PROBLEMS OF CORPORATE READJUSTMENTS IN ESTATE PLANNING AND ESTATE ADMINISTRATION

M. R. SCHLESINGER*

In planning or administering an estate having stock in a closely-held corporation, corporate stock readjustments will frequently be advisable. Such readjustments in closely-held corporations might be advisable for a number of reasons: (1) in order to raise funds necessary for tax and administration expenses, or (2) in order to withdraw funds from the corporation at favorable tax rates—and this regardless of the need for liquidity, or (3) in order to shift the ownership and/or control of the corporation itself or of the multiple businesses conducted by a single corporation. Those three aims, then, will be the objectives dictating our pre-death or post-death corporate readjustments.

A. CORPORATE REDEMPTIONS

1. *Redemptions in General*

In this area of corporate readjustments, the most fascinating Internal Revenue Code section is 302—most fascinating because it is most likely to yield favorable dollar results. Let us therefore first look to that section and certain related sections, analyzing them in the abstract before buckling down to their application to actual cases in our everyday practices.

Sections 301 and 316 together state the general rule respecting corporate distributions: that such distributions will be taxable at ordinary dividend rates to the extent of a corporation's accumulated earnings and profits or its current-year profits. This general rule, manifestly, is an unfavorable provision, because it taxes an *entire* corporate distribution and at *ordinary* rates.

Section 302 is a favorable provision because it is an exception to that unfavorable general rule respecting corporate distributions. Under certain circumstances delineated in section 302, amounts received upon redemption of shares will be treated as though those shares had been sold. That is to say, only the excess of amounts received over basis will be taxed, and, furthermore, that excess usually will be taxed at favorable capital gain rates. Three of those circumstances detailed under section 302 merit mention here, and two of those situations deserve our particularly close attention.

Section 302(b)(1) provides, in effect, that corporate redemptions

* Partner, Law Firm of Grossman, Schlesinger & Carter, Cleveland, Ohio.

will give rise to favorable capital gain treatment if those redemptions are not essentially equivalent to a dividend. That "essentially equivalent" language used to be the sole criterion prior to 1954 of whether or not a redemption of stock would be taxed as an ordinary dividend or taxed, to the extent of gain only, at capital gain rates. The provision was so ambiguous, however, that it led to a host of litigation. In order to bring some certainty to this area, Congress in 1954 enacted certain mathematical tests under sections 302(b)(2) and (3). Section 302(b)(1) perpetuates the old, ambiguous "essentially equivalent" test, however, and in view of its ambiguity, at the *planning* stage a counselor would be foolhardy to place reliance upon that so-called "basket" provision. That is not to say that reliance should not be placed on section 302(b)(1) in litigation, but obviously the planning stage is different from the litigation stage. We turn, therefore, to two definite mathematical tests enacted in 1954, one being the substantially disproportionate test and the other being the complete redemption test.

Under the favorable provisions of section 302(b)(2), we look to the percentage of voting and common stock owned by the taxpayer-stockholder whose shares are redeemed. If that percentage of stock outstanding is less than 80% of what that percentage was prior to the redemption, then the favorable provisions of section 302 will apply. Thus, if a stockholder owned 60% of the outstanding voting common stock of a corporation before redemption but emerges owning less than 48% of that stock, then his percentage ownership will have been cut back by more than 20% and the favorable provisions will apply. Under this substantially disproportionate test, it is also necessary that the stockholder wind up owning less than 50% of the voting stock.

The second of the interesting definite mathematical tests is provided by section 302(b)(3). Thus, if a taxpayer-shareholder's stock is completely redeemed, then, as you might suppose, the stockholder gains favorable tax treatment.

What I have so far said about section 302(b)(2) and section 302(b)(3) by no means tells the entire story. Those provisions are further complicated by the ownership attribution rules, a series of rules which require that stock owned by persons and various entities related in certain prescribed manners to the stockholder whose shares are being redeemed be attributed to that shareholder. This is a rule of constructive ownership, and the stockholder whose shares are being redeemed is treated as though he owned the shares actually owned by others who are related to him.

There are two broad groups of these attribution rules and, for

reasons which will soon be apparent, it is important that we be aware of these two different groupings. Under section 318(a)(1) stock is attributed among family members. Thus, stock owned by a wife is deemed to be constructively owned by the husband and vice versa; and the rule is similar as between parents and children.

In addition to the *family* attribution rules prescribed in section 318(a)(1), there are other attribution rules. The most important of these other attribution rules are found in section 318(a)(2), which provides for attribution as between partnerships and partners, estates and trusts on the one hand and beneficiaries on the other, and corporations and substantial stockholders.

Now with that background of the statutory provisions behind us, let us apply that law in the actual practice of administering estates. For that purpose, we shall take four hypothetical cases.

In case number one we assume a corporation whose entire stock was owned by the decedent. His will is the more or less conventional will which we would expect of a sophisticated estate plan for a man of moderate or better wealth. That is to say, he left the marital deduction outright to his wife but provided that the balance of his estate should go in trust for the benefit of his wife, son and daughter.

Now let's come to the administration of the estate. Let's assume that the executor distributes some of the stock to the wife under her marital deduction and the balance of the stock goes into the trust. Now it is proposed to redeem the stock from the wife so that she will end up with a zero percent stock ownership in the firm. At first blush, of course, that redemption would appear to satisfy the disproportionate redemption test of section 302(b)(2) and indeed even the complete redemption test of section 302(b)(3), since the wife will wind up owning no stock at all. However, the attribution rules again intrude at this point. Some of the stock is owned by the trust and the wife and children are beneficiaries of the trust. Accordingly, the wife started out owning, actually and constructively, 100% of the stock of the corporation and after the redemption she will wind up owning constructively 100% of the stock.[1] There will have been no cut-back whatsoever for purposes of the favorable provisions of section 302.

[1] Stock owned by a trust is attributed to beneficiaries proportionate to their actuarial interests in the trust. Int. Rev. Code of 1954, § 318(a)(2)(B). Thus, all of the stock owned by the trust would be attributed to the wife and her children. That portion attributed to her children would be reattributed to her under the family attribution rules. Int. Rev. Code of 1954, § 318(a)(1). In the aggregate, 100% of the stock would thus be attributed to her. If the children's remainder interests are contingent, then to the extent of alternate contingent interests or reversions, a small percentage of the stock might not, under certain circumstances, be attributed to the mother. This possibility of her emerging with a somewhat less than 100% constructive ownership

Now let's take case number two which is not quite so obvious. Let's assume that the decedent had owned 50% of the stock of his corporation and his son owned the other 50%. Let's further assume that the will is the same as the one which we previously considered, involving a testamentary trust for the benefit of the wife, son and daughter. In the administration of the estate the executor proposes to redeem all of the estate's stock.

Even in this situation the favorable tax provisions of section 302 will not apply. You will recall that the son owns 50% of the stock. He is also a beneficiary of the trust. Accordingly, his stock is attributed to the trust, and, under rules providing for multiple attribution, the stock owned constructively by the trust is then attributed in the second instance to the estate. The estate is deemed to have owned actually and constructively 100% of the stock before the redemption and to own constructively 100% of the stock after redemption. As a result, once again favorable advantage cannot be taken of section 302 because of these attribution rules.

Under case number three we assume the same facts as in case number two, and, in addition, a buy-and-sell agreement between the shareholders on the one hand and the corporation on the other; pursuant to this pre-death agreement, the corporation will buy the decedent's stock from his estate. In spite of this buy-and-sell agreement and its obligatory nature, a redemption of all of the stock owned by the estate still will not prevent attribution of the son's stock through the trust to the estate in the first instance, or to the widow in the second instance. A 1956 Revenue Ruling expressly makes it clear that the existence of the buy-and-sell agreement does not alleviate the harsh attribution rules.[2] The moral from that ruling is rather obvious to those of us who are engaged in drawing buy-and-sell agreements incident to our estate planning activities.

Manifestly, these attribution rules are very harsh. Accordingly, Congress enacted a limited relief provision in the form of section 302(c)(2). That relief applies in certain situations if certain requirements are met. The taxpayer whose stock has been completely redeemed must file with his income tax return for that year a statement prescribed by the Commissioner and agreeing to notify the Commissioner if he acquires any stock in the same corporation within ten years; should he so acquire stock, the relief is not available and the usual statute of limitations on deficiencies will not apply. Furthermore, it relieves only against those attribution rules applying among

is of academic interest only, because the disproportionate redemption rule of § 302(b)(2) requires that the shareholder wind up with a less than 50% voting interest.

[2] Rev. Rul. 56-103, 1956-1 Cum. Bull. 159.

family members under the provisions of section 318(a)(1). You will remember our observation that you must keep absolutely separate in your mind the family attribution rules and the various other attribution rules, for example, calling for attribution as between trusts and estates on the one hand and beneficiaries on the other, or between partnerships and partners, or between corporations and substantial stockholders. Those other attribution rules are found under section 318(a)(2) and (3). The relief provisions of section 302(c)(2) apply, however, only to *family* attribution rules under section 318(a)(1). That limitation to relief is most important to those who are active in estate planning. As we have seen, it will frequently be impossible to redeem stock once the head of a family dies—this because of attribution rules as they relate to estates and trusts and because the relief provision does not operate to mitigate the harshness of those rules. Speaking very broadly, we can say that where a closely owned corporation has its stock held by family members, it will generally be much more difficult to effect a redemption after the death of the father than it will be before. We shall presently be discussing the possibility of redemptions before his death.

Now we vary the facts a bit more in order to emphasize further the very narrow scope of this relief provision. In case number four we assume that a father and his son-in-law each owns 50% of the stock in the corporation. The father dies, leaving a will which was the culmination of a well-thought-out estate plan, *i.e.*, a will that leaves the maximum marital deduction to his wife and leaves the balance of his estate in trust for the wife and daughter. Now let's administer that estate. With the thought of maximizing the possibilities of redeeming the stock that was owned by the deceased father, that stock is distributed outright to the widow in satisfaction of the marital deduction legacy to her. At this point, then, the stock is owned 50% by the widow and 50% by her son-in-law. After redemption from the widow, all stock will be owned by the son-in-law. His stock, however, will be attributed to his wife,[3] but the stock constructively owned by her will not be re-attributed to her mother; there is a statutory prohibition against multiple family attribution.[4] There is, nevertheless, another route pursuant to which the son-in-law's stock will be attributed to the widow. Let's trace the steps which bring about that result. The son-in-law's stock will be attributed to his wife under the family attribution rules.[5] Then the stock constructively owned by the daughter will be attributed to the trust, she being the

[3] Int. Rev. Code of 1954, § 318(a)(1)(A).
[4] Int. Rev. Code of 1954, § 318(a)(4)(B).
[5] Int. Rev. Code of 1954, § 318(a)(1)(A).

beneficiary of the trust.[6] Then in the third step, the stock constructively owned by the trust will be attributed once again to the widow, she being a beneficiary of the trust.[7] Thus, immediately prior to the redemption the widow owns 50% of the shares actually, and the second 50% of the shares she owns constructively because of the attribution rules. Up to this point, therefore, it would appear that before the redemption the widow owns actually and constructively 100% of the stock and after the redemption she will still own constructively 100% of the stock, so that the complete redemption provision cannot apply.[8] Now, how about the relief provision of section 302(c)(2)? You will bear in mind that its operation is limited to the *family* attribution rules of section 318(a)(1). As we have seen, the son-in-law will be the sole shareholder after the redemption and his shares are attributed to his wife in the first of those multiple attribution steps. This first attribution is pursuant to the *family* attribution rules. The Commissioner, however, in a 1959 ruling takes the position that the only type of attribution which is cancelled out under the relief provision is family attribution to the *distributee himself*.[9] It is the distributee who must file a statement under section 302(c)(2) in order to be eligible for its relief provisions, and the Commissioner has expressly adopted the view that stock must be attributed to that distributee because of his standing in a family relationship to a person next to him in the attribution chain. In case number four our attribution chain consists of three links. First was the attribution from the son-in-law to his wife. Second was the attribution from the daughter to the trust. Third was the attribution from the trust to the widow. Manifestly, the last link attributing the stock from the trust to the widow was not pursuant to the family attribution rules. This being the case, according to this recent ruling, the widow cannot gain relief under the provisions of section 302.[10]

Now in point of fact, there is some doubt as to the validity of that ruling. I feel that, under the language of section 302(c)(2), the Commissioner's narrow construction unfortunately has much merit, al-

---

[6] Int. Rev. Code of 1954, § 318(a)(2)(B).

[7] *Ibid.*

[8] The percentages of constructive ownership might be slightly reduced to the extent that there are in the trust contingent interests other than the daughter's remainder. This consideration, however, is not material. See *supra* note 1.

[9] Rev. Rul. 59-233, 1959-2 Cum. Bull. 106.

[10] The daughter's constructively owned shares could be attributed to the mother under either the family or the trust attribution rules. Relief would be afforded in the former instance but not the latter. The ruling did not involve an alternate family attribution step in the last link, but it is assumed that as long as there is non-family attribution in the last step-whether as an alternate or a sole link—the ruling will apply and relief will not be available.

though I would guess that no one thought about that narrow construction when the provision was enacted. That is a technicality which really should be mitigated by amending legislation. At the planning stage, at any rate, you had better assume that the relief provision is just as narrow as the Commissioner has ruled.

We have seen, then, how difficult it frequently will be to redeem stock in a closely held family corporation after the father's death. If we look at the situation *before* his death, however, we shall see that the possibilities will frequently be quite intriguing. We shall see that it is possible during the father's lifetime to do things which will not be feasible taxwise once he has died.

We are going to assume that the husband-father who comes into your office for an estate plan does not own all of the stock in the family corporation. Let's assume, for example, that his son, daughter and wife all own some of the stock. Now let's look at the possibility of redeeming stock from each one of the stockholders in turn, bearing in mind that of course we do not want ordinary dividend consequences and we therefore want the favorable provisions of section 302 to apply without being cancelled out because of the intrusion of those unfavorable attribution rules.

Let's first look at the husband-father. How about redeeming all of his stock and thus qualifying for favorable treatment under the complete redemption provisions of section 302(b)(3)? Manifestly there will be family attribution to him from his wife, from his daughter, and from his son, pursuant to the provisions of section 318 (a)(1). At this point, however, you will want to take a long, hard look at the relief provisions of section 302(c)(2). Its favorable provisions will apply, according to its terms, if immediately after the distribution and for ten years thereafter the distributee—and that means the husband in context of what we are now discussing—has no interest in the corporation either as a stockholder, officer, director or employee. What is more, he must file with his return for the year in which the redemption occurs a statement agreeing to notify the Commissioner of the acquisition by him of any interest in the next ten years. Should such an interest be obtained, the relief provision does not apply to the redemption year and the conventional statute of limitations on a deficiency against him is extended.[11] Under the ten year look-back requirement the relief is generally denied if any of the redeemed stock was acquired during the past ten years from a person standing in an attribution position to the taxpayer, or if the taxpayer during that period made a transfer to such a person.[12]

[11] The ten-year look ahead provisions are contained in the Internal Revenue Code of 1954, § 302(c)(2)(A).

[12] Int. Rev. Code of 1954, § 302(c)(2)(B).

Now the experience of our office has indicated quite clearly that many family heads are unwilling to divorce themselves from such prohibited interests in the corporation, even though their sons or sons-in-law might already be interested in the business and participating in its management. If that is the case, then of course you will have to give up any hopes of qualifying under section 302(c)(2). Furthermore, we have had instances in which the family members have acquired their stock from the family head during the past ten years. In such event you will have to be content with at least waiting out the period.

In those cases where it is not possible to comply with the relief provisions of section 302(c)(2) governing redemption of the husband's shares, you might want to stabilize his interest by exchanging those shares for preferred stock. We shall address ourselves below to the possibility of issuing preferred stock, but for the present we explore a bit further the redemption area.

In our experience it will frequently be more easy, from the practical standpoint, to redeem the shares of the wife or the daughter —this because it is quite likely that neither of them has an interest other than their stockholders in the corporation or, if they have such an interest, they are more apt to be willing than the family head to give it up for the next ten years. The only stumbling block here, of course, is the possibility that they might have acquired their stock during the past years from someone standing in an attribution position to them—in our case most likely the husband-father. If that is the case, then it will be necessary to postpone redemption until the ten-year period has expired. In that connection, you might find it wise to issue preferred stock, stabilize the value of their shares, and then wait out the ten years for redemption.

At the practical level you can understand, therefore, that it will frequently be possible where a husband, wife, son and daughter own shares in the family corporation to redeem the shares of any one or more of them that you wish to take out of the corporate picture. As we have already seen, however, it will generally be impossible to effect such redemption without prohibitive tax payments after the husband-father has died. Most assuredly there is a tremendous tax premium on comprehensive, efficient, pre-death estate planning including in that concept possibility of redeeming stock in a closely-held family corporation.

2. *Redemptions to Pay Death Taxes and Administration Expenses*

Another favorable redemption section which merits our attention here is section 303. Paradoxically enough, although the section

can operate only after the stockholder's death, it is nevertheless necessary to keep the section firmly in mind in planning a stockholder's estate prior to his death.

Section 303 permits the receipt of proceeds in redemption of stock owned by a decedent up to an amount equal to death taxes and administration expenses without the paying of any ordinary dividend tax. You can readily appreciate the practical importance of this exemption provision in light of what we have just seen respecting the attribution rules and the impact of them upon section 302 where a redemption is attempted following a stockholder's death. In brief, we saw that in the case of a family-owned corporation, qualification under the favorable provisions of section 302 might be very difficult following death. Section 303, however, to the extent that it is applicable, will apply even though advantage cannot be taken of section 302. You can appreciate therefore the overwhelming importance of section 303. What is more, although section 303 according to its terms merely exempts from ordinary dividend tax, the fact is that in the actual working out of a redemption following a death, little or no capital gain tax will be paid; this is because the basis of the stock will of course have stepped up to, or approximately up to, the redemption price in view of the basis provisions which subsitute for a decedent's cost of his stock the value of that stock at the time of his death or during the one-year period after his death, as the case may be.[13] To the extent that section 303 is applicable, therefore, a redemption under it will frequently cost less in tax than a pre-death redemption under section 302.

To qualify under section 303 it is necessary that the stock in a single corporation owned by the decedent be either more than 35% of his gross estate or 50% of his taxable estate. For these percentage purposes there is some possibility, under the provisions of section 303, to aggregate the ownership of stock in more than one corporation, but in the interests of simplicity, let us skip over that aggregating provision for our present purposes.

We are going to be concerned with the estate of Mr. Milton. Let us assume that his gross estate is in the neighborhood of $400,000. We should also note that Mr. Milton owned closely held corporation stock which is subject to the corporation's right to redeem at $120,000. Thirty-five percent of the gross estate of $400,000 comes to $140,000. The 35% requirement of section 303 could not be satisfied.

Those two requirements of section 303 are in the disjunctive,

[13] Int. Rev. Code of 1954, § 1014.

however, so let's see whether the 50% requirement can be met. When Mr. Milton died, he had debts and administration expenses of something in excess of $60,000, leaving an adjusted gross estate in the neighborhood of $340,000. The maximum marital deduction would be $170,000, and taking off the $60,000 exemption as well would leave a taxable estate of $110,000. You will recall that the alternative second requirement of section 303 is that the redeemed stock have a value of more than 50% of the decedent's taxable estate. Under the estate tax provisions that phrase "taxable estate" is more like what one generally thinks of as being the *net* estate, *i.e.*, the estate after the deduction of administration expenses, debts, and, what is more, the marital deduction and even the $60,000 exemption.[14] Manifestly, if Mr. Milton's taxable estate in this technical sense is going to run at around $110,000, the $120,000 value of corporate stock will easily meet the requirement that it exceed 50% of that $110,000 taxable estate.

I suggested above that the post-death provisions of section 303 should be considered even in the pre-death estate planning stages. The reason why you should have section 303 in mind at such an early stage is because its provisions might govern your selection of property for purposes of effectuating a gift program. Quite obviously, if Mr. Milton should give away all of his closely held corporation stock, pursuant to a gift program suggested by you, section 303 cannot possibly operate at the time of his death. Futhermore, if he gives away some but not all of his closely held corporation stock during his life, he might kill the qualification which would otherwise obtain under section 303.

Quite apart from Mr. Milton's situation, we can summarize the effects of a gift program under section 303 by making two observations: First, a gift of close corporation stock might operate to defeat qualification under section 303. Second, and on the other hand, a gift of property other than close corporation stock might increase the likelihood of meeting the percentage requirements of section 303. A gift of other property increases the likelihood of the close corporation stock which remains in the estate aggregating more than 35% of the diminished gross estate or more than 50% of the diminished taxable estate.

The moral, therefore, is that the selection of gift property in the pre-death estate planning stages should be made with an eye firmly fixed upon the problem of not killing qualification under section 303 or, in the alternative, of actually setting up qualification under section

[14] Int. Rev. Code of 1954, § 2051.

303—bearing in mind at all times that section 303 is indeed a very valuable tax privilege.

3. Hot Stock

Section 306 was designed to preclude a common stockholder from taking a preferred stock dividend, or, in the alternative, from going through the motions of exchanging a portion of his common stock for preferred while retaining the balance of his common stock—and then either selling the preferred stock or having the corporation redeem it. Prior to 1954 there were hopes (firmly supported by a decision by Sixth Circuit Court of Appeals)[15] that the proceeds of such redemption or sale would be taxable only to the extent of gain and then only at favorable capital gain rates, rather than at ordinary dividend rates, as contended by the Commissioner. Section 306, in brief, enacted into law the Commissioner's contention.

As a result, the redemption or sale of section 306 stock will generally result in ordinary dividend tax. It will sometimes be of importance, however, that the section 306 taint attaching to such preferred stock is removed by death of the shareholder. As a result, section 306 does not then apply, and it is possible to sell the preferred stock following his death without fear of ordinary dividend tax treatment. At first blush, it might appear, therefore, that preferred stock should frequently be issued at the estate planning stage so that it will be available for disposition after death. The difficulty with this superficially attractive plan, however, is that although neither the sale nor the redemption proceeds will be taxed as ordinary income under the provisions of section 306, it is quite likely that in many circumstances redemption proceeds (albeit not sale proceeds) will be taxable as ordinary dividends because of a failure to meet the favorable exceptions which I have discussed in connection with section 302 respecting redemptions.

That observation, of course, still leaves open the possibility of sale after death. I don't see any particular tax difficulty with sale. There is, however, an overwhelming practical difficulty in the fact that preferred stock is increasingly being labled as a hybrid security having neither the security advantage of a debt on the one hand, nor the speculative advantage of common stock on the other. Preferred stock simply is not attractive as an investment and the chances of selling preferred stock in a close corporation are indeed very thin. Accordingly, at the practicing level, I am not at all sure that a recognition of the limits of section 306 and of the beneficial effects of death

[15] Chamberlin v. Comm'r, 207 F.2d 462, 44 Am. Fed. Tax R. 494, 53-2 U.S.T.C. ¶ 9576 (6th Cir.), *cert. denied*, 347 U.S. 918 (1953).

will be of actual working importance to you in causing the issuance of preferred stock prior to death. I am afraid that the apparent availability of cash through disposition of that preferred stock after death is more theoretical than real.

B. Corporate Recapitalizations

We have already mentioned situations in the pre-death planning stages in which we will not want to redeem stock on account of our inability to comply with the favorable provisions of section 302, but in some of these cases we might want to stabilize the dollar value of the particular shareholder's stock. As a result, we will want to issue preferred stock. Now just let's review some situations as they might arise in everyday practice—situations where we cannot advise the redemption of stock but where, nevertheless, we want to stabilize the dollar value of that stock by issuing preferred stock in lieu of it.

Let's suppose that we have a father and a son, both stockholders in a closely held corporation. Let us further suppose that the father does not want to retire from the business. As a result, the attribution rules of section 318 will apply, the relief provisions of section 302(c)(2) from those attribution rules will not apply, and accordingly the favorable tax provisions of section 302 cannot be employed. In such a case it is quite likely that you will want to advise the issuance of preferred stock to the father in lieu of his common stock. Any increase in value of the business will then attach to the son's shares, and although you have not gotten the father out of his proprietary interest in the business, you have done the next best thing by stabilizing the dollar value of his stock.

Now let's take a second case. Supposing again a father and son own the stock of a corporation. In this case the father is actually willing to retire. But let us assume that the son acquired his stock from his father seven years ago. As a result, a redemption from the father will not satisfy the ten year look-back requirement of section 302(c)(2). In this case, preferred stock can be issued as an interim device, so that the father takes preferred instead of his common at the present time. Assuming that the father survives the three years, then at the end of the total ten year period which will come three years from now, the situation can be examined again to determine whether or not it is advisable to redeem the father's preferred shares, because at that time it will be possible to gain the advantage of section 302(b)(3).

Now let's change the facts a bit and assume that a father, his wife and his daughter all own stock in a closely held corporation. Let's assume that the wife and the daughter acquired that stock from

the father less than ten years ago. Here again a redemption from the wife or daughter will not satisfy the ten year look-back requirement of section 302(c)(2). Again, preferred stock can be issued as a sort of interim device and after the ten year period has elapsed you can re-examine the situation to determine the advisability of actually going through with the redemption when the benefits of section 302 can be obtained.

In all of these cases you will want to substitute new preferred stock for old common stock. Accordingly, an exchange of stock is in order. In effecting such an exchange, however, if the present value of the common stock—and hence the value of the preferred new stock which is to be received on the exchange—is more than the basis of the common stock, then you will want to be sure that the exchange will be tax-free under the tax-free provisions of the taxing statutes.

In that connection you will want to look at sections 354 and 368. Section 354, to put the matter rather briefly but with sufficient accuracy for our present purposes, provides that an exchange of stock for stock pursuant to a reorganization will be tax-free. Accordingly, you have to set up what is technically termed a "reorganization" under the taxing laws.

For this purpose we look to section 368 and we find under that section a definition of reorganization as including a recapitalization. Looking further, we see that under the Regulations issued under section 368 an issuance of new preferred stock in exchange for old common stock does qualify as a recapitalization.[16]

At this point you might assume that all your worries as counsellor in this phase of the estate plan are completed. Such is not the case, however, because of the judicially-imposed "business purpose" test.[17] Pursuant to this test, even though an exchange is tax-free under the letter of the law, unless that exchange serves a business purpose, it will nevertheless not be treated as tax-free. The business purpose requirement, in other words, is a sort of "now you see it, now you don't" aspect of these tax-free exchange provisions. You only think you qualify, but in reality you might not.

Now actually in most cases we need not worry about the business purpose requirement in context of the situations which we are now discussing. In most of those cases we will be exchanging new preferred stock in return for old common stock in order to place the common stock proprietorship of the business in the person or persons who are actually running the business. If that is the case, then we

---

16 Treas. Reg. § 1.368-2(e)(3) (1955).

17 Gregory v. Helvering, 293 U.S. 465, 14 Am. Fed. Tax R. 1191, 35-1 U.S.T.C. ¶ 9043 (1935).

can rest assured that the business purpose requirement is met, because the cases firmly establish that proposition.[18]

C. DISTRIBUTIONS OF STOCK (THE PREFERRED ALTERNATIVE)

In some cases you will have your choice of either issuing new preferred stock in *exchange* for old common stock, pursuant to the sections of the law which we have just examined, or, in the alternative, of issuing preferred stock as a *dividend* on the common stock, leaving all of the old common stock outstanding. Such a dividend, incidentally, is tax-free under the express provisions of section 305. Section 305 was first put in the Code in 1954 and it puts to rest any lingering doubts respecting the judicial treatment of a dividend of preferred stock on common stock.

It will sometimes be possible for you to effect your client's purposes either by exchanging a portion of his common stock for new preferred stock or else by issuing new preferred stock as a dividend on the outstanding common stock. This choice will arise whenever you do not want the corporation to terminate completely your client's common stock interest.

In turn, you will not want the corporation to terminate completely your client's common stock interest when his aim is to sell some or all of his common stock, generally to shift the control of the corporation into a new managing stockholder or managing stockholder group. By way of example, let us assume that we have Mr. Old, the sole stockholder of the corporation, and that his stock is worth $100,000. Let us assume that Mr. New has been working as his assistant for seven or eight years, that Mr. Old wants to retire completely or go into semi-retirement, and that Mr. New wants a substantial proprietary interest in the firm. Indeed, we may assume that Mr. New is unwilling to continue beating his brains out for the firm unless he acquires a substantial stock interest. On the other hand, Mr. New does not have much money and does not care to go on the hook by borrowing a considerable sum in order to acquire the amount of Mr. Old's stock which he wants.

At first blush that problem might appear unsolvable. It can be solved, however, by issuing preferred stock to Mr. Old in the amount of, let us say, $90,000 and then having Mr. Old sell some or all of his remaining common stock, now stripped down to a value of only $10,000. In other words, he now has common stock of such a reduced value as to leave him free to negotiate with Mr. New for its purchase.

[18] Marjorie N. Dean, 10 T.C. 19 (1948), *acq.*, 1949-1 Cum. Bull. 1; Elmer W. Hartzell, 40 B.T.A. 492 (1939), *acq.* 1939-2 Cum. Bull. 16; Rev. Rule 54-13, 1954-1 Cum. Bull. 109.

That is the type of situation of which we are talking, and that is where you will have the choice of either exchanging nine-tenths of Mr. Old's common stock for new preferred stock or else of simply issuing a stock dividend in $90,000 par value of preferred stock. Where that choice is present, then it is the feeling of this author that the preferred stock dividend approach rather than the exchange approach is slightly preferable, although the margin is not very great.[19] The dividend approach is slightly preferable because, pursuant to the express provisions of section 305, a dividend of preferred stock on common is tax-exempt and as of the present date at least, there does not appear to be any superimposed judicial gloss upon that stock dividend section requiring a business purpose. My margin of preference is not very great, however, because even where you have an exchange, you should be able to satisfy an examining agent that a business purpose exists, where in point of fact the transaction was effected in order to shift a common stock interest in the corporation to a new managing group. On the other hand, there is no point allowing the question to arise in the agent's mind, and you can prevent any question by following the stock dividend route under section 305.

D. Corporate Liquidations

Partial redemptions under section 302 and section 303 have been discussed above. In taking advantage of those two sections, the corporation itself would of course not go out of business, since only a portion of its stock would be redeemed. As we have already seen, however, it will frequently be impossible to take advantage of section 302 in the case of the family-owned corporation, once one of the stockholders has died. Furthermore, in the case of section 303, even when the percentage requirements for its application can be met, there is a dollar limit to the amount of proceeds which can be withdrawn in redemption of stock under that provision.

In looking to those partial redemptions, don't under any circumstances overlook the possibility of a *complete* liquidation under section 331. A complete liquidation is treated just as though the stockholders sold their stock in exchange for the cash and other assets received upon the liquidation of the corporation. In this connection there is a possible opportunity or bonanza, brought about by death, which should not be overlooked by the attorney planning the administration of the estate of a deceased shareholder. The basis of an estate's stock in the corporation steps up to the value of that stock at the date of death or one year after the date of death, as the case may be.[20] As a

---

19 See Cavitch, Ohio Corporation Law with Federal Tax Analysis § 9.23(3) (1961).
20 Int. Rev. Code of 1954, § 1014.

result, the estate will be charged with little or no capital gain tax upon the redemption of its stock. Furthermore, if the liquidation is complete, there will then be no ordinary dividend tax.[21]

Manifestly, therefore, when a substantial stockholder in a corporation dies, the tax consequences of a complete liquidation will turn on questions surrounding the stock owned by *other* shareholders, because there will be little or no tax consequences upon complete liquidation to the estate-shareholder. How many other shareholders are there? How much stock do they own? Is the basis of their shares low or is it high? Quite clearly, no rule of general application can be pronounced, but equally clear, whenever a substantial shareholder of a corporation dies the possibility of complete liquidation with no tax to the estate—not even a capital gains tax—should not be overlooked. By this I do not mean to suggest that the non-tax implications of a non-corporate operation should themselves be overlooked. As counsellor, you will want to inquire not only into the tax consequences, but into the non-tax consequences as well. But assuming that there is a reasonable opportunity to run the business in non-corporate form, it might well be that the tax bonanza of a complete liquidation with little or no tax should have your serious attention.

E. Corporate Separations

Now let's turn our attention to corporate divisions or separations which are incident to estate planning, either before or after the death of a substantial stockholder. As a typical example, let us suppose that the stockholders of a corporation are comprised of two branches of a single family—perhaps the second generation of a family—or perhaps of two different families. Suppose, then, that there is disagreement respecting corporate policies. In the context of such a problem, as corporate advisor you will want to explore the possibility of dividing the corporation so that each group of stockholders may continue its separate way with a portion of the corporate enterprise allocated to each.

We are here talking about the continuance of both operations after the division of the corporation among the stockholders. Furthermore, each of the operations will be continued in corporate solution.

Now to be a little more specific, let us assume that a corporation operates two shoe stores. Sometime ago the father, who was the sole shareholder, died, leaving his stock to his two sons. With the passage of years, differences between the sons have grown and they have conflicting ideas respecting the operation of the two shoe stores. It might be

[21] Int. Rev. Code of 1954, § 302(b)(3).

possible to divide up this corporate business so that one takes over, in corporate form, the operation of one shoe store, and the second son takes over, again in corporate form, the operation of the second shoe store. It might be possible to distribute tax-free to one son the shares of a newly created or long existing subsidiary corporation operating one of the shoe stores, tax-free in exchange for his shares in the distributing corporation. Assuming that such a division into two corporations is possible consistently with tax objectives—that is, tax-free—then as corporate counsel you will have obtained a handsome result: the ownership of one corporation owning one store by one son, and the ownership of the corporation's stock entirely by the other son. Each son will then be free to pursue his own policies without interference from any co-stockholder.

Section 355, under certain circumstances, permits stockholders of a simple corporation to rearrange their stock holdings so that the simple corporation is divided and the shareholders own stock in more than one corporation—and this without incurring any income tax upon their receipt of shares in the other corporation. According to section 355, each corporation after the distribution must operate a trade or business. Furthermore, the distributing corporation must have operated the trade or business (either itself or through a subsidiary) for at least five years prior to the date of distribution. The Regulations adopt a two-business test and dwell upon the necessity for the distributing corporation—either itself or through a subsidiary—to have been operating *two* businesses, each for at least five years.[22] The examples under the Regulations rigidly apply this two-business rule.

Actually, however, the first difficulty is not in the application of the two-business rule, but rather in determining whether or not the statute in point of fact requires two separate businesses; it appears merely to require that a business shall have been conducted for at least five years[23] and that, after the separation, each corporation be actively engaged in a business.[24] Furthermore, the majority of the Tax Court in the *Coady* case decided in early 1960 expressly held that the two-business requirement of the Regulations is invalid.[25] If I were involved in litigating the question, I would place my own personal money on the side of the majority of the Tax Court. Again, however, we are here at the *planning* stage, and that being the case, I must reluctantly suggest that you assume that there is a two-business requirement under section 355.

---

22 Treas. Reg. § 1.355-1(c) (1955).
23 Int. Rev. Code of 1954, § 355(b)(2).
24 Int. Rev. Code of 1954, § 355(b)(1).
25 Edmund P. Coady, 33 T.C. 771 (1960).

You should observe that under the tax-free provisions of section 355 it is necessary that the distributing corporation distribute *stock* in a corporation owning and operating the second business. In the usual case, of course, both businesses will have been operated by the same corporation, without the intervention of a subsidiary corporation. In that conventional situation, it is quite easy, however, for you to square the distributing corporation around to the position where it can make a distribution of subsidiary corporation stock in exchange for the receipt by it of its own shares. This can be done by deliberately organizing a subsidiary corporation and transferring to it the assets of the second business in an exchange which is tax-free under section 351. Section 351 is the section which is so frequently used in making the transfer of assets tax-free to the shareholder when a new corporation is organized, and I shall not linger over its provisions. Suffice to say that it is extremely easy to take advantage of section 351 by having the parent corporation exchange its assets comprising the second business in exchange for stock in a newly-formed subsidiary corporation. That being true, the parent corporation is then in a position to take advantage of section 355 by distributing the stock in its newly-formed subsidiary corporation in exchange for its own outstanding stock owned by the shareholder who is to be divorced from the old corporation. The five year business rule, incidentally, is the subject of a sort of tacking procedure here because even though the subsidiary corporation is newly formed, if the business which was transferred to that subsidiary has been conducted for an aggregate of more than five years by the parent and subsidiary together, then the five year rule has been satisfied.[26]

If then, you can satisfy the two-business rule, you should consider section 355 in estate planning when you have two groups of stockholders who are at loggerheads. That might occur after the death of a principal shareholder or you might even care to avail yourself of section 355 in planning an estate prior to the death of the principal shareholder. Thus, a father might want to divide up an existing corporate enterprise in his will between different branches of his family, contemplating the fact that the entire corporate enterprise will not be satisfactorily run by both branches operating together. That being true, you might want to divide the business tax-free to the father under section 355, thus placing yourself in position to draft a will disposing of the stock in two corporations rather than in only one corporation.

Quite clearly, therefore, section 355 will frequently be a useful estate planning tool.

---

[26] Int. Rev. Code of 1954, §§ 355(b)(2)(C) and (D).

SUMMARY

We have seen that corporate readjustments will frequently be important in pre-death and post-death estate planning.

In the area of corporate redemptions, we saw that section 302, exempting stock redemptions from ordinary dividend taxation in certain circumstances, can be extremely valuable. At the practicing level, however, where a corporation is family-owned, section 302, because of the ownership attribution rules, will frequently no longer be available after the head of the family dies. Frequently, therefore, there will be a handsome premium in taking advantage of section 302 in pre-death planning. We saw that section 303, applicable only after a stockholder's death, sometimes permits redemption of the decedent's shares without ordinary dividend taxation; the amount so qualifying is, however, limited.

We examined the tax-free provision permitting the exchange of new preferred stock for old common stock. In some instances, however, it will be preferable simply to issue a preferred stock dividend on common stock, rather than to follow the exchange route. This substitution of preferred for common stock will be advisable when it is desired to shift the control of a corporation and stabilize the dollar value of the interest of an erstwhile common stockholder.

We saw that a complete corporate liquidation after a sole or major stockholder's death will frequently be advantageous. In probating an estate, the possibility of such complete liquidations should not be overlooked.

Where stockholders or groups of stockholders are in disagreement, a corporate separation will frequently solve the problem and permit each faction to go its own independent way.

The foregoing matters all concern corporate readjustments. Perhaps surprisingly, however, they are all germane to estate planning, which manifestly involves more than the mere drafting of wills and trust agreements.