bequeathed, (4) liquidated upon death, or (5) transferred by sale, tax free exchange or gift during the owner's lifetime. The estate planning solution in any particular case will, of course, depend upon the type of business organization which is involved.

II. SOLE PROPRIETORSHIP

The sole proprietorship is not a business organization separated from its owner. A proprietorship is not taxed as an entity apart from its owner, even though a separate set of accounting records may be

⁵ Int. Rev. Code of 1954, § 6075(a); Tex. Tax-Gen. arts. 14.12, 14.16 (1960).

kept for the business enterprise. The individual owner conducting the proprietorship is taxed on the income of the business only once and at rates applicable to individuals. The business will terminate upon the death of the owner unless provision is made for the continuance of the enterprise by family members or by legal representatives. Another characteristic of the sole proprietorship is that by definition there are no others with proprietary interests to carry on or to purchase the enterprise. Moreover, unlike a corporation, the death of the sole proprietor may well be disastrous to the business since this sole owner may embody the only managerial talent, business experience and capital which is employed in that business. The taxation of the business profits directly to the business owner may stultify the growth of the business and is very likely to impede the accumulation of profits in the business itself. Furthermore, the sole proprietorship because of its dependence upon the talents of one person may have a limited market and a narrow appeal from the standpoint of a sale or other disposition.

Typical examples of proprietorships range from the small one man organizations like the corner grocery store, drug store, insurance agent, contractor, to the lone practitioner of a profession such as the architect, doctor, dentist, engineer or lawyer.

The critical question facing the sole proprietor in his estate planning is whether there will be available on his death a capable successor to his one man operation. It may be that the business is run by a husband and wife team in which event the wife would be quite qualified, competent and interested in carrying on the business. An adult child might be another choice as a successor and in addition there may be other relatives who have an ability to carry on the organization. If there is neither wife, child nor relatives who are interested in the business, there may be capable employees who would purchase the proprietorship from its owner.

If there is no adult child of the owner but a minor child who may eventually want to go into his father's (or mother's) business, then thought should be given to the creation of an inter vivos trust of part of the enterprise⁶ for this child or a testamentary trust in the proprietor's will which would continue the entire business until such time as the child attains his majority or is in a position to decide the matter of retention or disposition. Although it is doubtful whether many corporate trustees would be willing to operate an unincor-

⁶ Int. Rev. Code of 1954, § 704(e), provides that a person shall be recognized as a partner if he 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.

porated business interest in a trust,⁷ a faithful employee or reliable relative might be prevailed upon to serve in this capacity for a few years.⁸

Where the owner of the sole proprietorship has solved the problem of successor management and desires to retain his interest for his estate or heirs, the next big hurdle is to ascertain whether or not his estate will have the liquidity with which to meet the administrative expenses, debts and death taxes. It is most important that proper planning be undertaken to have available the cash for these obligations which will be needed at death. These cash requirements can be calculated roughly in advance.⁹ The business will have to be appraised and its value added to the other assets of the owner. The estate and inheritance taxes can then be approximated.

Ways and means of obtaining part of the cash requirements from the business itself may include selling assets to a third party and leasing them back in those cases where the business has real property or other assets suitable for sale and leaseback. Another answer might be found in long-term financing using the same assets as collateral security for the loan. Still another method of reducing the cash requirements needed on death might be to invest a certain amount of the owner's non-business property in real estate located abroad. Since real estate located abroad is specifically exempt from the gross estate pursuant to Section 2031(a) of the Code, the amount of estate tax which would be subsequently due would be reduced proportionately.¹⁰

A new section added to the Internal Revenue Code permitting installment payments of tax may be very useful in reducing the amount of immediate cash necessary for the payment of the federal estate tax.¹¹ If the sole proprietorship constitutes a sufficiently large portion of the owner's estate, it will be possible to pay in ten or fewer annual installments that part of the estate tax attributable to

⁷ See Cowdery, Trachtman, Pfeleiderer & Johnson, *Handling Businesses in Trust*, 93 *Trusts & Estates* 105 (1954).

⁸ When a small business is to be administered by a testamentary trust, one of the major objectives may be to have the income spread among the beneficiaries in low brackets or, by the use of a spray power, a portion between beneficiaries and the trust itself, as the trustee may determine. The purpose to minimize taxation in this regard may be thwarted if the trustee insists that the business in trust be incorporated. It appears that many corporate trustees demand this be done to reduce their potential liability as fiduciaries. It may be possible to have the bank or trust company refrain from demanding incorporation where adequate powers and protective clauses are placed in the will with respect to decisions made by the trustees in running the business.

⁹ In addition to cash savings and marketable securities one of the most important sources for cash funds is insurance on the life of the owner.

¹⁰ See note 50 and accompanying text *infra*.

¹¹ Int. Rev. Code of 1954, § 6166.

the inclusion of the value of the business interest in the gross estate. If the value of the proprietorship exceeds either 35 per cent of the owner's gross estate or 50 per cent of his taxable estate, the cash requirement may be reduced by making an election pursuant to this section. It is important in estate planning for the sole proprietor to make certain that these exact percentage requirements can be met. If the business owner desires to utilize this installment payment of the estate tax and there is any doubt as to whether the percentages can be complied with, several steps can be taken to meet the requirements of this section. The owner may increase his investment in the business or he may decrease the value of the balance of his gross estate. The latter step may be accomplished by inter vivos gifts¹² to members of his family, inter vivos charitable donations or investments in real property located abroad.

A. Changing The Form Of The Sole Proprietorship

In the initial stages of estate planning, it may be appropriate for the owner of the sole proprietorship to give some thought to changing the form in which he is doing business. Not all of the estate planning techniques are available to the sole proprietor and other sound planning devices favor the partnership or corporate form of doing business. At this point, the arithmetic of a particular situation may indicate clearly that it would be more advantageous for the owner to incorporate his business. Incorporation might prove advantageous during the owner's lifetime as well as at his death, since the corporation is taxed as a separate entity with a tax rate of only 30 per cent on the first \$25,000 of taxable income and may accumulate profits up to \$100,000 without the imposition of an improper accumulation penalty.¹³ Moreover, shares of stock are easy to dispose of to multiple beneficiaries both during the owner's lifetime and after his death.¹⁴

B. Section 1361 Of The Code

In addition to the alternative of actually incorporating his business under state law, the sole proprietor has been given an option under Section 1361 to be treated and taxed as a corporation. Gen-

¹² The gift tax permits annual exclusions of \$3,000 for each donee for gifts of a present interest. A future interest does not qualify for this annual exclusion, with the exception of certain gifts in trusts for minors pursuant to the provisions of Int. Rev. Code of 1954, § 2503(c). Each taxpayer has a lifetime exemption of \$30,000. For example, a husband and wife may give away \$60,000 during their life without the imposition of a gift tax.

¹³ Int. Rev. Code of 1954, § 531.

¹⁴ Other advantages of the close corporation are presented in the text accompanying note 40 *infra*.

erally, this option is available to a proprietor who does not have more than a 10 per cent interest in the profits or the capital of any other unincorporated business enterprise taxable as a domestic corporation and if the proprietorship is one in which capital is a material income producing factor, or 50 per cent or more of the enterprise's gross income is derived from trading in its own name or from brokerage commission. In other words, 50 per cent or more of a proprietor's gross income must consist of gains, profits or income derived from trading as a principal or from buying and selling real property, stock, securities or commodities for the account of others. The election under Section 1361, once made, is irrevocable except that where there is a 20 per cent or more change in the capital and profits a new election becomes available. Obviously there are many proprietorships which cannot meet these stringent requirements and could therefore not make this tax election. Note also that the electing proprietor will not be considered an employee for purposes of Section 401(a), relating to qualified stock bonus, pension or profit sharing plans.

C. Disposition Of Sole Proprietorship

If because of a failure to find competent successor management, excessive needs for cash or the desire of the sole proprietor to reinvest the proceeds of the enterprise in a more conservative form, it is decided to sell or dispose of the organization, then good timing and the method of sale or disposal become very important.

An inter vivos sale of a proprietorship will ordinarily be preferred to a testamentary one. The business will undoubtedly bring a higher price during the owner's lifetime than it will in a post-death sale. It will usually be more advantageous for the sole proprietor to be present in order to participate, negotiate and help his attorney in handling the sale. The proprietor may even be willing to offer the purchaser the assurance that he will continue with the business, either as a manager, administrator or on a consulting basis. With a proprietorship this assurance is usually more valuable than a covenant not to compete. This assurance would provide the purchaser with the proprietor's continuing knowledge, skill and contacts. Moreover, such a limited continuation in the business may ease the proprietor through the conflicting motivation of desiring to sell the business during his lifetime on the one hand and hesitating to retire on the other. The easiest solution will, of course, be a sale to an interested purchaser who has sufficient financial ability to pay a fair market figure for the business enterprise. To facilitate the purchase the business could be disposed of on an installment purchase basis.

If the business is not sold until death, the purchase price of such a business will undoubtedly be much smaller where there is an express direction to the executors to sell the enterprise. Unless there is a pre-arranged sale, the sole proprietor's will should not direct the sale or liquidation of the business. Mandatory action may depress the market for the proprietorship. If a sale of the business has been arranged before death, and is to be carried out after death by a buy and sell agreement, then the will should expressly instruct the executor to comply with the terms of the sale.

If the owner sells the business during his lifetime there will be recognizable gain or loss.¹⁵ Where the owner's basis in the business is substantially less than the proceeds received from the sale, there will be a correspondingly substantial tax. This tax will, of course, reduce the amount available for investments in other media, but there is some consolation in the fact that only the net proceeds of this transaction after income tax will be later subject to the estate tax. Of course, if the proprietorship is retained until the owner's death, the property will receive a new basis equivalent either to the date of death value, or its value at the optional valuation date. That value will thereafter be the basis of the interest for purposes of determining taxable gain or loss. Thus, if the proprietorship is disposed of shortly after the owner's death there should not be any substantial income tax to the estate.

The executor or administrator and the legatees who acquire title do not step into the shoes of the decedent. The personal representative stands in a different position, because the functions and activities of an executor, who administers and liquidates an estate, normally do not constitute the carrying on of a trade or business.¹⁶ It follows, therefore, that usually the assets of a business become capital assets upon or after the death of the proprietor.

D. Buy-Sell Agreement

An agreement between the proprietor and the prospective buyer, who may be either an employee, competitor or some third party, generally provides as a minimum for the inclusion of the following points to take effect at or after the death of the proprietor: (1) an agreement to purchase and sell the entire business; (2) a method of determination of the purchase price for each type of asset; (3) an allowance for liabilities assumed; (4) the time when the sale is to be consummated; (5) a method of payment to the estate; (6) a

¹⁵ Int. Rev. Code of 1954, § 1231.

¹⁶ Estate of Jacques Ferber, 22 T.C. 261 (1954).

provision for default by either party; (7) collateral to be supplied by the buyer; (8) restriction on use of trade name, patents or other intangibles; (9) bond or other protection to save the buyer harmless from income or death taxes and other debts of the decedent; and (10) a statement concerning the binding effect of the agreement.

III. PARTNERSHIP

A partnership is a multiple proprietorship form of business organization composed of an aggregate of individuals doing business together as co-owners for a profit. Like the proprietorship, but unlike the corporation, the partnership is not treated as a separate and distinct entity apart from its owners.¹⁷ For most purposes a partnership is considered to be a mere conduit through which the business income passes into the hands of its members. Hence, a partnership's income tax return is generally nothing more than an information return.¹⁸ Partners are taxed only once on their distributive shares of partnership income and at rates applicable to individuals. Like the proprietorship, and again unlike the corporation, the partnership offers no tax shelter to its owners and the business is unable to accumulate capital at advantageous rates. The Internal Revenue Code defines a partnership broadly as a syndicate or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, estate or corporation.¹⁹

The partnership, like the proprietorship, is a fragile thing and under the Texas law the death of a partner may dissolve the partnership.²⁰ The tax law provides, however, that a partnership will continue unless no part of its business is carried on in a partnership or a 50 per cent interest changes hands within a year.²¹ Furthermore, the partnership agreement may provide for the continuation of the

¹⁷ The Texas courts, following the common-law view, have repeatedly stated that the partnership is not a legal entity separate from the partners. *Frank v. Tatum*, 87 Tex. 204, 25 S.W. 409 (1894). Although income taxation of the partnership is unaffected, the partnership is an entity for most purposes of the Texas Uniform Partnership Act. Bromberg, *The Proposed Texas Uniform Partnership Act*, 14 Sw. L.J. 437, 445 & n.25 (1960); see *Sher & Bromberg, Texas Partnership Law in the 20th Century*, 12 Sw. L.J. 263, 269 n.31 (1958). The Act became effective on January 1, 1962. *Tex. Rev. Civ. Stat. Ann. art. 6132b, § 45* (1961).

¹⁸ *Int. Rev. Code of 1954, § 701*.

¹⁹ *Int. Rev. Code of 1954, § 7701(a)(2)*.

²⁰ *Martin v. Dial*, 57 S.W.2d 75 (Tex. Com. App. 1933). The Texas Uniform Partnership Act permits agreement that the death of a partner will not cause dissolution of the partnership. *Tex. Rev. Civ. Stat. Ann. art. 6132b, § 31(4)* (1961) (effective Jan. 1, 1962; see note 17 *supra*); see Bromberg, *supra* note 17, at 456-57; cf. *Sher & Bromberg, supra* note 17, at 302 & n.210.

²¹ *Int. Rev. Code of 1954, § 708(b)(1)*.

partnership in the event of the death of a partner. The agreement may also provide that the surviving partners will carry on the business and pay to the estate of the deceased partner, over a period of years, a designated portion of the partnership earnings.

Unlike the sole proprietorship, the partnership will presumably have one or more persons competent and interested in continuing the business enterprise after the death of one of the partners. Thus, any going concern value may be maintained for the estate of the deceased partner or prospective purchaser of the deceased partner's interest.

The estate planning problems faced by the owner of a partnership interest are similar to those problems faced by the sole proprietor, inasmuch as the partnership is a form of multiple sole proprietorship. Should the partner's interest be retained for his family or should it be disposed of? Does the partner have a family member, such as a wife, adult child or other relative with the interest and ability to replace him as a partner? Will the surviving partners in the partnership business be willing to accept such a designated beneficiary as a new partner? Will the partnership agreement permit a deceased partner to select a successor partner? In a professional partnership composed of lawyers, doctors, accountants, engineers or architects it will not be possible for a deceased partner's wife, child or relative to replace him unless such person is also a member of that profession and licensed in that particular state.

Another question facing the partner is whether his capital—if capital is a material income producing factor in the partnership—can be employed as profitably in some other type of investment. The probability is that his capital has been earning more in that particular partnership business and is also subject to greater risks than in some more conservative investment.

Liquidity of the partner, as in the case of the sole proprietor and the owner of a close corporation, is a most important consideration. The liquidity problem, at least in connection with the federal estate tax, may be ameliorated under proper circumstances by reliance on the new provisions of Section 6166, which provide for payment in ten or fewer annual installments. However, the partner must meet two requirements. First, the value of his partnership interest must exceed either 35 per cent of his gross estate or 50 per cent of his taxable estate. Second, the partnership must have ten or fewer partners or the partner must own 20 per cent or more of the total capital interest in the partnership. A valuation must be made of the partnership interest and this value must then be compared with the

other non-partnership assets. The percentage requirements of this section can then be complied with either by increasing the value of the partner's interest in the partnership or by decreasing the value of the remainder of his estate.

If the estate planning decision has been made in favor of a disposition of the partnership interest, there are essentially three methods which may be utilized. First, there may be a cash distribution by the partnership in liquidation of the interest. Second, there may be a property distribution by the partnership in liquidation of the interest. And, third, there may be a sale to a partner or to a third party. Each method, depending upon the controlling circumstances, may result in different tax consequences to both the partner and the partnership.

Payment to a deceased partner's estate under a partnership agreement for his entire interest in capital and profits is treated as a capital transaction.²² There are two exceptions to this rule where distributions are made by a partnership. These are payment for (a) unrealized receivables and (b) good will of the partnership, unless the partnership agreement provides for payments with respect to good will.²³ Any payment in excess of the amount agreed to be paid for a partnership interest, such as a distributive share of income or a guaranteed payment, will be considered income to the partner and a deduction of the partnership, or in the case of payments geared to profits, as a reduction of the distributive share of the other partners.²⁴ If a partnership agreement provides for payments for the deceased partner's share of good will, such payments are also capital in nature. Any payments in excess of the value of a partner's interest (without an agreement) would be ordinary income.

In measuring the gain or loss upon a sale or liquidation of a deceased partner's interest, that portion of the proceeds, other than that taxable as ordinary income, will be offset by the decedent's basis for his interest, so that there may be a capital or Section 1231 loss to offset ordinary income. The basis of the partnership interest (excluding receivables) to the decedent's estate will be the fair market value at the date of death or, if the alternate valuation date is elected, the value one year after death or the value during such year if the interest is sold or liquidated at such time. Due to the stepped-up adjustment and basis upon death, it is unlikely that there will be a substantial variation between the sales price or the amount

²² Int. Rev. Code of 1954, § 741.

²³ Int. Rev. Code of 1954, § 736(b)(2).

²⁴ Int. Rev. Code of 1954, § 736(a).

received in liquidation shortly thereafter and the basis adjusted to market value at the date of death.

If the partnership agreement provides for continuing payments to a deceased partner's estate, the primary problem is to determine when the payments to the estate are taxable to the estate as income in respect of a decedent and when they are to be treated as a return of capital, taxable only to the extent that they exceed the estate's basis for its partnership interest. It is also necessary to determine, in connection with the remaining and surviving partners, when the payments are to be treated as a distributive share of partnership income or guaranteed payments, deductible in computing the survivor's own distributive shares, and when they are to be treated as the purchase price of the decedent's interest in the partnership.

Although prior to the enactment of the 1954 Code the earlier case law was not clear in answer to these questions, Section 736 solves most of the uncertainty in this area. Section 736 divides payments made to the estate of a deceased partner into two categories: (1) those made to acquire the decedent's interest in partnership properties including good will, if the partnership agreement provides for a payment for good will, but not including unrealized receivables; (2) all other payments. Under Section 736(b), payments in the first category are taxed as a liquidating distribution. They are not taxable to the estate, except to the extent that they exceed the estate's basis for its partnership interest. Accordingly, they do not reduce the remaining partner's distributive shares of partnership income, but might cause an adjustment of the bases of the remaining partnership assets.

Payments in the second category include payments for the decedent's interest in unrealized receivables, payments in the nature of mutual insurance and payments attributable to good will where the partnership agreement does not provide for a payment for good will. Under Sections 736(a) and 753 they are taxed to the estate in full as income in respect of a decedent and, if based upon the partnership's profits, will be treated as a distributive share of partnership income, which will consequently reduce the survivor's distributive shares. If determined without regard to the partnership income, they are treated as guaranteed payments deductible as an expense by the partnership.

A. Buy-Sell Agreement

It may be highly desirable for the partners to enter into an inter vivos business purchase agreement whereby the surviving partners

agree to purchase the interest of a deceased partner. The business purchase agreement binds the surviving partner to purchase, and the estate of the deceased partner to sell, the business interest of the decedent at a determined or fixed formula price. This type of purchase agreement can be a very satisfactory solution to both the decedent and surviving partner. To the surviving partner it means a fixed purchase price for the deceased partner's interest, the ownership of the entire business, and freedom from interference by the estate or heirs of the deceased partner. The agreement will provide for the deceased partner and his estate a market for the business interest and it may well establish a value for estate tax purposes for the partnership interest.

The problems involved in a partnership buy-sell agreement may generally be classified in two categories: (1) the problems incident to determining the allocation of the amounts payable by the continuing partners to the estate of the deceased partner or the retiring partner; and (2) the problems involved in raising cash for the prospective payments.

Payments made to a deceased or retiring partner by the partnership are treated a number of different ways. If the payments are made by the partnership to the deceased or retiring partner in exchange for partnership property other than unrealized receivables or in some cases good will, the payments are treated as distributions by the partnership.²⁵ The retiring partner will realize capital gain, and the estate of the deceased partner will generally receive the payments tax free because of the stepped-up basis. Payments made for unrealized receivables, and in some cases good will, and payments made in excess of the value of the partnership interest will be ordinary income to the estate.²⁶ It is therefore to the estate's advantage to have more consideration allocated to other partnership assets. If the allocation is reasonable the Commissioner will probably accept it.²⁷

Gain attributable to good will may also be treated as a distribution by the partnership if the partnership agreement provides for payment with respect to good will and the payment is reasonable.²⁸ It is therefore important to include a provision covering good will in the partnership agreement, if the partners wish payments by the partnership for good will to be treated as distributions. Such treatment is generally advantageous to the deceased or retiring partner to whom the payments represent a recovery of capital or capital gains, and

²⁵ Int. Rev. Code of 1954, § 736(b); Treas. Reg. § 1.736-1(a)(2) (1956).

²⁶ Int. Rev. Code of 1954, § 736(a); Treas. Reg. § 1.736-1(a)(3) (1956).

²⁷ Treas. Reg. § 1.736-1(b)(1) (1956).

²⁸ Int. Rev. Code of 1954, § 736(b)(2); Treas. Reg. § 1.736-1(b)(3) (1956).

a disadvantage to the continuing partners who cannot deduct the payments. If a good will provision is desired, the valuation placed on good will by the partners in arm's length dealings will generally be accepted by the Commissioner.²⁹ The amount allocated to good will is significant if the total payments will exceed the value of the partner's interest in partnership property including good will, because excess payments will be treated as ordinary income.

For estate tax purposes the value of the deceased partner's interest in the partnership will be included in his estate. If there is an outstanding buy-sell agreement, the amount fixed in the agreement at which the survivors have the right or obligation to purchase his interest will be the value included in his estate, unless the decedent was free to sell his interest during life.³⁰ For these reasons it is desirable (1) to have an agreement fixing the price, and (2) to have a provision in the agreement prohibiting unrestricted disposition of a partnership interest.

In order to provide money with which to make the contractual payments, buy-sell agreements are frequently funded with life insurance. One of the better arrangements is to have each partner own and pay the premiums on policies on the lives of the other partners. Under this method the proceeds of the policy on his life will not be included in his estate on death because he does not retain the incidents of ownership.³¹ On the death of a partner the insurance proceeds will be used to purchase his interest as determined by the partnership agreement. The buy-out agreement should have a provision entitling the surviving partners to purchase any insurance policies held by the decedent on the lives of the survivors. This will enable the survivors to fund a new or continuing buy-sell agreement among themselves without the necessity of obtaining, if available, new insurance at increased premium rates. Section 101(a)(2)(B) of the Code permits a partner purchasing a policy under those circumstances to obtain the proceeds tax free on death. A provision should also be included in the agreement for the method of payment in the event the insurance proceeds are inadequate. Installment notes are frequently used, because they spread the payments over a number of years, and do not force immediate liquidation of partnership assets, additional contributions, or undesirable borrowing. If these excess payments are likely to be substantial, it may be desirable to have the payments represented only by an open contract obligation, to pre-

²⁹ Treas. Reg. § 1.736-1(b) (1956).

³⁰ Estate of Lionel Weil, 22 T.C. 1267 (1954); Claire Giannini Hoffman, 2 T.C. 1160 (1943).

³¹ Int. Rev. Code of 1954, § 2042.

vent lumping of income in the estate in one year.³² This is particularly important if the payments are primarily income rather than capital payments. A provision should also be included for payment of premiums in the event the partner does not pay them. For this purpose it may be preferable to have a trustee or the partnership hold the policies.

A funded plan is not always desirable. The first partner to die would generally have been better off if he had simply purchased insurance on his own life. He would then own both the partnership interest and the insurance proceeds. Under an insurance-funded plan, he owns the partnership interest and either directly or indirectly the policies on the lives of the survivors. The survivors, on the other hand, have a windfall to the extent the decedent's interest in both the partnership and the policies exceeds the amount of premiums paid for the insurance. These differences can be adjusted to some extent by requiring additional payments to the deceased. In addition the plan may be written to make the funding optional with each partner, where under the circumstances funding is not imperative. For example, in a partnership between an older and a younger man the younger partner with a few personal assets may wish to have insurance on the life of the older in order to acquire his interest in the event of death, whereas the older may have adequate resources to buy out the interest of the younger if he should die first; or the older may have no interest in continuing the business, so that insurance proceeds may not be of interest to him.

B. *Change Of Partnership Form*

Good estate planning may call for thought to be given to the question of whether or not the partnership form of doing business should be changed. For example, should the partners elect to be taxed as a corporation pursuant to the option granted in Section 1361 of the Code? Should the partners incorporate under state law or would there be any advantage in setting up an association taxable as a corporation?

Electing under the provisions of Section 1361 may have certain advantages to the successor in interest of the deceased partner. A deceased partner's interest may be liquidated or purchased in such a manner that some portion of the consideration received by the estate or the heir may be taxed as ordinary income. This is possible, as explained above, if unrealized receivables or inventory items which

³² Cf. *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), commented on 15 Sw. L.J. 401 (1961).

have appreciated substantially in value represent part of the partnership interest of the decedent. By having the partnership classified as a corporation for the year of redemption,³³ the payments received upon complete termination of the decedent's interest would be recognized as received in exchange for that interest pursuant to Section 302(b)(3). The application of Section 302(b)(3) is authorized specifically by Section 1361(k). Moreover, the distribution could be qualified as a redemption in order to pay death taxes under the provisions of Section 303.³⁴

This election must be weighed carefully against the disadvantages of the irrevocability of the election as well as the partnership advantage of having guaranteed amounts paid to the estate of a deceased partner constituting deductible items. As a corporation, on the other hand, no deduction would be allowed for any portion of the amount paid as a redemption. A deduction would be available to the electing entity only as to that portion of the amount paid as a death benefit to a surviving widow or a beneficiary pursuant to the provisions of Section 101(b).

C. Association Taxable As A Corporation

The unincorporated business enterprise electing under Section 1361 of the Code to be taxed as a corporation cannot take advantage of pension, profit sharing or stock bonus plans. There are many advantages in a plan properly qualified under Section 401. The income of the pension or profit sharing trust is tax exempt. The owner's share of the fund can, under certain circumstances, be withdrawn as capital gains and the undistributed share will pass to the owner's beneficiaries free from estate tax pursuant to Section 2039(c). The partners in a partnership, however, are employers and therefore do not qualify under their partnership form of doing business for participation in pension, profit sharing or stock bonus plans. Therefore, if the partners want to take advantage of this form of tax sheltered investment, they must either incorporate under state law or form what is known as an "association taxable as a corporation." Ordinarily it would be preferable for the partnership to incorporate directly under the state law. In the case of certain professional partnerships, however, such as doctors, dentists, engineers, architects and lawyers, it is not always possible to incorporate under the laws in many states; and for some professionals incorporation is unethical by virtue of the rules of their particular professional society. In

³³ As noted in the text following note 14 supra, dealing with this tax option, not all partnerships can comply with the statute and qualify for this change of status.

³⁴ See text accompanying note 47 infra.

these instances it may be appropriate to give attention to the creation of an association during the lifetime of the partners.

An association is a very old, common-law form of doing business utilized three to four hundred years ago in England. It was gradually replaced by the corporate form of doing business when corporations were recognized by the early acts of Parliament. Associations have been given judicial recognition in this country for many years.³⁵ Recently a number of tax decisions have approved the association form of doing business for doctors and other professional persons,³⁶ and these cases have thus given approbation to the pension or profit sharing plan which the association was utilizing.

In classifying organizations for tax purposes, the treasury regulations³⁷ outline certain tests and standards which are to be applied in determining the classification of an organization, *i.e.*, whether it is an association, a partnership, a trust or some other taxable entity. The question confronting an association is whether it more closely resembles a corporation or a partnership. Resemblance in the case of organizations, as in the case of individuals, is determined by a comparison of characteristics. The characteristics which indicate that an organization is an association are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interest.³⁸

In order to create an association taxable as a corporation it is necessary to compare these characteristics set forth in the regulations with the local state rules pertaining to partnerships. If these characteristics, or a majority of them, can be acquired under the local state rules by the partnership adopting Articles of Association (similar to a corporate charter) and operating like a corporation then the new treasury regulations³⁹ give a green light to this type of business

³⁵ *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110 (1925). Associations for groups which cannot incorporate have been given statutory recognition of a sort by the Texas Uniform Partnership Act. Tex. Rev. Civ. Stat. Ann. art. 6132b, § 6(3) (1961) (effective Jan. 1, 1962; see note 17 supra); see Bromberg, Texas Uniform Partnership Act—The Enacted Version, 15 Sw. L.J. 386, 387-89 (1961); cf. Bromberg, *supra* note 17, at 441.

³⁶ *Kintner v. United States*, 216 F.2d 418 (9th Cir. 1954); *Galt v. United States*, 175 F. Supp. 360 (N.D. Tex. 1959).

³⁷ Treas. Reg. § 301.7701-2(a)(1) (1960).

³⁸ These characteristics are gleaned from the Supreme Court's decision in *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

³⁹ For example, Treas. Reg. § 301.7701-2(g) (1960), Example 1 states: A group of seven doctors forms a clinic for the purpose of furnishing, for profit, medical and surgical services to the public. They each transfer assets to the clinic, and their agreement provides that except upon complete liquidation of the organization on the vote of three-fourths of its members, no member has any individual interest in its assets. Their agreement also provides that neither the death, insanity, bankruptcy, retirement, resignation, nor expulsion

enterprise. Moreover, the new Texas partnership law may lend recognition to this type of entity. The unincorporated organization can then adopt a pension, profit sharing or stock bonus plan.

IV. CLOSE CORPORATIONS

The closely held corporation, unlike the partnership and the sole proprietorship, is treated as a separate and distinct entity apart from its owners. It operates under its own special and sometimes esoteric set of tax rules as set forth and delineated in Subchapter C of the Code. In addition to the conventional state chartered corporation, the Internal Revenue Code defines a corporation to include associations, joint stock companies and insurance companies.⁴⁰ The corporation, unlike the partnership and the sole proprietorship, has the advantage of a 30 per cent tax rate⁴¹ on its net taxable income up to \$25,000 per annum and the privilege of accumulating its profits without fear of penalty up to an amount of \$100,000.⁴² These two facets of corporate tax law lend themselves to estate planning in connection with this type of business enterprise.

The death of the owner of the incorporated enterprise does not automatically work a dissolution of the business as in the case of the sole proprietor. The company will not necessarily collapse without the owner on hand to run it, and being incorporated it is in the best form for a relatively smooth change of management. The owner's estate planning decisions with respect to retention or disposition of his stock are similar to those faced by the sole proprietor and partner. The degree of risk to the future security of his family must be considered. The availability of competent successor management and the probable effect of his death on the going concern value and future of the corporation must be weighed. However, there may be a better chance for competent successor management in the case

of a member shall cause the dissolution of the organization. Under the applicable local law on the occurrence of such an event, no member has the power to dissolve the organization. The management of the clinic is vested exclusively in an executive committee of four members elected by all the members, and under the applicable local law, no one acting without the authority of this committee has the power to bind the organization by his acts. Members of the clinic are personally liable for all debts of, or claims against, the clinic. Every member has the right to transfer his interest to a doctor who is not a member of the organization, but he must first advise the organization of the proposed transfer and give it the opportunity on a vote of the majority to purchase the interest at its fair market value. The organization has associates and an objective to carry on business and divide the gains therefrom. While it does not have the corporate characteristic of limited liability, it does have the characteristics of centralized management, continuity of life, and a modified form of free transferability of interests. The organization will be classified as an association for all purposes of the Internal Revenue Code.

⁴⁰ Int. Rev. Code of 1954, § 7701(a)(3).

⁴¹ Int. Rev. Code of 1954, § 11(b)(1).

⁴² Int. Rev. Code of 1954, § 535(c)(2).

of the corporation than in the other forms of doing business. The extent to which other assets of the owner's estate will be sufficient to provide the necessary cash and liquidity to meet the obligations of creditors and tax collectors must be calculated. Of course, where the owner's interest in the corporation is a minority one, this factor alone may dictate a decision to provide for a withdrawal of his interest.

After a careful consideration of these estate planning questions the owner's decision may be: (1) to have the corporation acquire his interest through some type of redemption, (2) to have the corporation acquire only a sufficient amount of his stock interest through redemption to enable his executor to pay death taxes and other expenses, (3) to enable co-participants or key employees to buy out his interest in the stock, or (4) to effect a recapitalization, reorganization or merger of the business in order to enable relatives or employees to continue their participation in the business after the owner's death.

A. *Redemption*

In the case of small closely held corporations it is a common estate planning practice to have the company itself redeem the decedent's stock interest. A redemption of stock is a purchase by the corporation of its own stock in exchange for property. Such a purchase or redemption is primarily useful in family situations to buy out deceased shareholders, retire elderly or dissident shareholders, realign shareholders' interests or shift control, pay death taxes or finance acquisitions. If the company is to redeem or purchase a stock interest there will, of course, have to be available funds in order to enable the company to make the purchase. This accumulation of funds will be considerably facilitated in many instances by the corporate form of doing business and the concomitant privileges of accumulating income and the low corporate tax rate.⁴³

The principal danger to the shareholder, if the company is to buy out his interest, is that a redemption of his stock may result in a dividend taxable at ordinary income rates. This is a danger to both the redeeming and the remaining shareholder. Any such redemption must be planned with all the limitations contained in Sections 302, 303, and 304, clearly in view. Care must be exercised in order to avoid the impact of Section 302 which might transfer the payment for the decedent's stock interest into a taxable dividend. If the requirements of Section 302 are met, however, the distribution will

⁴³ Frequently, these measures are augmented by the use of life insurance on the life of the shareholders.

be treated as an exchange resulting in capital gain⁴⁴ to the shareholder whose stock is redeemed. If the stock is redeemed after the death of the owner, the stock will have been recently acquired from a decedent and will have had its basis stepped up under Section 1014 to an amount equivalent to the fair market value of the stock at the date of death. Thus, there may be little or no gain or loss realized on the redemption of a deceased owner's stock.

Section 302 treats distributions from a corporation as essentially equivalent to a taxable dividend to the stockholder (including the stockholder's estate) unless the distribution in redemption falls under the heading of one or more of the subdivisions of Section 302(b). The two main headings under which redemptions may be relieved of dividend treatment are a substantially disproportionate redemption, which is defined in detail in the statute, and a redemption which results in a complete termination of a stockholder's interest. A redemption of a portion of the decedent owner's stock or a distribution to all stockholders out of surplus to provide funds to purchase the decedent's stock may be treated as a taxable dividend.⁴⁵

In order to ascertain whether there has been a complete termination of a stockholder's interest in the corporation it is necessary to consult the constructive ownership rules of Section 318 which attributes stock of certain family members to the estate and vice versa. This section provides generally that the estate will be considered the owner for purposes of redemption of stock owned directly or indirectly by a beneficiary of the estate. If a beneficiary of the estate owns shares of the redeeming corporation this fact could seriously impair the use of a redemption. For example, if a husband provides in his will that his stock shall pass to his wife, this stock will be attributed to her if she also owns shares and the husband's shares are redeemed. Hence, redemption of stock held by the deceased husband's estate will not be considered as a termination of interest if the surviving wife also owns shares in the corporation. If a complete distribution can be made to such a beneficiary prior to the redemption it may be possible to avoid disqualification because of stock ownership in that beneficiary. The regulations⁴⁶ provide that the attribution rules shall not be applied after the beneficiary has received all of the property to which he is entitled, when he no longer has a claim against the estate arising out of having been a beneficiary and where there is only a remote possibility that it will be necessary

⁴⁴ This assumes that there is a gain and that the stock is a capital asset.

⁴⁵ Ernest F. Becher, 22 T.C. 932 (1954), aff'd, 221 F.2d 252 (2d Cir. 1955).

⁴⁶ Treas. Reg. § 1.318-3 (1960).

for the estate to seek return of the property or to seek payment from him to satisfy claims against the estate.

If a redemption cannot be achieved under Section 302,⁴⁷ it may be possible to receive a distribution from the corporation in redemption of enough stock to pay death taxes, funeral and administrative expenses under the provisions of Section 303. To take advantage of this section, the stock in the corporation held by the estate must represent more than 35 per cent of the gross estate or more than 50 per cent of the value of the taxable estate. Where stock of more than one corporation is owned by the estate, such stock may be added together to consider whether the percentage requirements have been satisfied, but in this case the estate must own more than 75 per cent of the stock of each corporation.

In planning to take advantage of this section, if the stock owner's percentage holdings do not coincide with the percentages specified in the statute, two other approaches may solve the problem. Increase the ratio of stock held by having the owner purchase additional shares from other stockholders or, if bonds have been previously issued, convert the bonds into stock. Decrease the rest of the owner's estate in order to comply with the percentage requirements by outright gifts, inter vivos transfers in trust for children or other relatives, donations to charity and, perhaps, by the purchase of real estate abroad.

If the businessman owns stock in two corporations but not a sufficient amount in either corporation to meet the percentage requirements then a merger or consolidation of the two companies might be effectuated.

B. *Recapitalization*

It may be necessary to reorganize the business structure of the company in a way which will facilitate the accomplishment of the continuation of the enterprise and at the same time fulfill the owner's desire to leave his stock interest to his wife, children or other relatives. This objective can be accomplished by creating and issuing a new class of stock. For example, where the business owner has sons who are active in the organization and a wife and daughters who are inactive, it may be desirable to have the company issue a preferred stock dividend on the outstanding common stock. Although such a stock dividend of preferred stock on common stock is tax free pursuant to the provisions of Section 305 of the Code, the preferred stock will be subject to tax upon a later sale at ordinary

⁴⁷ See note 34 *supra*.

income tax rates to the extent that the corporation had earnings and profits at the time of the stock dividend. This kind of stock is referred to as "tainted" stock or "Section 306" stock. However, upon the stock owner's later death, the ordinary income "taint" on the Section 306 stock is removed. Thus, if it is intended to retain this stock until death, the ordinary income tax disadvantages can be overcome. The owner can then provide in his will that the preferred stock will go to his wife and daughters and the common stock will go to his sons. By this maneuver the inactive members of the family receive the preferred stock and the active or business managing members of the family receive the common stock. If the owner desires to place additional income in the hands of his children or other beneficiaries, the preferred stock may be placed in an inter vivos trust or given outright to selected donees. Thus, the dividend income paid on the preferred stock will be removed from the businessman's top income bracket and the value of the stock itself will be effectively removed from the owner's estate on his subsequent death.

Another type of corporate recapitalization which might be appropriate to accomplish the owner's objectives would be an exchange of the outstanding common stock for two new classes of common stock, one of which would be a non-voting stock. This type of recapitalization may be accomplished tax free either under the provisions of Section 368(a)(1)(E) or pursuant to the provisions of Section 1036. For example, the company could issue a Class A voting common stock and a Class B non-voting common stock in exchange for the old common stock. These two new classes of stock may be received by the owner without income tax consequences. The Class B common stock could then be given to the wife, children or other relatives either during life or by a testamentary disposition. The Class B common stock could also be sold to co-participants or key employees who would have all the advantages resulting from long term growth in the value of the business due to their industry and enterprise.

C. Merger

Another method that the owner may utilize in planning his estate is a merger or consolidation of his closely held company with another organization. In a merger the business owner or his estate receives stock and securities of the continuing corporation which are equivalent in value to the merged or consolidated business interest. The ideal type of merger from an estate planning point of view is

one in which the shares of the surviving or continuing organization are readily marketable and have an easily determinable value. Where the stock of the acquiring corporation is listed on a stock exchange or actively traded over the counter such a goal can be achieved. Receipt of this kind of marketable stock will place the owner or his estate in a position where there will be available the equally good alternatives of either retaining the shares as an investment or disposing of all or part of them, if necessary, to achieve liquidity or diversification. Merger may also solve the problem of successor management. Such a merger or consolidation can ordinarily be achieved tax free under the provisions of the reorganization sections of the Code⁴⁸ without a diminution in the value of the estate as the result of a capital gains or ordinary income tax.

D. *Spin-offs*

Where the owner has two separate business activities under the same corporate roof and desires to divide this enterprise in order to retain part and sell or give the other part to certain relatives or key employees, a technique that may furnish a solution is the spin-off. This type of corporate division is sanctioned under certain conditions as outlined in Section 355 of the Code. In a spin-off, Corporation A forms a new Corporation B, transfers part of its assets to B in exchange for B stock, and then distributes the B stock to its shareholders without the surrender by them of any A stock. There will be no gain or loss if the requirements of this section are met. The move would serve to reduce the value of the A stock. The B stock could then be sold to key employees, transferred to an inter vivos trust, given to a charitable foundation or used in some other manner consistent with the owner's wishes and objectives.

E. *Non-Commercial Annuity*

Another technique that the owner may utilize in planning his estate is the non-commercial annuity contract. Generally speaking, under this type of contract the shareholder exchanges his stock in the corporation for a contractual promise by the corporation to pay this stockholder so much money each year for the rest of his life. In a small, closely held family corporation, one of the elder stockholders may desire to terminate his interest in the business in favor of a younger relative or family member, if assurance can be given that such retiring person will have a fixed amount of money to live on during his remaining years. The continuing shareholders

⁴⁸ Int. Rev. Code of 1954, §§ 368(a)(1)(A)—(E).

would like to have control of the company. In this situation the non-commercial annuity contract may be a solution. By way of illustration, assume that the value of the retiring shareholder's stock is \$100,000 and that his life expectancy as computed by life insurance actuary tables is ten years. The shareholder would exchange his stock in the corporation in consideration for an unsecured contractual agreement by the corporation to pay this shareholder \$10,000 per year for the rest of his life. The net effect of the transaction is that: the shareholder receives an amount of money each year which is not taxed all at once but in installments as received; the corporation does not have to part with any substantial amount of its capital in one year; the remaining shareholders are in control of the corporation by virtue of this stock redemption and have not had to invest any of their own money to buy out the retiring shareholder. The value of the transferred property is not includible in the gross estate of the transferring party, if the value of the transferred property is not greater than the value of the annuity received therefor.⁴⁹

F. Installment Payments Of Estate Tax

The estate of the owner may qualify for the deferred estate tax payment privileges authorized under Section 6166 of the Code. There are two requirements for closely held stock interests. The first is that the value of the owner's stock interest in the corporation must exceed either 35 per cent of the gross estate or 50 per cent of the taxable estate. If more than 50 per cent of the value of each of two corporations is included in the estate, they may be treated as one for the purposes of the statute. The second requirement is that either the corporation must have ten or less shareholders, or that the businessman must own 20 per cent or more of the value of the voting stock of the corporation. As in the case of the sole proprietor and partner, analysis of the estate of the close corporation owner may indicate the need for readjustment of his interest in order to meet the percentage requirements of this section.

G. Subchapter S Of The Code

A "small business corporation" may, pursuant to Section 1371, elect not to be subject to income tax as a corporation, with the result

⁴⁹ In *United States Nat'l Bank v. Earle*, 45 Am. Fed. Tax R. 1317 (D. Ore. 1953), the court held that property which had been transferred by the decedent to her daughter in 1937, in return for a promise by the daughter to pay the decedent an annuity of \$5,000 for life, was not includible in the gross estate of the decedent upon her death in 1949. The court held that the 1937 transfer constituted a bona fide sale for an adequate consideration in money or money's worth. The transfer was not one in which the decedent retained the right to income for life, was not made in contemplation of death, was not intended to take effect at or after the decedent's death, nor was there a retention of any reversionary interest.

that the shareholders will include in their gross incomes the current taxable income of the corporation whether or not it is distributed. If the corporation has utilized the tax option to have the income taxed directly to the individual shareholders, the executor must consent to the election within 30 days after his appointment or the option is vitiated for that year. The election will also be lost if the division of shares under the businessman's will raises the number of stockholders to more than ten. Attempts to avoid this loss by transferring the shares in the corporation to a trust will fail because the option is not available to a corporation which has a trust as a stockholder. Proper and explicit instructions to the executor must be carefully planned and stated in the will or codicil in those cases where the tax option is in effect.

H. *Foreign Real Estate*

Real property situated outside of the United States is not included in the gross estate.⁵⁰ It is possible to utilize this exclusion in a number of advantageous ways. This exemption may be useful where the businessman is trying to comply with the fractional interest requirements of Section 6166 or Section 303 of the Code. The section may also be a way of avoiding the rule which taxes gifts made in contemplation of death. Section 2035 provides that the value of the gross estate shall include property transferred in contemplation of death, except real property situated outside of the United States. Because of the proximity of many haven countries⁵¹ like the Bahamas and Bermuda, the purchase of foreign real estate is not a formidable problem. This real property can then be devised by will in lieu of making an outright gift in order to avoid the contemplation of death issue or in order to comply with some fractional ownership requirement of the Code.

The value of the real estate will not be included in the owner's estate for federal estate tax purposes nor will the interest be taxed in the foreign land if the proper haven country is selected for the purchase. It is to be noted that this "loophole"—an epithet inexactly but freely applied to any provision which someone opposes—has recently been animadverted on by the Secretary of the Treasury in connection with the President's recommendations of changes in the Code.⁵²

⁵⁰ Int. Rev. Code of 1954, § 2031(a).

⁵¹ A haven country is one which has no income, estate, transfer or gift tax.

⁵² See "President's Tax Message Along With Principal Statement, Detailed Explanation, and Supporting Exhibits and Documents" submitted by Secretary of the Treasury Douglas Dillon at Hearings Before the House Committee on Ways and Means, 87th Cong., 1st Sess. 33 (1961).

One method of purchasing foreign real estate which will take into effect possible fluctuations in foreign real estate values is the following: *A*, a U.S. citizen, agrees to purchase a piece of property in fee simple from *B*, an owner of land in a foreign haven country. *A* immediately executes a will under the law of the foreign jurisdiction granting power to a trustee to sell the property on his death. *A* instructs his foreign trustee to enter into a cross option agreement with *B* whereby *B* agrees with the trustee to repurchase the property at an agreed figure either on the expiration of five years from that date or at a time not more than twelve months after *A*'s death, whichever time is sooner. *B* further agrees that the purchase funds paid to him by *A* will be placed in escrow under terms and conditions which are agreeable to *A*'s trustees and *B*. The usual provisions of such an escrow agreement provide for release of the purchase funds only for the purpose of repurchase of the property by *B*. The income from the purchase funds during the term of the escrow contract are payable to *B*. This arrangement guarantees security of *A*'s capital regardless of the foreign real estate market fluctuation. Caveat: As noted above, this practice is presently under study by the House Ways and Means Committee. Although any change in our tax laws designed to sweep foreign real estate into the gross estate may be extremely difficult to administer, careful and continuing attention must be paid to any new legislation impinging on this area.

V. CONCLUSION

Estate planning for a business owner involves many factors and multiple approaches. Not all of these approaches are available to the businessman because of the particular business entity through which he operates. Furthermore, it is obvious that not all of life's unusual eventualities may be anticipated or controlled by the business owner. The nature of the business activity coupled with the personal and financial circumstances of the owner and his family are the basic factors from which the estate plan must evolve. Income, estate and gift tax consequences are major hurdles which must be clearly analyzed and calculated in advance in order to provide an imaginative and comprehensive plan for the estate. The methods then available for handling the estate are numerous and a substantial degree of flexibility is available to create a successful and all inclusive plan for the business owner.