

1996

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ESTATE TAXES AND THE CLOSELY HELD BUSINESS: THE BEGINNING OF THE END?

Robert A. McLeod†

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I. INTRODUCTION

The owners of a closely held business often spend much of their lives building their businesses. Unfortunately, many closely held businesses fail after the death of the founder due to a failure to properly plan for estate taxes and business succession.¹ The purpose of this article is to review the basic estate tax issues that face closely held business owners and to provide general descriptions of the solutions to the issues presented.

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1. Benton C. Strauss, *Estate & Gift Planning for the Business Owner*, in 10 TAX ADVISORS PLANNING SERIES 1 (Research Institute of America, Series No. 10, Jan. 1995).

II. THE GROSS ESTATE AND ESTATE TAXES ON THE CLOSELY HELD BUSINESS

The basic problem facing a closely held business owner is that the owner will probably have to pay an estate tax on the value of the business. While this seems simple enough, the wrong question is: "Does your estate have sufficient assets to pay the estate tax?" The answer will almost always be "yes." The real question, however, is: "Will you have to sell part or all of your business to pay the tax?" The corollary to this question is: "Will your business survive after paying the estate tax?" To bring these questions into focus, a review of the basic estate tax structure and how estate taxes are calculated is appropriate.

A. *The Decedent's Gross Estate*

A decedent's estate will pay an estate tax on all of the decedent's "property, real or personal, tangible or intangible, wherever situated," net of allowable deductions and credits.² Some of the most common items included in the gross estate are: joint tenancy interests,³ cash and securities,⁴ retirement plans,⁵ life insurance,⁶ transfers with retained life estates⁷ or

2. I.R.C. §§ 2031, 2033 (1994). See *T. Righter v. United States*, 439 F.2d 1204 (Cl. Ct. 1971) (including the value of closely held stock in the decedent's estate for tax purposes). Generally, the value of the decedent's estate is calculated as of the time of his or her death. *Estate of Angello v. Commissioner*, 103 T.C. 605 (1994). The property value "included in the decedent's gross estate is its fair market value[,] . . . the price at which property would change hands between a willing buyer and a willing seller . . ." *Estate of Neff v. Commissioner of Internal Revenue*, 57 T.C.M. (CCH) 669, 674 (1989).

3. I.R.C. § 2040 (1994); see *Krakoff v. United States*, 439 F.2d 1023 (6th Cir. 1970) (including a joint tenancy interest in decedent's estate for tax purposes).

4. I.R.C. § 2031(b) (1994). In *Estate of Belcher v. Commissioner*, 83 T.C. 227 (1987), *action on decision*, (Nov. 13, 1989), the decedent had sent gift checks totalling \$94,960 to various charities. However, she died before any of the checks cleared the bank. The Internal Revenue Service Commissioner found "a limited, equitable exception to [Treasury Regulation section 20.2031-5] for checks issued in good faith to charitable donees" and agreed with the Tax Court that the money should not be included in the decedent's estate. *Id.* at 228; see *Estate of Newcomer*, 447 F. Supp. 1368 (W.D. Pa. 1978) (including securities in decedent's estate for tax purposes).

5. I.R.C. § 2039 (1994); see *Montgomery v. Commissioner*, 458 F.2d 616 (5th Cir.) (including annuity in decedent's estate for tax purposes), *cert. denied*, 409 U.S. 849 (1972); see also *Estate of Deobald v. United States*, 444 F. Supp. 374, 377 (E.D. La. 1977) (holding that "section 2039(c) does not require a spouse's community property interest in retirement funds to be included in the decedent's gross estate"); cf. *Giardine v. Commissioner*, 776 F.2d 406 (2nd Cir. 1985) (holding that where a life insurance

transfers taking effect at death,⁸ and of course, the closely held business interests.⁹

The gross value of joint tenancy property owned with a decedent's spouse is usually subject to a fifty percent exclusion from the gross estate.¹⁰ However, joint tenant interests held with someone other than the decedent's spouse may be fully included in the gross estate if the non-decedent joint tenant did not pay full and adequate consideration for his or her joint tenancy interest(s).¹¹

Cash and securities held in the decedent's name are property interests that are included in the decedent's gross estate at their full fair market value at the time of death.¹² All of the decedent's annuities, I.R.A.s, profit sharing plans, or other

beneficiary did not expressly elect a lump-sum distribution, proceeds representing the decedent's interest in a qualified retirement plan were not includable in the gross estate).

6. I.R.C. § 2042 (1994); see *Baptiste v. Commissioner*, 29 F.3d 1533, 1538-39 (11th Cir. 1994) (including proceeds of decedent's life insurance in value of gross estate where decedent, at the time of death, had incidents of ownership in the policy); *Hunter v. United States*, 624 F.2d 833 (8th Cir. 1980) (holding that decedent's position as potential trustee of a life insurance policy did "not constitute an incident of ownership under section 2042(2)" and thus, should not be included in decedent's gross estate).

7. I.R.C. § 2036 (1994); see *Estate of Maxwell v. Commissioner*, 3 F.3d 591, 593-94 (2nd Cir. 1993).

8. I.R.C. § 2037 (1994); see *Estate of Fried v. Commissioner*, 445 F.2d 979, 983 (2nd Cir. 1971) (including death benefit in gross estate where right to receive benefit was conditioned upon decedent's death and decedent had reversionary interest), *cert. denied*, 404 U.S. 1016 (1972).

9. I.R.C. § 2033 (1994); see I.R.C. §§ 2031-2044; see also *Estate of Thompson v. Commissioner*, 864 F.2d 1128, 1133 (4th Cir. 1989) (noting that Congressional intent behind Code § 2032A was to enable family and small businesses to continue operating after death of the owner).

10. I.R.C. § 2040(b)(1) (1994); see I.R.C. § 303 (b)(2)(B) (defining "qualified joint interest" for purposes of the fifty percent exclusion embodied in § 2040(B)(1)); Gen. Couns. Mem. 38,892 (Aug. 31, 1982) (stating that § 2040(b) requires that one-half of the value of real property held in joint tenancy, a qualified joint interest, be included in decedent's gross estate); see also *Gallenstein v. United States*, 975 F.2d 286, 292 (6th Cir. 1992) (stating that the "fifty percent rule" should be applied to qualified joint interests "included in the estates of decedents dying after 1981" and "allowing the '100% contribution rule' for joint interests purchased prior to 1977").

11. I.R.C. § 2040(a) (1994); see *Estate of Peters*, 386 F.2d 404, 407 (4th Cir. 1967) (stating that when a decedent owns property jointly with someone other than a surviving spouse, "[s]ection 2040 looks to the source of the consideration represented by the property and disregards legal title"). In *Peters*, the court found that where decedent held property in joint tenancy with son, "the value of [the] property is includable in the decedent's gross estate to the extent that the decedent furnished the consideration for acquiring the property." *Id.* at 407.

12. See *infra* part III(A) for an alternate valuation option.

retirement plans, regardless of the named beneficiaries, are included in the gross estate.¹³ Naming a beneficiary other than the estate does not remove the asset from the estate.¹⁴

The proceeds from life insurance, contrary to conventional wisdom, are included in the decedent's gross estate even though the proceeds are paid after the decedent dies, and even though life insurance proceeds are typically not subject to *income tax*.¹⁵ The proceeds of life insurance are included in the gross estate if the decedent retained incidents of ownership in a life insurance policy.¹⁶ Incidents of ownership include ownership of the life insurance policy, the ability to change beneficiaries, fiduciary control over the insurance, or other retained control over the life insurance.¹⁷

Internal Revenue Code [Code] sections 2035 to 2046 address several forms of property transfers prior to decedent's death that will be partially or fully includable in the decedent's gross estate. For example, retained life estates in a trust or real property are brought back into the estate.¹⁸ Revocable transfers such as property held in a revocable trust are also pulled back into the estate.¹⁹ Property to which the decedent possessed a

13. I.R.C. § 2031(a) (1994).

14. I.R.C. § 2045.

15. Life insurance proceeds are excluded from gross income under Code § 101(a)(1). However, when life insurance is transferred for valuable consideration, income tax may be due. When life insurance is transferred with loans against the policy cash value, the proceeds of a life insurance policy may be taxable. I.R.C. § 61(10); *see* *Simon v. Commissioner*, 285 F.2d 422 (3rd Cir. 1961) (stating that recognizable gain accrued to the taxpayer, for federal income tax purposes, where pursuant to a prearranged plan, the taxpayer mortgaged real estate and thereby received an amount in excess of property's adjusted basis).

16. *See* I.R.C. § 2042(2) (1994) (defining "incident of ownership" for purposes of the valuation of life insurance policies).

17. *Id.* § 2042(2); Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974). In *Estate of Headrick v. Commissioner*, 918 F.2d 1263 (6th Cir. 1990), the court held that decedent had not possessed any incidents of ownership in an insurance policy where a bank acted as trustee of the policy in an irrevocable trust. *Id.* at 1268.

18. I.R.C. § 2036 (1994); *see* *Estate of Patterson v. Commissioner*, 736 F.2d 32, 33 (2nd Cir. 1984) (holding that a remainder interest in a testamentary trust was includable in the decedent's gross estate "because the remainder passed to the decedent outright under her husband's will and because the decedent did not disclaim the legacy of the remainder interest").

19. I.R.C. § 2038 (1994). *But see* *McNeely v. United States*, 16 F.3d 303 (8th Cir. 1994), in which the court reversed the district court's conclusion that certain gifts made by the decedent "within three years of her death with assets derived from her revocable trust were includable in the gross estate under Section 2038(a)(1) . . ." *Id.* at 304. The Eighth Circuit held that the gifts were not includable because the decedent "was

general power of appointment,²⁰ transfers for insufficient consideration,²¹ and other interests that are beyond the scope of this article may also be included in the decedent's gross estate.

It is essential to have a complete understanding of the decedent's estate and property transactions. Many of the transactions described by the above mentioned Code sections may have been executed years before the decedent's death yet may be included in the gross estate. Although this article does not review the broad scope of those transactions, the attorney representing an owner of a closely held business must be sensitive to the fact that current transactions may have an impact on the estate tax of the closely held business owner.

B. Deductions from the Decedent's Gross Estate

After the gross estate has been accumulated, the estate is allowed certain deductions before applying the estate tax.²² The most significant deductions for federal estate taxes include the marital deduction,²³ debts and losses of the decedent,²⁴

exercising her power to invade the trust corpus at will." *Id.* at 305.

20. I.R.C. § 2041 (1994); see *Estate of Vissering v. Commissioner*, 990 F.2d 578, 580 (10th Cir. 1993) (stating that "[u]nder I.R.C. § 2041 a decedent has a general power of appointment includable in his estate if he possesses at the time of his death a power over assets that permits him to benefit himself, his estate, his creditors, or creditors of his estate"); *Independence Bank Waukesha (N.A.) v. United States*, 761 F.2d 442, 445 (7th Cir. 1985) (finding that husband's will created a general power of appointment in his wife, and thus assets were part of the wife's estate).

21. I.R.C. § 2043 (1994); see *Estate of Iversen v. Commissioner*, 552 F.2d 977, 982 (3rd Cir. 1977) (holding that since decedent received no consideration for assets transferred to his wife's trust, the value of the trust was includable in decedent's gross estate).

22. I.R.C. § 2051 (1994). The available deductions are stated in Code §§ 2053-56A. See *Kisling v. Commissioner*, 32 F.3d 1222, 1227 (8th Cir. 1994) (stating that "gross estate includes the value of all interests in property which belong to the decedent at the time of death," including "all transfers made within three years of the decedent's death" unless excludable as gifts for which a gift tax return was not required to be filed).

23. I.R.C. § 2056(a) (1994). In *Estate of Heim v. Commissioner*, 914 F.2d 1322 (9th Cir. 1990), the court stated that the "marital tax deduction permits transfer of property within the marital unit, and thus avoidance of taxation of that property in the estate of the decedent, only if the property passes outright to the surviving or donee spouse." *Id.* at 1326; see *Estate of Mackie v. Commissioner of Internal Revenue*, 545 F.2d 883, 884 (4th Cir. 1976) (allowing marital deduction where decedent's will gave his wife the option to take enough properties from decedent's estate to obtain maximum allowable deduction under § 2056(a)).

24. I.R.C. §§ 2053, 2054 (1994); see *Estate of Johnson v. Commissioner*, 718 F.2d 1303, 1304 n.2 (5th Cir. 1983) (listing expenses, indebtedness, taxes, losses, charitable

expenses of administration,²⁵ and charitable deductions.²⁶

The marital deduction allows the decedent to give all or part of the estate to the surviving spouse, allowing for a significant deduction from the gross estate.²⁷ With this deduction, the decedent can effectively control the amount of estate tax due on the estate by controlling the amount of the marital deduction.²⁸ For example, the decedent may devise all but \$600,000 to the surviving spouse. The estate tax on \$600,000 will be sheltered by a tax credit resulting in no federal tax payment due on the estate.²⁹

Various remaining debts and expenses, chargeable to the estate, are also deductible from the gross estate.³⁰ For instance, outstanding debts and legal obligations of the decedent are deductible.³¹ Such debts include real estate taxes, mortgages, hospital and medical bills, and other liabilities that exist at the

transfers, and the marital allowance as allowable deductions from the gross estate). In *Estate of Huntington v. Commissioner*, 16 F.3d 462 (1st Cir. 1994), the court found that while "hard bargaining as would occur between hostile parties is [not] an absolute prerequisite to a deduction under § 2053," when the debt is incurred between family members, a deduction is not allowed "unless there is some showing of a bargained for exchange." *Id.* at 466-67 (citations omitted).

25. I.R.C. § 2053(a) (1994).

26. *Id.* §§ 2053, 2055; see *United States Trust Co. v. Internal Revenue Service*, 803 F.2d 1363, 1366 (5th Cir. 1986) (allowing deduction from gross estate for charitable bequest "funded by property owned by the decedent at death"); *First Trust Co. of St. Paul, Minnesota v. United States*, 402 F. Supp. 778, 780-81 (D. Minn. 1975) (holding that the I.R.S. erred in reducing from marital deduction administrative expenses incurred by estate when calculating deduction where decedent's will gave the wife a "total amount equal in value to the maximum 'marital deduction' available for federal estate tax purposes . . ."); see also *United States v. Benedict*, 338 U.S. 692, 696-97 (stating that purpose of tax deductions for charitable contributions is to encourage such donations).

27. See I.R.C. § 2056(a) (1994). The gift may be outright or in trust. I.R.C. § 2056(d)(2) (defining deductions which are allowed for certain qualifying trusts). Although the marital deduction seems simple, it is subject to strict statutory compliance.

28. *Id.*

29. See I.R.C. § 2010(a) (allowing for a \$192,800 credit to be charged against the tax imposed by § 2001 upon the estate).

30. I.R.C. § 2053.

31. I.R.C. §§ 2053, 2054; see *Estate of Morse v. Commissioner*, 625 F.2d 133, 135 (6th Cir. 1980) (holding that the obligation of decedent's estate to pay decedent's wife \$12,000 each year for life was not a claim against the estate for deduction under Code § 2053(a)(3) where the decedent's act was not founded on a promise or agreement that was contracted for adequate consideration); see also *United States v. Stapf*, 375 U.S. 118, 132 (1963) (claims against estate are deductible only if they "represent personal obligations of the decedent existing at the time of death"), *reh'g denied*, 375 U.S. 981 (1964).

time of death.³² Expenses necessary to administer the estate are similarly deductible from the gross estate.³³ Such expenses include funeral expenses, attorney fees, executor fees and accountant fees.³⁴ Gifts to charities made by the decedent's estate are also deductible from the gross estate.³⁵

C. The Estate Tax

After computing the taxable estate, the estate tax can be calculated.³⁶ The federal estate tax marginal rates begin at eighteen percent and reach the highest marginal rate of fifty-five percent on a \$3,000,000 estate, and a sixty percent rate for estates between the value of \$10,000,000 and \$21,040,000.³⁷ As noted, the estate tax of every decedent is applied to the gross estate net of allowable expenses.³⁸ The estate is allowed a tax credit of \$192,800, the equivalent of a \$600,000 taxable estate.³⁹

32. I.R.C. §§ 2053, 2054 (1994).

33. I.R.C. § 2053; *see* *Hibernia Bank v. United States*, 581 F.2d 741, 746 (9th Cir. 1978) (pointing out that administration expenses within the meaning of section 2053 has to be essential to the proper settlement of the estate, and not incurred for the individual benefit of the heirs, legatees, or devisees); *see also* *Estate of Smith v. Commissioner*, 510 F.2d 479 (2nd Cir.) (affirming the Tax Court's conclusion that the sale of assets beyond what was needed to pay the estate's debts, expenses, and taxes was not necessary for the administration of the estate), *cert. denied*, 423 U.S. 827 (1975).

34. I.R.C. § 2053(a) (1994); *see* *Proesel v. United States*, 585 F.2d 295 (7th Cir. 1978) (ruling that testatrix's estate was entitled to a deduction for reasonable attorney's fees), *cert. denied*, 441 U.S. 961 (1979).

35. I.R.C. § 2055 (1994); *see* *Commissioner v. Estate of Sternberger*, 348 U.S. 187, 189 (1955) (stating that the value of an immediate and unconditional bequest to charitable corporation is deductible for federal estate tax purposes); *Estate of McCoy v. United States*, 511 F.2d 1090, 1092-93 (6th Cir. 1975) (holding that deductions from decedent's gross estate of the presently ascertainable value of a bequest to a charitable organization is allowed under § 2055).

36. *See* I.R.C. § 2106 (1994) (describing taxable estates).

37. I.R.C. § 2001(c)(2).

38. Every decedent is taxed on his or her gross estate less allowable expenses. I.R.C. §§ 2106, 2051.

39. I.R.C. § 2010. The estate is also subject to a state death tax credit. I.R.C. § 2011(a). The state death tax credit reduces the federal estate tax but is usually ultimately payable to the state of the decedent's domicile (or multiple states in the case of an estate with property located in several states) and therefore does not decrease the gross estate tax payable on the estate. *See* *Second Nat'l Bank of New Haven v. United States*, 422 F.2d 40, 41 (2nd Cir. 1970) (holding an estate may not credit against federal estate taxes the death taxes paid to a state on property included in the state return but excluded from the federal estate tax return); *see, e.g.*, MINN. STAT. § 291.03 (1995) (requiring payment of Minnesota estate tax equal to the maximum allowable under I.R.C. § 2011); *Kelly v. Commissioner*, No. 5705 1991 WL 278273, at *1 (Minn. Tax. 1991). The federal estate tax may also qualify for other tax credits beyond the scope

The net estate tax is the tax liability we are concerned with in this article. As stated above, the problem is not the estate's ability to pay the estate tax, but the estate's ability to pay the tax without having to liquidate the closely held business.

D. Example of an Estate Tax Calculation

The following example illustrates the calculation of an estate tax on an estate that includes a closely held business. Assume the decedent is a widower who is the sole owner of a manufacturing company. The decedent's estate tax is computed as follows:

Gross Estate	
100% ownership of Acme Manufacturing Company	\$5,000,000
Retirement account	750,000
House	300,000
Vacation home	150,000
Cash and securities	<u>100,000</u>
Total Gross Estate	6,300,000
Less Deductions	
Funeral expenses	(\$10,000)
Legal, executor and accounting fees	(75,000)
Debts:	<u>(100,000)</u>
Total Deductions:	(185,000)
Taxable Estate (Total Gross Estate minus Total Deductions)	
	\$6,115,000
Estate Tax on Taxable Estate	(3,004,050)
Estate Tax Credit	<u>192,800</u>
Net Estate Tax	(2,811,250)
Net Estate After Taxes (Taxable Estate minus Net Estate Tax)	
	\$3,303,750

The estate tax payable on this example is \$2,811,250.⁴⁰ Assuming each asset, with the exception of the closely held business, is liquidated, the estate is \$1,511,250 short on its tax

of this review. See I.R.C. §§ 2012-2016 (1994).

40. See I.R.C. § 2106 (1994).

liability.⁴¹ Therefore, at least part of the closely held business must be sold to pay the remaining estate tax. If the closely held business has insufficient capital to pay this tax liability, the entire enterprise may have to be sold.

There are, however, alternatives available to the closely held business owner who is faced with the possibility of liquidating the business to pay the tax liability. The remainder of this article will discuss the alternatives and opportunities to pay an estate tax on a closely held business.

III. PLANNING OPTIONS

A. *Valuation of a Closely Held Business*

The first and most critical step in planning for the estate tax consequences of owning a closely held business is to possess a legitimate and useful valuation of the business.⁴² If the valuation is without substantive merit, then the Internal Revenue Service (I.R.S.) will certainly use its own valuation on an audit.⁴³ At that point, it may be too late for the taxpayer to create a new business valuation that will have any impact on the eventual tax assessment. Another important factor is that if the closely held

41. The retirement plan will also be subject to income tax and excise taxes before the payment of estate taxes. See I.R.C. §§ 691-92 (income taxes due); see also I.R.C. §§ 4971-4980B (listing excise taxes due on qualified pension plans and other similar plans). Therefore, the tax liability that must be paid by the closely held business in the above hypothetical is much higher.

42. See Treas. Reg. § 20.2031-2(f) (as amended in 1992); Treas. Reg. § 20.2031-3 (as amended in 1992); see also *Arc Realty Co. v. Commissioner*, 295 F.2d 98, 103 (8th Cir. 1961). An excellent source to value a closely held business is SHANNON P. PRATT ET AL., *VALUING A BUSINESS, THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* (3d ed. 1996). See also BYRLE M. ABBIN, *IS VALUATION THE BEST PLANNING GAME REMAINING?*, CA02 ALI-ABA 413 (1995); R. James Alerding, Jr., *Valuation of A Closely Held Business*, in 9 *TAX ADVISORS PLANNING* 1, 16-36 (Research Institute of America, Series No. 9, Mar. 1995).

43. The I.R.S. provides a comprehensive list of relevant factors that can be used in valuing a closely held business. Rev. Rul. 59-60, 1959-1 C.B. 237, 238-39 (listing eight factors utilized by the I.R.S. as fundamental in valuation analysis). See Rev. Rul. 83-120, 1983-2 C.B. 170.; Rev. Rul. 77-287, 1977-2 C.B. 319; Rev. Rul. 65-193, 1965-2 C.B. 370; see also *Estate of Ford v. Commissioner*, 53 F.3d 924, 927 (8th Cir. 1995) (stating that the Tax Court is not bound to accept opinions of value provided by experts in federal estate tax disputes).

The touchstone for valuation of a closely held business is Revenue Ruling 59-60; however, the I.R.S. has addressed the issue in a progression of subsequent rulings. See Rev. Rul. 80-120, 1983-2 C.B. 170 (amplifying Revenue Rules 77-287, 65-193, 60-213, and 59-60, all relating to the valuation of a closely held business).

business owner's valuation substantially understates the assessed valuation, significant tax penalties may be assessed.⁴⁴ On the other hand, if the taxpayer has a legitimate, even though aggressive, valuation of the closely held business, the taxpayer may be able to control the negotiation of tax liabilities. In addition, a legitimate business valuation may avert an audit altogether.

A closely held business may be valued by a discounted cash-flow analysis (income approach), a net-asset (cost) method, or upon a readily ascertainable fair market value.⁴⁵ The cash-flow analysis examines the cash flow of the business and applies a present value to that cash flow.⁴⁶ This form of analysis is useful for valuing two types of businesses: businesses that have fixed assets which generate steady income streams and businesses that depend on personal services or consulting for revenue. The net income is generally the net operating income. Net income consists of gross income less expenses such as payroll, repairs, property taxes and utilities.⁴⁷ Whether items such as depreciation or amortization should be added into the income are factors to be considered by the valuation expert.⁴⁸ Once the net

44. The understatement penalty is 20% of the understated portion of the asset if the valuation is 50% or less of the assessed value, and a 40% penalty if the valuation was 25% or less of the assessed value. I.R.C. § 6662(g)(1) (1994). A 20% penalty is also imposed for any negligent valuations or valuations made in disregard of the rules and regulations. I.R.C. § 6662(b)(1); see *Selig v. Commissioner*, 70 T.C.M. (CCH) 1125 (1995) (holding that section 6662 provides for an accuracy related penalty in the amount of twenty percent of the portion of any underpayment of tax liability attributable to, among other things, any substantial understatement of income tax); *Presby v. Commissioner*, 69 T.C.M. (CCH) 2648 (1995) (holding taxpayer liable for accuracy-related penalty due to negligence under section 6662(a)); *Grzegorzewski v. Commissioner*, 69 T.C.M. (CCH) 1788 (1995) (ruling taxpayers must prove that they were not negligent, careless, reckless, or intentionally disregarded the rules or regulations). *But see* *Bradley v. Commissioner*, 69 T.C.M. (CCH) 2400 (1995) (ruling a taxpayer can avoid liability for the addition to tax for negligence if he can show that he reasonably relied on the advice of a competent and experienced accountant to prepare his return).

45. I.R.C. § 2031(b) (1994); see *Estate of Bennett v. Commissioner*, 65 T.C.M. (CCH) 1816 at 1819-20 (1993) (listing four approaches to valuation used by taxpayer's expert). For a general discussion see James R. Hitchner & Gary Roland, *Marketability and Control Govern Value of Family Business*, 52 TAX'N FOR ACCT 24 (1994).

46. *Estate of Bennett*, 65 T.C.M. at 1820 (holding the discounted-net-cash-flow focuses on the present value of the future economic income to be derived by the owners of the business); see also Hitchner & Roland, *supra* note 45.

47. See Hitchner & Roland, *supra* note 45.

48. See, e.g., PRATT ET AL., *supra* note 42, at part 1.

income is established, the income is capitalized. There are at least five different methods to capitalize income.⁴⁹ Because of the complexity of the calculations and the options related thereto, the services of a valuation expert are clearly required.⁵⁰

The net-asset approach is fundamentally a liquidation value of the business entity.⁵¹ This approach, however, fails to consider fully the value of the minority interest.⁵² Valuation under this approach is most useful for businesses with large amounts of fixed assets and where the cash-flow analysis is not appropriate.⁵³

The readily ascertainable market approach examines whether a business interest can be traded on a readily ascertainable market. If so, that market price is used to value the business interest.⁵⁴ If the stock is not traded on an open exchange, the market approach may still, however, be useful. For example, if the stock is actually sold in an arms-length transaction on a date close to the valuation date, such sale price may be persuasive for valuation purposes.⁵⁵ Other factors that a taxpayer might consider when establishing a market price include the relevant markets within which the asset would be

49. The five methods of capitalization are: direct capitalization, mortgage equity, discounted cash flow, Ellwood, and residual method. See AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, *THE APPRAISAL OF REAL ESTATE* 470 (10th ed. 1992); L. W. ELLWOOD, *ELLWOOD TABLES FOR REAL ESTATE APPRAISING AND FINANCING* (4th ed. 1977); Charles B. Ackerson, *Ellwood Without Algebra*, *THE APPRAISAL JOURNAL*, 3 1970, reprinted in 1 READINGS IN THE INCOME APPROACH TO REAL PROPERTY VALUATION 135-45 (1977); see also *Pennant Associates v. Jackson Township*, 8 N.J. Tax 368 (N.J. Tax 1986).

50. See PRATT ET AL., *supra* note 42.

51. *Id.* This approach is essentially looking at the book value of the business. Alerding, *supra* note 42, at 32.

52. Alerding, *supra* note 42, at 32.

53. *Id.*

54. See Treas. Reg. § 20.2031-2(b) (as amended in 1992); Rev. Proc. 79-24, 1979-1 I.R.B. 565; *Dresser v. Commissioner*, 15 T.C.M. (CCH) 242 (1956).

The I.R.S. defines "fair market value" as the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas. Reg. § 25.2512-1 (as amended in 1992); Treas. Reg. § 20.2031-1(b) (as amended in 1965); see Rev. Rul. 83-120, 1983-2 C.B. 170 (valuation of preferred stock of closely held business); Rev. Rul. 77-287, 1977-2 C.B. 319 (valuation of restricted stock); Rev. Rul. 65-193, 1965-1 C.B. 370 (rule that valuation is factually based); Rev. Rul. 59-60, 1959-1 C.B. 237, 238-39 (list of factors to be considered in determining the fair market value of a business); see also *supra* note 43.

55. Rev. Rul. 70-512, 1970-2 C.B. 192 (giving an example of an alternate valuation analysis).

sold,⁵⁶ expenses in selling the closely held business,⁵⁷ the economic conditions surrounding the sale, the sale values of comparable publicly-traded stocks,⁵⁸ or any of the other items outlined below.

After the business has been valued at its macro level, each business may be subject to valuation discounts based on various factors. Two common factors are the minority interest discount⁵⁹ and the marketability discount.⁶⁰ While the minority interest discount and marketability discount are often lumped together to create one discount factor,⁶¹ the two discounts are distinct from one another.⁶²

If a business interest owned constitutes a minority interest in the business then the value of the business interest owned is reduced. That valuation reduction is called the minority interest discount. The value is reduced to reflect the fact that the minority interest in an entity cannot control the management of the company, compel payment of dividends or otherwise directly affect the value of the business.⁶³ Determining whether a gift

56. See *Transamerica Corp. v. United States*, 902 F.2d 1540 (Fed Cir. 1990) (discussing a sale of motion picture prints); *Perdue v. Commissioner*, 62 T.C.M. (CCH) 845 (1991) (discussing the valuation of Spanish galleon artifacts).

57. See *Estate of Joslyn v. Commissioner*, 566 F.2d 677 (9th Cir. 1977) (allowing underwriters costs to be deducted as a necessary portion of the cost of the sale of Joslyn stock).

58. See I.R.C. § 2031(b) (1994); Rev. Rul. 59-60, 1959-1 C.B. 237, 238-39.

59. The minority discount is reflective of the inability of the minority shareholder, a limited partner, to acquire control of the entity's assets by forced liquidation. See *Estate of Ford v. Commissioner*, 53 F.3d 924 (8th Cir. 1995); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Estate of Murphy v. Commissioner*, 60 T.C.M. (CCH) 645 (1990).

60. Closely held businesses often have no readily available market for the assets, as significant restrictions on their transfer cause them to be essentially unmarketable. See, e.g., *Estate of Berg v. Commissioner*, 976 F.2d 1163 (8th Cir. 1992); *Estate of Dougherty v. Commissioner*, 59 T.C.M. 772 (1990); *Estate of Mosher v. Commissioner*, 54 T.C.M. (CCH) 1578 (1988).

61. See *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962) (holding that a discount of 35% was a proper discount to be applied to the minority interests in the case); *Bartram v. Graham*, 157 F. Supp. 757 (D. Conn. 1957) (holding that a 20% discount was appropriate).

62. See generally *Alerding*, *supra* note 42, at 35, 59 (stating that "[a]lthough the two discounts are not mutually exclusive, they are sequential"). The Tenth Circuit analyzed the interplay between the minority interest discount and 2032A in *Estate of Hoover v. Commissioner*, 69 F.3d 1044 (10th Cir. 1995).

63. Factors to consider in valuating the minority interest include: whether the investment income (dividends and liquidation value) is dependent on decisions over which the minority shareholder has no

of shares of a closely held business is in fact a gift of a minority interest can be more difficult than it first appears. For example; the owner of a closely held business owns 100% of the business and gifts one-third of the shares to each of his three children. Did the owner make a gift of a majority interest or minority interest? Does the fact that each gift is made to family members change this result?⁶⁴ Although these are difficult questions and require careful review, they can provide great opportunity for minority interest discounts from the valuation.

A second valuation discount is the marketability discount. If a business interest cannot be sold on a readily accessible market then the business interest loses value. Therefore, if no appropriate market exists, the business interest valuation is reduced to reflect its lack of marketability. While it may seem tempting to draft buy-sell agreements that purposely create a marketability discount for the shareholders of a closely held business,⁶⁵ Code section 2703 may void such agreements and tax them at their full fair market value.⁶⁶

The factors recommended by the I.R.S. to value a business have been outlined in Revenue Ruling 59-60⁶⁷ and Treasury Regulation 25.2512-2(f)(2).⁶⁸ These factors include:

- a. The nature of the business and the history of the enterprise from its inception.

control; whether the valuation is of a company with liquid assets versus an operating company; whether the company is a low risk business or a high risk business; the size of the block; and whether there are comparable sales of minority blocks versus majority blocks.

Id.

64. In 1993, the I.R.S. stated that a minority discount is allowed for gifts, between family members, of stock in a closely held business even if control remains within the family. Rev. Rul. 93-12, 1993-1 C.B. 202. Compare *Phipps v. Commissioner*, 43 B.T.A. 1010 (1941), *aff'd*, 127 F.2d 214 (10th Cir.), *cert. denied*, 317 U.S. 645 (1942) (holding such a gift was a minority interest) with *Blanchard v. United States*, 291 F. Supp. 348 (S.D. Iowa 1968) (recognizing family control).

65. See discussion *infra* part III(f) on Buy-Sell Agreements.

66. I.R.C. § 2703(a) (1994). *But see* I.R.C. § 2703(b) (listing conditions under which Code § 2703(a) does not apply, including when there is a bona fide business arrangement and its terms are generally comparable to what an arms length transaction would be under the circumstances).

67. Rev. Rul. 59-60, 1959-1 C.B. 237, amplified by Rev. Rul. 77-287, 1977-2 C.B. 319 and Rev. Rul. 83-120, 1983-2 C.B. 170, expanded by Rev. Rul. 65-192, 1965-2 C.B. 259, modified by Rev. Rul. 65-193, 1965-2 C.B. 370.

68. Treas. Reg. § 25.2512-2(f)(2) (as amended in 1976); see *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990) (explaining the difficulty of applying these factors to a closely held business).

- b. The economic outlook in general and the condition and outlook of the specific industry in particular.
- c. The book value of the stock and the financial condition of the business.
- d. The earning capacity of the company.
- e. The dividend paying capacity.
- f. Whether or not the enterprise has goodwill or other intangible value.
- g. Sales of the stock and the size of the block of stock to be valued.
- h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.⁶⁹

B. Valuation Election of Internal Revenue Code Section 2032A

Farm property or real property used in a closely held business may be reduced in value for estate tax purposes provided the decedent's estate is not reduced by more than \$750,000.⁷⁰ The qualifications and requirements of Code section 2032A election are outlined as follows:

- a. The decedent must be a resident or citizen of the United States and the real property must be located in the United States;⁷¹
- b. The value of the farm or closely held business in the decedent's estate, including real and personal property and the family home, must equal at least fifty percent of the decedent's gross estate, exclusive of any mortgages or other indebtedness;⁷²
- c. The value of the farm or closely held business real property, no personal property, must equal at least twenty-five percent of the gross estate, exclusive of any mortgages or other indebtedness;⁷³

69. Rev. Rul. 59-60, 1959-1 C.B. 237.

70. See I.R.C. § 2032A(a)(2) (1994). For an example of the use of § 2032A in valuing a farm, see *Estate of Frieders v. Commissioner* 687 F.2d 224 (7th Cir. 1982), cert. denied, 460 U.S. 1011 (1983).

71. I.R.C. § 2032A(a)(1)(A) (1994); see *Estate of Hudgins v. Commissioner*, 57 F.3d 1393, 1397 (5th Cir. 1995) (summarizing the conditions that must be met to qualify for the special use valuation under § 2032A).

72. I.R.C. § 2032A(b)(1)(A) (1994). For a list of eligibility requirements, see *Estate of Thompson v. Commissioner*, 864 F.2d 1128, 1131 (4th Cir. 1989) (citing *Whalen v. United States*, 826 F.2d 668, 669 (7th Cir. 1987)).

73. I.R.C. § 2032A(b)(1)(B) (1994).

d. The real property must pass from the decedent to a qualified heir. A qualified heir includes an ancestor, spouse, lineal descendant of the spouse or parent, or spouse of a lineal descendant. Note that while this list includes a grandparent, brother, sister-in-law, step-child, or nephew, it does not include aunts or uncles;⁷⁴

e. The property must have been owned by the decedent or a member of the decedent's family for five of the last eight years before the decedent's death. Leases do not qualify;⁷⁵

f. During the five years of ownership, the decedent, or members of the decedent's family, must have materially participated in the operation of the family farm or closely held business;⁷⁶

g. The executor of the decedent's estate must make the section 2032A election with a timely filed estate tax return that identifies the property, describing its use and appropriate "best use" valuation.⁷⁷

If the property qualifies for a discount under section 2032A, there are two general valuation methods to value the property.⁷⁸ The more objective test is the capitalization of rents method⁷⁹ which is usually limited to farm property valuations. The second method is a subjective test that examines five factors: the income capitalization or yield expected on the property, the capitalized fair rental value of the property, assessed land values, the sales value of the property, or any of the other factors that fairly values the farm or closely held business.⁸⁰

The capitalization of rents method is computed by subtracting comparative state and local real estate taxes from the average annual gross cash rent from the property⁸¹ and dividing the sum of that number by the average annual effective interest rate for all new Federal Land Bank loans.⁸²

74. I.R.C. § 2032A(e)(1-2).

75. I.R.C. § 2032A(b)(1)(C)(i-ii).

76. *Id.*

77. I.R.C. § 2032A(a)(1)(B); see *Estate of Sequeira v. Commissioner*, 70 T.C.M. (CCH) 761 (1995) (finding taxpayer liable for taxes for failure to substantially comply with regulations under § 2032A, relating to the election of special use valuation).

78. I.R.C. § 2032A(e)(7-8) (1994).

79. I.R.C. § 2032A(e)(7).

80. I.R.C. § 2032A(e)(8); see *supra* note 62.

81. I.R.C. § 2032A(e)(7)(A)(i). The average annual cash flow is based upon the prior five year averages. I.R.C. § 2032A(e)(7)(A).

82. See I.R.C. § 2032A(e)(7)(A)(ii).

If a valuation is used under section 2032A, the appraisal must be filed with the federal estate tax return.⁸³

C. Redemptions Under Internal Revenue Code Section 303

When a person dies, the basis of that person's assets is usually stepped-up to the fair market value of each asset.⁸⁴ Thus when a person dies owning stock in a closely held business, the basis of the stock is stepped-up to the fair market value of the stock.⁸⁵

If a person has to pay estate taxes by liquidating some of the shares of stock in the closely held business, like in the example above, even though the basis of the stock is stepped-up, there may be adverse tax consequences. If a person owns 100% of a closely held business and the business redeems fifty percent of his or her shares of stock, the distribution from the corporation is usually treated as a dividend to the shareholder and is subject to income tax.⁸⁶ The corporate distribution is subject to income tax because the stockholder has not really changed the capital ownership or control of the business.⁸⁷ However, if a corporation redeems shares of stock from a corporate shareholder to allow the shareholder to pay death taxes, Code section 303 will not treat the redemption as ordinary income.⁸⁸

Section 303 recognizes that an estate must pay the tax on the value of stock in a closely held business.⁸⁹ Therefore, this Code provision recognizes that an estate redemption is not intended to convert ordinary income to a capital redemption. The redemption is simply to pay taxes. Since the stock basis is equal to the fair market value of the stock after a shareholder

83. Treas. Reg. § 20.2032A-8(a)(3) (1980).

84. I.R.C. § 1014 (1994); *see, e.g.*, Gallenstein v. United States, 975 F.2d 286, 287 (6th Cir. 1992) (holding that taxpayer whose husband died in 1987, acquired stepped-up basis in entire farm property that she and her husband owned as joint tenants since 1955).

85. *See, e.g.*, McEvan v. Commissioner, 241 F.2d 887, 888 (2nd Cir. 1957) (holding that for estate tax purposes, the adjusted basis of stock inherited by taxpayer in 1937 was accurately computed at its fair market value at the time of acquisition).

86. *See* I.R.C. §§ 301, 302, 318 (1994). The redemption is treated as a dividend because the decedent's estate has not changed its ownership in the stock. *Id.* The estate continues to hold 100% of the stock. Thus, any redemption is treated as a dividend and not a redemption.

87. *See* I.R.C. §§ 301, 302(b).

88. I.R.C. § 303.

89. *Id.*

dies, the redemption is a non-taxable transaction. If the redemption is for a value greater than or less than the stock's fair market value, then there may be a taxable redemption.⁹⁰

To qualify an estate for the Code section 303 redemption, the total value of the redemption cannot exceed the death tax payable plus the amount of funeral and administration expenses incurred by the estate.⁹¹ The redeemed stock must also constitute more than thirty-five percent of the gross estate (including transfers made within three years of death). Two companies can be aggregated to satisfy this test.⁹² Therefore, if a closely held business must redeem shares of a decedent's stock, Internal Revenue Code section 303 will provide the estate a non-taxable transaction to generate the cash necessary to pay death taxes, funeral expenses and estate administration expenses.⁹³

D. Gifting

An alternate strategy to paying estate taxes is to remove a closely held business interest from a taxable estate. Instead of seeking alternatives on the payment of an estate tax through appropriate valuations and section 303 redemptions, the goal now is to prevent the closely held business from becoming subject to an estate tax.⁹⁴

The first option to remove closely held business interests from an estate is out-right gifting. The shareholder of a closely held business can gift such shares to their children or any other person.⁹⁵ If the recipient of the gift receives a present interest in such shares, then up to \$10,000 of the value of such gift will not be subject to gift taxes.⁹⁶ If a person receives a future

90. *Id.*

91. *Id.*

92. I.R.C. § 303(b)(2)(B) (allowing stock in two corporations to be combined for purposes of Code § 303(b)(2)(A)).

93. *Id.*

94. The Code allows for extension of time for payment of an estate tax where the estate consists largely of interests in a closely held business. I.R.C. § 6166. For example, a closely held business owner can make annual gifts of stock of \$10,000 to anyone under § 2503(b) and for up to \$20,000 one year to spouse under § 2513.

95. See I.R.C. § 2503(b); see also Treas. Reg. § 25.2503-3 (1983); I.R.C. § 2511 (imposing gift tax whether transfer is direct or indirect, whether the property is real or personal, or tangible or intangible).

96. I.R.C. § 2503(b) (1994). A present interest is the right to the immediate use and enjoyment of the property. See *Newlen v. Commissioner*, 31 T.C. 451, 456 (1958) (defining present interest as the right given to a primary beneficiary).

interest in the property, such as a gift in a trust where a person is the beneficiary of the trust, then the annual exclusion does not apply.⁹⁷

The gift tax is a cumulative tax for gifts made during a person's lifetime. The gift tax is subject to the same tax rates as the estate tax system.⁹⁸ Thus, if a person makes a taxable gift of \$100,000 in year one to person X, the gift is taxed up to the twenty-eight percent marginal estate tax rate.⁹⁹ If in year two the person gifts \$200,000 to person Y, the \$200,000 gift is taxed at a thirty-four percent marginal rate.¹⁰⁰ The gift tax is then assessed on the marginal rate on the cumulative gifts total of \$300,000 (\$100,000 + \$200,000).

Gifts before a person dies has two distinct benefits. The first benefit is that any appreciation on the gift escapes estate taxation.¹⁰¹ For example, if a share of stock is gifted at a value of \$100 per share but later appreciates to \$1,000 per share, \$900 per share appreciation escapes estate taxation. The second benefit is that the gift is tax exclusive while estates are tax inclusive.¹⁰² If a person gifts \$100,000 to another, no part of that \$100,000 gift will be subject to gift taxes. The recipient of the gift receives \$100,000. If the \$100,000 is subject to estate taxes, the recipient receives \$100,000 less estate taxes. Therefore, gifts provide greater tax benefit to the recipient than being subject to the estate tax.

Lifetime gifting also has the benefit of the use of the annual exclusion. Code section 2503(b) allows any person to transfer up to a \$10,000 present interest in any one year to another person without incurring a gift tax.¹⁰³ If a person transfers \$10,000 cash to another person, no gift tax is due on the transaction. It is important to remember that the annual

97. Treas. Reg. § 25.2503-3 (1983).

98. I.R.C. § 2502 (1994).

99. See I.R.C. § 2010 (implying that the unified tax credit will probably prevent the need to pay *any* gift taxes).

100. I.R.C. § 2001(c).

101. Like the estate tax, the gift tax is imposed upon the act of transfer and is measured by the value of the property passing from the donor. *Ward v. Commissioner*, 87 T.C. 78, 108 (1986).

102. Compare I.R.C. § 2501(a) (West Supp. 1996) (imposing tax on the transfer of property by gift by any individual) with I.R.C. § 2001(a) (imposing tax on the taxable estate of every decedent).

103. I.R.C. § 2503(b).

exclusion only applies to present interests; it does not apply to future interests.¹⁰⁴ Thus, if a parent gifts \$10,000 cash into a trust for the benefit of a child, the gift is subject to gift taxes if the child cannot immediately withdraw the cash from the trust. The gift tax must be paid because the gift does not grant the child a present interest.

An exception to the future interest provision of the annual exclusion is the use of *Crummey* Trusts. A *Crummey* Trust is a trust based upon the famous case, *Crummey v. Commissioner*.¹⁰⁵ A *Crummey* Trust mixes the use of the annual exclusion and trust instruments. If a person wants to make annual gifts but would like the gift assets managed by a trustee, the person may want to use a *Crummey* Trust. A *Crummey* Trust provides the beneficiary of a trust the right to withdraw, within a reasonable period, gifts made to the trustee of the trust.¹⁰⁶ The beneficiary's right to withdraw such property is usually for a period of approximately thirty days.¹⁰⁷ The trustee notifies the beneficiary when a gift is made to the trust. After the withdrawal period expires, the trustee manages the trust property and may only distribute the trust property pursuant to the terms of the trust instrument. For example, if a person creates a *Crummey* Trust for his or her two children, that person can contribute up to \$20,000 of property to the trustee of the trust without paying any gift taxes. Thus, if a parent who owns a closely held business would like to transfer ownership of the stock to his or her children, the parent may want to create a *Crummey* Trust and transfer the stock over a period of several years.¹⁰⁸

104. See Treas. Reg. § 25.2503-3(a) (as amended in 1983) (stating that no part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar period).

105. 397 F.2d 82 (9th Cir. 1968).

106. See generally Strauss, *supra* note 1, at 29.

107. The actual length of time necessary for a beneficiary to receive trust property is not certain. Some trusts leave the withdrawal period open for the entire year. The I.R.S. has ruled that a period of 30 days is sufficient time. Priv. Ltr. Rul. 90-30-005 (April 19, 1990); Priv. Ltr. Rul. 87-12-014 (Dec. 18, 1986). The I.R.S. has also ruled that three days will not qualify. Priv. Ltr. Rul. 80-22-048 (Mar. 4, 1980), see Rev. Rul. 81-7, 1981-1 C.B. 474 (recognizing that if a trust instrument gives a beneficiary the power to demand immediate possession and enjoyment of corpus or income, the beneficiary has a present interest).

108. An advantage of a *Crummey* Trust is that the donor is able to make gifts to an adult beneficiary. Cf. I.R.C. § 2503(c) (1994) (contribution exclusions for a § 2503 trust applies only to minority beneficiaries).

There has been considerable debate whether a person can have a withdrawal right in a *Crummey* Trust and have no beneficial interest in the trust. For example, a trust is created for the benefit of the trustor's two children, but the two children and six grandchildren each have a withdrawal power. If \$80,000 is then contributed to the trust with the intent to qualify such contributions for the annual exclusion, there has been some question whether the gifts for the grandchildren will qualify. While it appears that this type of *Crummey* Trust may work,¹⁰⁹ great caution should be exercised before drafting such an instrument.¹¹⁰

E. Life Insurance Trusts

If the owner of a closely held business does not want to gift shares of the business during that person's lifetime, a life insurance trust may provide a flexible source of funds to pay estate taxes imposed upon a decedent's estate. Using the taxable estate example from part II, the decedent's estate needed to pay \$1,511,250 in estate taxes from the closely held business. If the business does not have the liquidity to pay the taxes through a section 303 redemption,¹¹¹ the estate needs an alternative source of cash that is not in the decedent's estate. Such cash may be found in a life insurance trust.

A life insurance trust is an irrevocable trust. The trustee of the life insurance trust purchases life insurance on the closely held business owner. The person who creates the trust may contribute a currently existing policy to the trust, but all "incidents of ownership" in the policy must be removed.¹¹²

109. See *Estate of Cristofani v. Commissioner*, 97 T.C. 74, 84 (1991) (holding that the grandchildren's unhindered right of withdrawal represented a present interest in trust corpus and that trustor was eligible for the gift tax exclusion under Code § 2503(b) for each of the grandchildren). The IRS however will litigate such abuses. See Tech. Adv. Mem. 96-28-004 (July 12, 1990).

110. See I.R.C. § 2642(c)(2)(A) (1994) (addressing an exception for certain transfers in trust). While this type of *Crummey* Trust may qualify for the gift tax annual exclusion, the gifts to the grandchildren will not qualify for the generation-skipping tax annual exclusion. *Id.*

111. See *supra* part III.C.

112. Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974); see Priv. Ltr. Rul. 96-02-010 (Jan. 12, 1996) (discussing incidents of ownership over life insurance policy and relevant estate tax regulations); see also *Swanson v. Commissioner*, 518 F.2d 59, 63 (8th Cir. 1975) (stating that the sale of a life insurance policy to a trust in which the insured was considered the owner for income tax purposes qualified for the section 101

Incidents of ownership may include the ability to change the beneficiary of a policy, retention of ownership of a policy, the ability to assign or cancel a policy or any other factor that indicates the testator has ownership in a policy.¹¹³ More important to the concept of incidents of ownership is the fact that “ownership” does not necessarily mean ownership in the legal sense. Ownership means the ability to possess or control the real economic benefits of a policy.¹¹⁴ Such incidents of ownership may even include a contingent reversionary interest in the insured.¹¹⁵ If an irrevocable life insurance trust is used by a closely held business owner, the trust should be carefully drafted to avoid any incidents of ownership.

If a person creates an irrevocable life insurance trust and properly operates the trust, then when the person dies, the life insurance proceeds collected by the trust are *not* included in the decedent’s gross estate. The trust can then purchase shares of the closely held stock from the decedent’s estate sufficient to pay the estate’s death taxes. The trust can then distribute the purchased shares to the decedent’s heirs or to whomever the decedent may wish via the trust instrument.

F. Buy-Sell Agreements

Very often, several owners of a closely held business have buy-sell agreements among themselves. In the alternative, children of closely held business owners may also have a buy-sell agreement with their parents. The buy-sell agreement can create two significant problems.

The first problem is that the persons who are supposed to “buy” usually do not have the cash to exercise their rights under the buy-sell agreement.¹¹⁶ To assure sufficient cash to exercise rights under a buy-sell agreement, life insurance should be

exception for a sale of the policy to the insured).

113. Treas. Reg. § 20.2042-1(c)(2) (as amended in 1974).

114. *Id.*

115. See Tech. Adv. Mem. 93-49-002 (Aug. 25, 1993) (applying a broad interpretation of a reversionary interest to a complicated shareholder buy-sell agreement where an insurance trust was a vehicle to fund the buy-sell agreement).

116. An alternative way to assure that the persons who were supposed to “buy” had enough cash was a one dollar buy-sell agreement provision upheld by the Pennsylvania Supreme Court. *Estate of Brown*, 289 A.2d 77 (Pa. 1972) (upholding a buy-sell agreement providing that each brother conveyed his shares of the closely held business to the survivor for one dollar per share).

purchased by each owner of the closely held business on the lives of the other owners.¹¹⁷ On the same note, children should own life insurance on their parents. The life insurance should be purchased in sufficient amounts to fully exercise the buy-sell agreements. If life insurance is purchased, be careful of the estate tax implications of Code section 2042.¹¹⁸ As discussed above, life insurance is included in a person's estate if that person retained incidents of ownership in the policy.¹¹⁹ Thus, if a parent purchases life insurance on his or her own life so the children can exercise the buy-sell agreement, the proceeds of the policy will probably be subject to an estate tax. The life insurance may also be brought back into the estate if the decedent had a reversionary interest as discussed above.¹²⁰ Therefore, the life insurance should be independently owned by the person who can exercise the buy-sell agreement. If an irrevocable life insurance trust is used as an alternative, great care should be taken to be sure the decedent retains no incidents of ownership of any kind. Again, incidents of ownership may include reversionary interests, fiduciary powers, powers to change the payment of proceeds,¹²¹ or any other interest that affects the enjoyment of the policy and proceeds.¹²²

The second significant problem with a buy-sell agreement is the estate tax implications of Code section 2703 which ignores buy-sell agreements that try to establish a stock-repurchase price at less than fair market value.¹²³ If a closely held business was designed by agreement or capitalization to restrict the value of

117. It may be difficult to assure sufficient cash to exercise the rights under a buy-sell agreement if the agreement provides for a changing and uncertain share price. See *Renberg v. Zarrow* 667 P.2d 465 (Okla. 1983) (holding that provision of buy-sell agreement that allowed survivors to buy decedent's shares at a price set by majority shareholders each year, or if no price was set in any year, at most recent price was inherently fair).

118. I.R.C. § 2042(2) (1994) (including in the gross estate the proceeds of life insurance of which the decedent possessed any incidents of ownership at the time of death).

119. See *supra* part III.E.

120. *Id.*

121. See Rev. Rul. 81-128, 1981-1 C.B. 469 (defining the term "incidents of ownership").

122. Treas. Reg. 20.2042-1(c)(4) (as amended in 1974); see *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975) (holding that the husband had sufficient incidents of ownership in life insurance policies to require that proceeds be included in his estate for estate tax purposes), *cert. denied*, 424 U.S. 977 (1976).

123. I.R.C. § 2703 (1994).

the business for estate tax purposes, then Code section 2703 states:

the value of any property shall be determined without regard to (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.¹²⁴

The test under section 2703 asks: 1) Is the transfer to a family member? 2) Is the transfer for less than full value? 3) Does the transfer have a bona fide business purpose? 4) Are the terms of the agreement similar to comparable arms-length transactions?¹²⁵

As an illustration, assume that Father, Mother and Son own equal interests in a business. At the time of incorporation, the company was worth \$3 million. The buy-sell agreement provides that each person's total shares may be repurchased by the other shareholders for \$1 million. On a day many years later, the Father dies and the company is worth \$9 million. The personal representative is forced to sell Father's shares for \$1 million. Code section 2703 will probably ignore the buy-sell agreement and value the Father's total shares at \$3 million. The Father's estate now only has \$1 million in cash to pay the tax on a \$3 million asset. Further complicating matters is the marital deduction. If the Father's assets are devised to the Mother, a buy-sell agreement such as this would probably be classified as terminable interest property and therefore not qualify for the marital deduction.¹²⁶

It is important to remember that the restrictive provisions contemplated by section 2703 reach far beyond shareholder agreements. The types of restrictions and covenants that will be ignored for estate tax purposes may be "contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholder's agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity."¹²⁷ Therefore, the advisor of a closely held business should be mindful of any corporate matter that artificially sets a stock

124. *Id.*

125. I.R.C. § 2703(b).

126. I.R.C. § 2056(b)(1).

127. Treas. Reg. § 25.2703-1(a)(3) (1992).

repurchase price lower than the fair market value for estate tax purposes.¹²⁸

G. Tax Deferral of Estate Taxes

Whether the owner of a closely held business has planned for his or her eventual death, the estate has one last option to reduce the burden of estate taxes on the closely held business. The estate can defer payment of the estate taxes.

Code section 6166 allows a taxpayer to defer payment of the entire tax liability due on a closely held business, as opposed to the estate tax on the gross taxable estate, for up to fourteen years.¹²⁹ The tax principal may be deferred completely for up to five years and the payment on the tax balance may be paid in installments over ten years, with the first payment commencing on the fifth year of the deferral.¹³⁰ To qualify for this tax deferral, the value of the closely held business must exceed thirty-five percent of the adjusted gross estate.¹³¹ A closely held business interest is defined as a sole proprietorship, twenty percent or more of the capital of a partnership, a partnership interest in a partnership of fifteen or fewer partners, twenty percent or more of the value of the voting stock of a corporation, or corporate stock in a corporation with fifteen or fewer shareholders.¹³² It is important to note, however, that certain passive assets may not qualify for the deferral.¹³³

128. See I.R.C. §§ 2036 (a), (b), 704(e), 2701, 2704 (1994). These sections require careful review when establishing the value of closely held stock. Sections 2036(a)-(b) involve retained interests and retained voting powers that can pull the entire value of a corporation back into a decedent's estate. Section 704(e) requires capital to be a material income producing factor of a family partnership. Section 2701 may tax gifts of a senior family member to a junior family member of a corporate or partnership interest while retaining priority rights in the underlying corporation or partnership. This usually applies when a business interest is recapitalized and lesser interests are transferred to children. Section 2704 includes the value of rights that lapse upon a person's death in the value of the decedent's interests. Thus, if a taxpayer had controlling voting rights or other powers that lapse upon death, § 2704 will value the decedent's controlling interests as if they had not lapsed.

129. I.R.C. § 6166.

130. I.R.C. § 6166(a).

131. I.R.C. § 6166(a)(1). The adjusted gross estate is the gross estate less deductions allowed by sections 2053 or 2054.

132. I.R.C. § 6166(b)(1); see I.R.C. § 6166(b)(2)(A)-(D) (stating that husbands and wives holding community property or joint property are treated as one shareholder and interests held by a decedent's family are treated as owned by the decedent).

133. I.R.C. § 6166(b)(9).

Interest must be paid on the deferred tax during the deferral period and the installment period.¹³⁴ The interest charged on the deferral is based upon a formula tied to the federal short term interest rate, however, the first \$1,000,000 in estate assets is assessed at four percent.¹³⁵ The interest on the liability is deductible as an estate administrative expense.¹³⁶ Interest and tax principal must be paid during the installment period.¹³⁷

There are limitations to the deferral of the estate tax.¹³⁸ If fifty percent or more of the value of the business is withdrawn or disposed of, the extension of time to pay the estate tax is terminated.¹³⁹ Additionally, if there is a failure to pay principal or interest, the extension is terminated.¹⁴⁰ If the estate has undistributed net income in a year that an installment payment is due, payment of the estate tax is accelerated to the extent thereof.¹⁴¹

IV. CONCLUSION

Counsel to a closely held business must be aware of a broad range of legal issues. The attorney representing a closely held business should be able to spot the potential estate tax implications of managing the closely held business. The issues outlined above identify the major estate tax issues facing the closely held business owner. This article offers very general explanations of solutions to cure the estate tax issues that may arise. In no uncertain terms, however, is the fact that the tax issues discussed above are far more complex than the brief description offered. Careful review of the issues and the advice of trained counsel in the area of estate taxation is required before any action is taken to resolve such issues.

134. I.R.C. § 6166(f).

135. I.R.C. § 6601(j); *cf.* I.R.C. § 6166(b)(7)(A)(iii) (noting that the four percent rate may not apply to certain closely held interests).

136. I.R.C. § 2053; *see also* Rev. Rul. 81-256, 1981-1 C.B. 183 (providing for the deductibility of interest on the state death tax credit); Rev. Proc. 81-27, 1981-2 C.B. 548.

137. I.R.C. § 6166(f)(3) (1994).

138. I.R.C. § 6166(g).

139. *Id.* (excluding I.R.C. § 303 redemptions).

140. *Id.*

141. I.R.C. § 6166(g)(2) (allowing income accumulation for the first five years).

