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Estate Tax Planning Problems

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Many people have come to regard estate planning as a fairly new field in which to provide service for clients. I think the increased amount of interest developed in this area is due to the fact that the great impact of income and estate and inheritance taxes is being recognized by a larger portion of the population.

Actually, estate planning has been with us for a much greater period of time than is generally realized. Recently I attended a meeting at which a member of my firm discussed estate planning. In his introductory remarks, he pointed out that estate planning was as old as the laws regarding the rights to own property. He stated that the recognition of property rights and the existence of rights to dispose of such property rights could be traced back to the days of the Roman Empire. Fortunately, high estate and inheritance taxes have not been in effect for all that time.

In the United States we have had Federal estate taxes imposed for temporary purposes in four instances. The first instance was early in our history, the second instance was during the Civil War, and the third instance was during the Spanish-American War. These taxes were short-lived. The fourth instance came during World War I and it differed from the earlier laws in that its temporary nature turned permanent. Our present estate-tax law is the vigorous offspring of that law. One can engage in long discussions as to the propriety of such taxes and the philosophy supporting the imposition of such taxes but that is not the purpose of our meeting today. Perhaps these two examples will show how far these taxes now reach.

About three years ago I read an article in the newspapers regarding Mr. Marshall Field. The substance of the article was that an estate created by Mr. Field's grandfather's will had terminated and the corpus was being distributed to Mr. Field. The grandfather died in 1911 and the estate amounted to approximately $60 million on which no Federal estate tax was imposed.

A few weeks ago I read an article in the newspaper regarding a member of the Gould family who had died in the early part of 1960. The article stated that the gross estate was $60 million and that

administration costs had reduced it to about $47 million. The chief disbursement was some $12 million on account of New York State inheritance tax. The Federal estate taxes are yet to be paid. When one realizes that the Federal estate tax, before credit for state taxes, on a taxable estate of $10 million is $6,088,000 plus 77 per cent on the excess, the conclusion is that the heirs will be unhappy. The article indicated that there were about twenty heirs and this means that the average sum each heir will receive from the estate will be less than $1 million. It would seem that insufficient estate planning had been performed for Mr. Gould.

Many of us have talked to clients regarding estate planning and have found a certain amount of resistance to action. It seems to me that this resistance is often associated with the idea of death and in such case it is then desirable to try to separate the estate-planning problem from its association with death. I have found several arguments that have been strong enough to overcome the client's resistance to action. Some of them are listed below.

- The client should bear in mind that if he takes no action, the state in which he resides has laws regarding the descent of property. If he fails to act in this matter, the state will do the job for him without regard to his wishes.
- The client should realize that the estate-tax law is very similar to income-tax law in that the way a taxpayer handles a transaction can greatly change the tax result.
- If the client is a businessman, failure to engage in estate planning to save taxes can result in waste. It is comparable to exerting himself to increase his gross business while exercising no control over expenses, with the result that net income does not increase.
- Taxpayers spend large amounts of time and money to arrange income-tax transactions. If estate planning is not undertaken, the benefits achieved through income-tax planning will be dissipated in excessive estate taxes.
- Many taxpayers are proud of the business they have developed and built. Frequently estate planning is stimulated by asking the creator of a going business what will happen to it on his death. Pride in achievement and a desire to have the business maintained may overcome the resistance to estate planning.

One of the most discouraging things to a person interested in estate planning is to hear a client dismiss the subject with a breezy statement to the effect that the problem is under control because there is a will in existence. We all know this is a dangerous assumption, as both the law and family conditions change. A will drawn and executed today can become worthless next week owing to these changes. In my own experience, I have had two very good examples of this situation.

We recently were engaged by new clients to make some computations for estate-planning purposes. The family group comprised a father, mother, daughter, son-in-law, and grandchildren. The mother and daughter were the ones who held substantial amounts of property. The will of the mother provided that substantially all her property would go to the daughter. The will of the daughter provided that substantially all her property would go to the mother if the son-in-law predeceased the mother. Both wills had been written prior to the birth of the grandchildren and did not represent the present wishes of either the mother or daughter.

Our computations indicated that the tax to be determined on the basis of the daughter's will would be about $500,000 greater than if she had no will. Our immediate advice to her was to tear up the existing will. Further computations indicated that a new will, consistent with the daughter's present intentions as to disposition of her property, could produce added savings of nearly $175,000. Our computations regarding the estate-tax situation of the mother indicated potential savings of about $1,000,000. Needless to say new wills are being prepared.

About a dozen years ago we were performing audit and tax services for a corporation, but did no work for the officers. One of the elderly officers of the corporation became quite ill and his attorney requested us to make computations of his estate-tax liability. We made computations based on an existing will and found that it had been drawn prior to enactment of the marital-deduction section. Changes were recommended to take advantage of this section. A new will was prepared by the attorney and savings of about $50,000 were indicated. The new will was executed and the individual died a week later. The changes were timely and the savings were realized for the heirs.

ESTATE PLANNING TEAM

In recent years, those who are engaged in estate-planning work

have developed the concept of a team approach to the whole problem. I shall mention this in a brief way.

The team is composed of four persons. One of these should be the client's attorney, another should be a representative of a bank, another should be an insurance advisor, and the other should be the accountant who serves the client. Each of these persons is competent in his field and is able to contribute to the development of a well-rounded plan for the client.

The services of the attorney are very important as a member of this team. He can be of help in areas such as:

- Furnishing advice as to the laws of descent
- Analyzing the nature of property holdings
- Attending to the preparation of the will
- Preparing any trust instrument required
- Obtaining data regarding the intent of the client in this field so as to be of service in the settlement of the estate
- Serving as executor if appropriate

The banker can also be of great assistance in this task. He can help in matters such as:

- Suggesting investment policies and objectives for the estate
- Discussing provisions to be incorporated in any trust agreement
- Advising regarding the fiduciary matters if the bank is to be trustee
- Advising oftentimes regarding administration problems
- Acquiring knowledge of the client's wishes regarding disposition of his property and so permitting the bank to serve well as executor

The insurance advisor can also be of great help. He can offer his services in matters such as:

- Analyzing the present insurance situation
- Advising regarding rearrangement of insurance if desirable
- Helping to provide funds for estate tax purposes through insurance
- Arranging insurance in situations where buy and sell agreements exist

The accountant can be of considerable help in this field. If this were not true it is probable I would not be here today to present this paper.

There is no standard procedure as to the approach to the estate-

planning problem. Any one of the four persons can feel free to originate discussion of the problem. The important thing to remember is that all participants are trying to help the client and all steps taken should be based on that premise.

It is frequently said that the accountant is the team member who can best initiate the discussion. He generally is serving the client or businesses owned by the client and thus has access to financial data not always known to the others. His training permits him to make some studies based on this data and at any of his frequent meetings with the client he can bring up the subject.

We have now reached the point where the client has agreed to consider the problem. As a certified public accountant, my interest and experience has been in the areas where the accountant can contribute to the development of the plan. For the remainder of my time I plan to talk about some of the problems considered by my office and, if time permits, discuss some examples of plans that were developed. These remarks will deal with the problems in the Federal estate-tax field, as I assume the persons in the audience are from several states and, owing to differences in state laws, any comments concerning the state-tax results might be confusing.

VALUATION PROBLEMS

The valuation of the assets includible in an estate frequently presents more problems than any other part of the whole subject. Certain assets such as cash, notes, real estate, and listed stocks or bonds do not generally present many problems of valuation.

Ordinarily in making computations of probable estate taxes it is satisfactory to use market quotations of listed securities. These quotations, as found in *The Wall Street Journal* or comparable paper, should not necessarily be considered as absolute. Consideration should be given to the blockage rule if a lesser value would be desirable for estate-tax purposes.

Application of this theory is based on the idea that in many cases trading in a listed security is small and the sudden appearance on the market of a sizeable block of stock would depress the market price and thus affect the estate-tax valuation.

Many of us would agree that the offering of a large block would depress the market but favorable results have been achieved in this field where relatively small lots have been concerned. On July 19, 1960, the United States District Court for the Eastern District of

Pennsylvania issued its decision in the case of *Bartol* v. *McGinnes* in which this point was at issue.

The estate of Bartol held 1,440 shares of stock in the Insurance Company of North America. The stock is listed on the American Stock Exchange and 3,600,000 shares are outstanding. On the date of death only 100 shares were sold at a price of $86.50 to $87.50 and the Federal estate-tax authorities concluded the value was $87.00 per share. Representatives of the taxpayer presented testimony, by an expert in the brokerage field, to the effect that 1,440 shares could not have been sold on the day of death at that price and that, in order to sell such a number of shares, a price concession of about $3.00 per share was required. The Court held that the proper value was $84.00 per share. We normally relate the size of the block to the total outstanding but in this case a good result was obtained by relating it to market activity. Total sales for a two-weeks' period before and after death were only 1,450 shares. The important lesson to be learned from this case is that prompt action at the time of death to obtain an opinion from an expert would be more valuable than to wait until a controversy develops over the value.

A brief survey was made recently in my firm to learn what the experiences of various practice offices had been in this field. The replies indicated that blockage had been allowed in a substantial number of cases concerning securities listed on the New York Stock Exchange. In general, these cases showed that where a secondary distribution would have been required to market the shares on the date of death, blockage was allowed in an amount equal to the price concession and costs. In one case relating to a holding valued at several million dollars, the stock was sold at a concession of 5 per cent from market value and the proceeds were treated as equal to value at date of death.

The problems become much greater if the stock to be valued represents a substantial holding in a closely held company and there are no sales in the open market. Various methods are used and it can only be stated that perhaps no one method is absolute. Some of these methods are described in the following paragraphs.

Many years ago, the Internal Revenue Service issued A.R.M. 34 (Appeals and Review Memorandum) purporting to define an acceptable method for the valuation of intangible assets. It has been used to value goodwill, stocks, and other intangibles. Basically, average earnings are determined for a period of years, usually not less than five. These average earnings are reduced by an amount representing

a reasonable return on net tangible assets and the remainder capitalized at a reasonable ratio to arrive at the value of intangibles. Presumably the fair value of the net tangible assets plus the value computed as applicable to intangibles would produce a value for the stock of the company. This method is not often used and is considered by some people to be outmoded.

In 1959 the Internal Revenue Service issued Revenue Ruling 59-60 dealing with factors to be taken into account in valuing stock of a corporation. It lists a number of factors to be considered such as:

- Nature and history of the business
- Economic conditions existing in the industry
- Financial data as to balance sheets
- Earning capacity of the business
- Dividend-paying capacity
- Goodwill
- Prior sales and size of blocks to be valued
- Comparisons with similar stocks that are listed

After setting forth all these factors, the ruling indicates that the factors have different weight in different cases and that no standard capitalization of earning rates can be furnished. It seems to leave the question wide open for those who like mathematics.

Many investment analysts will evaluate a security by comparisons with ratios of earnings to quoted prices of listed securities of competitor companies. This is a relatively simple method but can produce distortion unless the companies concerned are comparable. For example, the selected company to use for comparison must be one for whose stock there exists a free and reasonably active market. Appropriate adjustment should be made for important differences in the capitalization of the companies. Adjustments might be required for the effect, if any, of differences in size of the companies. Differences in dividend-paying ability might call for adjustment. Consideration should be given to the existence of windfall earnings or abnormal deductions. Differing depreciation or inventory practices might require recognition.

The case of *Estate of David Levenson* (TC Memo. 1959-120) was recently reversed and remanded by the Court of Appeals for the Third Circuit and illustrates how different people reach different conclusions based supposedly on the same facts. It is based on the question of value for estate-tax purposes of stock in a closely held company. The representatives of the estate argued for a value of $250 per share whereas the Commissioner of Internal Revenue held the value to be $1,033 per

share. The Tax Court considered the matter and found the value to be $900 per share. The Tax Court criticized the Commissioner for using earnings for a five-year period because the Korean War distortion of earnings was a factor. It suggested that a ten-year period was proper but didn't use it. The Court of Appeals pointed out that, if the Tax Court had computed value on the basis it had suggested was proper, the result would be $739 per share. There also is an interesting comment in the case to the effect that the earnings approach is preferable in the case of valuing stock of an operating company as opposed to the valuation-of-assets approach in the case of a holding company.

One of my partners in an eastern office recently had an interesting experience in this field. He became an appraiser appointed by the court to establish the value of stock in a closely held company. He and the two other appraisers held hearings for several days and received a mass of evidence and testimony. According to the testimony the value of the stock varied from 10 cents per share to $13.50 per share. The three appraisers could not agree and each one filed an opinion with the court. The values fixed by the appraisers were $5.50, $7.75, and $9.50 per share. The court has decided that the value is $7.35 per share.

Sometimes it is necessary to consider the future effect of events that have taken place. One of our offices was given the task of computing the value of stock includible in an estate. Careful study of the company and its competitors disclosed the fact that the earnings trend of the company ran contrary to the industry. Investigation showed that the industry as a whole had been guilty of certain anti-trust law violations. The Department of Justice had obtained consent decrees from other members of the industry and on termination of these practices earnings had dropped. The company whose stock we were trying to value had taken part in the same practices but had not signed a consent decree. Its earnings therefore had not shown the same decline as its competitors. Review of the situation showed that a complaint had just been filed by the Department of Justice. It was clear that the company would also sign a consent decree and in our computations of the value of the stock we gave effect to the anticipated drop in earnings. The basis for the adjustment was the fact that the action had been filed before the valuation date. Adjustment to reflect this situation was accepted.

We have found also that in some cases consideration should be given to the fact that the business is closely held and chiefly operated by the key stockholder. In such situations, his efforts contribute

largely to the success of the company and the value of its stock so that his death might have an important impact on the value of the stock, particularly if a replacement is not as competent.

Another method for determining value of stock in closely held corporations, or an interest in a partnership, is by the use of buy-and-sell agreements. In order for these agreements to be useful, adverse interests must exist in the ownership of the stock or partnership interest so that the agreements may be entered into on an arm's-length-bargaining basis. For example, if two shareholders in a corporation are not related and an agreement is entered into that provides a buy-and-sell arrangement regardless of which person dies first, the values determined in accordance with the agreement should stand up. On the other hand a buy-and-sell agreement between two brothers or between a father and his sons would have difficulty in being sustained because it would, undoubtedly, be held by the Commissioner of Internal Revenue to be an agreement not entered into on an arm's-length basis. These agreements should be periodically drawn as to the method of determining price and should be carefully reviewed in order that full consideration can be given to changes in the financial position of the business, the financial position of the parties concerned, and, perhaps, changes in the company's type of business.

In some of the cases where buy-and-sell agreements are in existence, it has been the practice for each party to acquire life insurance on the life of the other party. The payment of the necessary premiums to obtain a sufficiently large amount of insurance has often been a burden and in other cases the problem has been handled by having the company acquire the insurance and on the death of one party the company will retire the interest held by the decedent. There have been some cases suggesting that the remaining stockholders have, in effect, received a dividend. However, the Commissioner has since announced, following an adverse decision, that a mere increase in percentage interest in a corporation after a redemption will not of itself be treated as a dividend. Thus, if the redemption is a fair market value and is not in reality a purchase by the remaining shareholders, it appears that danger no longer exists in this area.

The foregoing suggestions by no means cover this area. There are other methods that might be more appropriate in some cases. The accountant trying to compute the value of stock in a closely held company should be aware of the possibilities in these types of methods and should think about and develop others if they can be supported.

intimate knowledge of the company is of great importance. Finally, it should be understood that the value determined by the accountant must be defended in the estate-tax proceedings and that the final result may be a compromised figure.

PROBLEMS ENCOUNTERED IN PAYMENT OF TAX

After the accountant has made the necessary computations to establish the approximate value of the gross estate, it is necessary to make a computation to determine the approximate tax. It is frequently found that the estate is substantial and that the related taxes are also substantial. In many cases it is found that the assets of the estate are chiefly represented by a holding in a closely held business and that the estate will have difficulty in making payments of the necessary taxes when due. There are some steps that can be taken to deal with this problem. Section 6161 of the Internal Revenue Code provides that, on proper application to the District Director of Internal Revenue, an extension of time can be had for making payments of the estate tax. Generally, this is based on a showing to the effect that hardship would result if payment were required when the return is filed. It is my opinion that this hardship test could be applied in a situation where the assets cannot be disposed of for cash as opposed to a situation where the executors may not wish to dispose of assets for cash.

Section 6166 of the Internal Revenue Code, which was enacted in 1958, represents an additional relief provision. It provides that, if 35 per cent of the gross estate or 50 per cent of the net estate is represented by a holding in a closely held company, the estate's representatives may elect to make payment of tax in not more than ten equal installments over a period of ten years. The deferral applies only to the portion of the tax applicable to the holding of stock in a closely held company. Unpaid amounts are subject to interest and, in some cases, it may be possible to take advantage of this section in order to meet the tax liability without undue hardship.

In some cases where the estate does not appear to be in a liquid condition, insofar as the existence of funds for the payment of estate taxes is concerned, estate planners have suggested that life insurance be obtained. It must be recognized, however, that in cases of this sort, the age of the persons concerned may be such that the acquisition of insurance might be too costly. In addition, there is always the possibility that the client may not be insurable. Another problem exists

in the treatment of the insurance proceeds for estate-tax purposes. If the decedent has retained the incidents of ownership, it may well be that the proceeds thereof will be includible in the gross estate and may of themselves increase the estate-tax liability they are supposed to satisfy. This circumstance might suggest that the policies be given away.

Some people have undertaken to overcome this disadvantage by creating trusts for the benefit of children or by making gifts directly to children under circumstances whereby the income of the trust would be used by the recipient to obtain insurance on the life of the donor. On the death of the donor the proceeds are payable to the beneficiaries and are not includible in the estate. The beneficiaries of the estate holding such proceeds are in a position to lend money to the estate for the payment of estate taxes if such is more desirable than a sale of stock in a closely held company.

WAYS TO REDUCE ESTATE TAXES

One of the most commonly recommended programs for the creation of estate-tax savings calls for the adoption of a regular gift program to persons who would ordinarily be the beneficiaries under the donor's will. As you know, a donor may have a lifetime exemption of $30,000 together with an annual exclusion of $3,000 per person per year. These amounts can be conveyed to donees without the payment of any gift tax. Additional amounts will be subject to tax, but, because of the way in which the tax is computed, it makes no difference as to how the excess over the annual exclusion is given. There is no benefit derived in spreading the gift out over a period of time other than the right to use the $3,000 annual exclusion per donee.

If the gift is in cash, listed securities, real estate, or personal property, the question of valuation is generally not difficult. Reference to quoted prices or appraisals are generally adequate for the purpose. In the case of a gift consisting of stock in a closely held company, however, the same type of valuation problem arises as in the case of valuing such stock for estate-tax purposes. In general, the approach would be approximately the same as for estate tax purposes, but, if the amount to be transferred is minor in relation to the total shares outstanding, it might be reasonable to discount the value otherwise computed.

I know of several cases where one of the principal assets of a prospective estate has been shares of stock in a closely held company.

A considerable amount of uncertainty has existed concerning the proper method of computing the value of the stock and significant amounts of stock have been donated to children for which gift-tax returns have been filed. These gift-tax returns have been examined by representatives of the Internal Revenue Service and it has been possible, in connection with the audit thereof, to present the taxpayer's views on the proper method of computing value. These determinations have been helpful because they have indicated the approach the Internal Revenue Service takes with respect to a particular company and in cases where disputes arise it has been possible to have available for assistance in this matter, a donor who generally has been the person most responsible for building up the value of the company. These opinions are frequently quite helpful for resolving a gift tax matter, whereas, if it relates to an estate-tax matter, such an individual no longer is living.

There is one additional point to consider in connection with the filing of gift-tax returns and that is the fact the statute of limitations begins to run from the due date of a gift-tax return if filed on a timely basis. The running of the statute of limitations in a gift-tax matter has the same advantage as it may have in the case of an income-tax matter. In some cases where people are disposed to make bequests to charity, income-tax savings have been obtained by making gifts of stock during the lifetime of the individual. In some cases the gifts have been made directly to the charitable beneficiary, whereas in other cases the donor has undertaken to create an exempt foundation which will receive and hold the gift for the intention of disbursing all of the income to charitable organizations.

Sometimes it appears desirable to make gifts for the benefit of minor children, or grandchildren, and, if such property is placed in a trust, where it may be desirable to accumulate the income, it will be found that the gift to the trust, or periodic additions thereto, may not qualify for the annual exclusion of $3,000 since it would be held to be a gift of a future interest. I am aware of one instance where this problem has been resolved by creating two trusts. One trust was set up on a basis requiring distribution of its income currently and these gifts in question could therefore qualify for the annual inclusion. The second trust was set up on a basis requiring that it receive the bulk of the property and that it accumulate its income until the donee reached his or her majority.

For many years there has been a great deal of interest on the part

of the various stock exchanges in obtaining legislation to permit gifts to minors without the necessity of creating trusts or guardianships. Within the last few years most of the States have adopted what are now known as the Uniform Gifts to Minors Laws. Under the general terms of these laws an individual can deliver stock to a custodian, selected by himself, to hold the property for the benefit of minor children. The Internal Revenue Service has given consideration to this matter and has for the present, at least, provided one stumbling block to this procedure. It has said that, if a donor makes a gift to minors under the provisions of such an act and names himself as custodian, the income will be taxable to the donee, but the corpus will be includible in the estate of the donor custodian. This, of course, could be overcome by the donor's naming someone other than himself as custodian. I suppose that, in a community-property estate, unless the gift was of separate property, he would be well advised not to name his spouse as custodian.

The 1958 changes in the Internal Revenue Code provided an important incentive to donors and people to whom they make gifts. Prior to this time if a donor conveyed property to a donee, the basis of the property for determining gain in the hands of the donee was the basis to the donor or the last person who acquired it other than by way of gift. This seemed to work particular hardships in cases of the transfer of appreciated property since the gift tax was applied on the appreciated basis, whereas the income-tax basis of the property to the donee was the old cost. This change in the law permits the donee to increase the basis taken over from the donor by the amount of the gift tax paid with respect to such gift provided the resulting figure is not greater than the fair market value of the property conveyed. To state it simply, it means that, in order to obtain the maximum benefit, the gift must be of property that has appreciated in an amount equal to or greater than the gift-tax liability concerned in the transfer. This benefit applies to gifts after the date of the enactment in 1958 and also to property acquired before that date if still held by a donee on such enactment date.

It can be realized then that if the gift is of appreciated property, where the basis may be increased by the gift tax, an income tax benefit is obtained by the donee upon subsequent sale of the property. This benefit, assuming a long-term transaction where the alternative tax applies, is equivalent to 25 per cent of the gift tax paid and has the effect of reducing the cost of the gift by that amount.

It should also be borne in mind that there is generally a substantial saving if property is conveyed by way of gift as opposed to conveyance by way of death. This is true because the gift represents property taken out of the estate at the highest applicable brackets and subjected to gift tax at generally much lower brackets. If the gift is of appreciated property, the donee receives a benefit as to the gift tax paid and the gift tax itself represents funds that have been removed from the donor's estate where they would have been subject to estate tax, so that in proper cases computation will indicate that a gift of property can be made at very substantial savings. For example, we have a client who has an estate of about $12 million. He is possessed of a holding of stock in a listed company which cost him $30,000 and which has a present market value of $100,000. If this stock is retained by him and included in his estate, the Federal estate-tax rate after credit of 67 per cent will apply. (We are not considering the California inheritance or gift tax.) This property, if given, will be subject to gift tax of about $26,000 because of the fact that substantial gifts have been made in the past. After giving consideration to the reduction in Federal estate tax, at the rate of 67 per cent, for the value of the gift and the gift tax and offsetting this by the gift tax and income tax on sale of the property by the donee, we find that the gift approach will reduce over-all taxes by about $45,000 and the donee will be better off by that amount.

Some people have been reluctant to make gifts owing to the fact that they might be held to have made such gifts in contemplation of death. Section 2035 of the Internal Revenue Code provides that, if the donor survives the gift by three years, it cannot be held made in contemplation of death. It has seemed to us that this is a situation wherein a taxpayer has everything to gain and nothing to lose for, if the gift is held to be made in contemplation of death, the law provides that credit shall be had for any gift tax paid with respect to such amounts as are includible in the estate. While there is some limitation, in my experience full credit has been received. It would seem that full credit would be obtained in all cases where the over-all estate-tax rate is greater than the applicable gift-tax rate. In this connection it might be well to note that recently legislation was proposed, but not adopted, which would require the gift tax paid to be includible in the gross estate also, if the gift was determined to be made in contemplation of death.

Care should be taken to choose property that is liable to appre-

ciate, for the subject of gifts. It should be obvious that, if the property represents stock in a growing company, it is much more desirable to transfer the stock by way of gift and allow the appreciation to take place while the property is in the hands of the donee than to retain such property and have all the appreciation become subject to estate tax on the death of the individual. There is a possible disadvantage in making gifts of stock in a closely held company in that the estate of the taxpayer might be placed in a position where it would not be possible to effect a redemption of stock, by the company concerned, to provide funds for the payment of estate and inheritance taxes and administration expenses. Section 303 of the Internal Revenue Code provides that, if stock in a closely held company represents 35 per cent of the gross estate, or at lease 50 per cent of the net estate, a redemption of such stock to the extent of taxes and administration expenses by the company concerned will not result in a dividend. It can be seen, therefore, that gifts of property should be so handled that the estate of the donor will be able to meet the tests set forth in section 303 if there is any expectation that it will be necessary to take advantage of its provisions.

Another opportunity exists for people to improve their estate-tax position by the purchase of United States Government bonds. Certain issues of United States Government bonds are presently selling at substantial discounts and under the terms of their issue they may be surrendered at par in satisfaction of estate taxes. It appears that such bonds will be includible in the estate at the current market value on the date of death to the extent they are not used for the payment of taxes. On the other hand, to the extent they are used for the payment of taxes, it may be necessary that that portion be included at face value or treated by the estate as a gain on disposition to the extent of the difference between market and par.

There is a growing realization on the part of many people that investments in foreign real estate present an opportunity for important estate-tax savings. These savings stem from the fact that section 2033 of the Internal Revenue Code provides that the estate of a decedent shall not include the value of real property situated outside of the United States. At the present time the Dominion of Canada imposes an estate tax of 15 per cent on the value of such realty if located in Canada and held by United States citizens. In addition, certain provinces impose succession taxes at relatively low rates while the other provinces have ceded their rights to the Dominion under agree-

ments which are scheduled to expire in 1962. I do not know whether an extension of the present arrangement will be granted. Some of our clients have undertaken to acquire real estate for rental purposes that is located in the Dominion of Canada and these investments have been acquired on the basis of investment value rather than purely for the estate-tax savings contemplated, although they themselves are material. There are other areas, such as Bermuda and some of the West Indies Islands, where, I understand, no inheritance taxes are imposed and it is my further understanding that other people are making investments in real estate in these areas. This could be an important saving to an individual who is in a substantial estate-tax bracket.

Another area in which important savings in estate taxes can be realized is in situations where a husband and wife are both possessed of substantial income, but one is possessed of a much greater amount of property than the other. In such cases the assumption by one spouse of the entire income-tax liability disclosed by the joint income-tax return does not constitute a gift and can be used to accomplish what can be described as tax-free gifts. I am acquainted with a situation presenting this type of transaction where the husband's taxable income was about $400,000 per year and the wife's taxable income was about $200,000 per year. There was no indicated saving from the filing of separate returns. Joint returns were filed and the husband paid the entire income-tax liability from his separate funds. In view of the fact that the wife's tax liability would have been in the area of $150,000 per year, the husband, in effect, made a tax-free gift of that sum to her each year. The saving to be effected was dependent on the difference in the applicable estate-tax brackets to the husband's estate and the wife's estate. This benefit was available because the will of each party did not leave property to the other.

It is sometimes possible to effect income-tax savings by the device of having an estate accumulate income during the period of administration. This is particularly so if the beneficiaries are themselves possessed of substantial income and do not need the income from the estate immediately. In order to accomplish this saving, it would, of course, appear desirable for the will to provide that income not be distributed during the period of administration. This type of provision would appear safer than to permit the distribution to be at the discretion of the executor.

Another important section of the Internal Revenue Code, which should not be overlooked since it can provide estate-tax advantages,

is section 2056 dealing with bequests to a surviving spouse. The Internal Revenue Code sets forth certain requirements concerning qualification as a marital deduction and these should be carefully considered. Subject to certain exceptions, it can be stated briefly that to the extent property is conveyed by will to a surviving spouse, an amount equal to not more than 50 per cent of the estate may escape tax until the death of the surviving spouse. There are a number of questions met with in handling this so-called marital deduction and some of the points to be considered are discussed hereinafter.

It would appear that a maximum benefit would be derived from this deduction in cases where the decedent had all the property and the surviving spouse had none. In cases where the surviving spouse has some property, a conveyance to the surviving spouse of 50 per cent of the estate of the decedent might create an estate for the surviving spouse greater than half of the decedent's, thus incurring greater estate-tax liability. It would seem that in providing for such deduction the amount to be conveyed should be such as would be necessary to produce the over-all maximum tax benefit.

Another problem comes up in connection with the treatment of expenses and estate taxes as between beneficiaries. If the full 50 per cent is conveyed to the surviving spouse, it may work out that the remaining beneficiaries, who may be children, will find their share materially reduced by the estate tax payable on such share. Sometimes this is not desirable and a saving might be created if the will provides for a transfer to the surviving spouse of an amount that will be determined in such a way that the marital deduction and other beneficiaries share equally in the tax imposed.

Another point that needs careful consideration in connection with the delivery of property in satisfaction of the marital deduction is the selection of the property itself. For example, if the estate is made up of a number of items of property, some of which are expected to be fairly stable in value over the near future and others are expected to have possibilities of appreciation, it would appear more desirable to transfer the stable property, which might be bonds, to the surviving spouse and transfer the property subject to appreciation to the children or other beneficiaries. This would, to an important degree, fix the estate taxes payable on death of the surviving spouse and would not at such time subject the appreciation to estate tax.

USE OF PERSONAL HOLDING COMPANY

For many years tax practitioners have been reluctant to create a personal holding company because of the severe tax that would be assessed in the event income was not distributed to the shareholders. It has generally been known that the existence of such a company would result in duplicate tax. However, under certain conditions it may be useful to consider creating a personal holding company in connection with estate planning. One of our clients was possessed of a substantial amount of assets and held in his own name sizeable holdings of marketable securities. A large amount of appreciation existed on these securities and, even though he had carried on a substantial program of gifts, his estate continued to increase principally through appreciation in these securities. The following plan was devised and, after obtaining a private ruling from the Commissioner of Internal Revenue on its tax consequences, was placed in effect.

1. Our client exchanged, without tax implications, his marketable securities for preferred stock and common stock in a newly created company. The ratio of preferred stock to common stock was about nine to one. The par value of the preferred and common stock represented the fair market value of the securities received for such stock. A dividend rate was fixed on the new preferred stock so that substantially all of the dividend income of the corporation would be required to make the dividend payments on the new preferred stock.
2. The client then commenced a program of giving to his children the common stock in this personal holding company.
3. To give himself some protection regarding the value assigned to the common stock for gift-tax purposes, some of the common stock also was given to a charitable organization. The result of this gift was that any increase in the gift tax would also result in an increased deduction for contributions.
4. The benefit of this plan for estate-tax purposes is that the value of the property conveyed to the corporation would be reflected in the estate of the creator by the par value of the preferred stock because his gift-tax program will have divested him of all ownership of common stock. Thus, all further appreciation would accrue to the common stock which is in the hands of the children and/or the charitable foundation.

From an income-tax standpoint the cost of the personal holding company is very little because the taxpayer is in quite high brackets, the net cost being less than 1 per cent of the dividends received from the securities.

It might be well to point out that this sort of plan might not be desirable if the taxpayer concerned has an intention of selling any substantial portion of the securities.

REDEMPTION IN LIQUIDATION

The example recited previously dealt with an estate-tax planning benefit by the creation of a personal holding company. The more usual situation presents the problem of getting out of a personal holding company arrangement. Usually we find a family corporation that has been long established has accumulated substantial amounts of earnings and profits and has substantial amounts of unrealized appreciation on its assets. Because of the capital-gain tax arising from liquidation, generally, little can be done toward liquidating the company during the shareholder's lifetime. Under certain conditions, it may be possible to overcome some of this difficulty. Take the case of a client who owns shares of stock in a personal holding company and assume that the remainder of the stock is owned by brothers, sisters, nephews, and nieces. Under this type of ownership the stock attribution rules in section 318 of the Internal Revenue Code of 1954 would not apply. On the death of our client, the corporation undertook to make a pro-rata distribution of decedent's share of every asset owned in the corporation in complete redemption of the decedent's interest. This partial liquidation accomplished the following results:

1. The heirs of the decedent obtained the share of property out of the hands of the personal holding company.
2. The estate of the decedent was subjected to insignificant capital-gains tax on the redemption owing to the step-up in basis for estate-tax purposes.
3. Funds necessary to pay estate taxes and administration expenses were obtainable at little or no tax cost to the estate because of the stepped-up basis of the property received in the redemption.
4. It was not necessary to undertake a redemption of stock under section 303, which would probably have caused the corporation to sell securities, with capital-gain tax consequences, in order to obtain necessary funds.

5. The remaining shareholders did not have to suffer the consequences of a complete liquidation.

If it is contemplated that a liquidation situation can be created, care should be taken so that the attribution rules of section 318 cannot be applied. For example, if a situation of this sort appears possible, none of the shareholders should undertake to give stock to a child, for the attribution rules would then apply and the redemption of the stock would not constitute a complete termination of interest.

Ordinarily, in a distribution in redemption of stock, it would appear desirable to make pro-rata distribution of each asset in order not to create any discrimination as between the stockholders. It also appears, based on a private ruling obtained by our firm in a complete redemption situation, that a disproportionate distribution of assets would not serve to upset the desired treatment of the redemption.

RECAPITALIZATIONS

In our firm we have many corporate clients whose stock is owned by the members of one or two families. We have found that a recapitalization eases the problems of moving the family business from one generation to the next.

One of our clients publishes a daily newspaper. At the time we were reviewing the company operation and determining the objectives of its shareholders, the original founders of the newspaper were no longer in the picture. The stock at that time was owned two-thirds by the son of the original founder and his mother, and the remaining one-third by the son of the other founder and his mother. The original founders were only distantly related. Both the women here concerned were over seventy years old. The two men were both active in the management of the newspaper and they were comparatively young, being in their late thirties or early forties.

The founder of the newspaper who had control of the corporation had bequeathed to his son a controlling interest in the newspaper but this resulted in no interest's passing to either of his two daughters. The majority founder's son felt quite keenly his responsibility to his sisters and was most interested in seeing that they ultimately realize their fair share from the estates of the mother and father.

The founder with the minority interest had recently passed away and we had been engaged in a rather lengthy controversy with representatives of the Internal Revenue Service respecting the proper valuation to be placed on the stock for Federal estate-tax purposes.

All the shareholders had been quite disturbed during this period of negotiation and were anxious that such controversies be eliminated or minimized in the future.

The wife of the majority founder was interested in having the value of her stock pegged for estate-tax purposes, in receiving a stock that would pay a fair rate of return, and a stock that would be a suitable vehicle for gifts to her daughters whether by lifetime disposition, testamentary disposition, or combination of gifts and bequests. Neither of her two daughters had an active rôle either as employee or as director or officer of the corporation and it was desirable from the corporation's viewpoint that their holding be limited to preferred stock.

The company had kept dividends to the minimum and had plowed back all earnings to expand the business operations. One of the important objectives to be achieved by this recapitalization was to have a security that would pay a reasonable rate of return to those persons who were not active in the management of the company.

Taking into account the desires of the various shareholders, we recommended that the corporation be recapitalized with two classes of stock outstanding—common and 6 per cent preferred stock. In determining the value of the corporation's present common stock, reference was made to the settlement arrived at with the Internal Revenue Service. This seemed to provide an equitable base for determining the amount of preferred and common stock that would be received on the exchange. The fair market value of the corporation was approximately 20 per cent less than book value on this basis.

The two young men received shares of common stock in exchange and one of the ladies received preferred stock for her former holding of common, which she was going to give to her two daughters. The remaining stockholder received common stock. She wanted her son, who would receive her stock either by gift or bequest, to have increased holdings of common stock because of his active participation in the management of the newspaper.

We requested an advance ruling on this transaction and secured a favorable ruling on all its aspects. The Internal Revenue Service did go so far as to rule that the preferred stock received by the one shareholder would not constitute section 306 stock. While none of the shareholders received both common and preferred stock, the Internal Revenue Service did gratuitously comment that if any shareholder received both preferred and common stock in exchange that the effect

would be substantially the same as the receipt of a stock dividend and accordingly the preferred stock issued to them would constitute section 306 stock. Another gratuitous comment was that this ruling was not to be considered in any way affecting the possible application of the unreasonable accumulation of earnings tax.

PRIVATE ANNUITY

It appears that, in addition to the plans generally considered and those mentioned hereinbefore, some benefit can be derived by use of a private annuity. A private annuity generally calls for a transfer of income-producing property from one member of a family to another, usually from a parent to a child. Generally, the property has substantial appreciation present and, because of the amount concerned, a gift or a sale does not appear desirable. Use of an annuity can accomplish a number of things.

- It can produce income-tax savings for the parent.
- It can produce estate-tax savings as the property has been removed from the potential estate.
- It avoids gift tax.

The transaction is accomplished by causing the parent to transfer the property to the child in exchange for a valid promise on the part of the child to pay the parent an annuity for life. Care should be taken to make certain that the fair market value is properly determined and that the amount of the annuity is based on the parent's normal expectancy. If these steps are followed, it appears that the annual exclusion for income-tax treatment of the annuity is the fair value of the property divided by the life expectancy. The amount in excess of the annual exclusion is treated as ordinary income. The annual exclusion is treated as a recovery of basis to the extent thereof and the excess between basis and the fair market value is construed as a capital gain as it is received. If the parent outlives his expectancy, the annual exclusion is tax-free. The result to the child appears to be that the property will take a basis in his hands equal to the annuities paid. If the parent dies before his normal expectancy, the cost to the child, of course, will be decreased, whereas, on the other hand, if the father survives his expectancy, the property will have cost the child more. Such cost might be recoverable through depreciation or certainly on ultimate sale of the property.

Aside from the estate-tax savings that might result from a transac-

tion of this sort, it is my understanding that, in a proper situation, income-tax savings can be generated. It also permits a parent, if he wishes, to devote a portion of his capital to his normal living costs and the property still remains in the family unit. Ordinarily, the income from the property will be such that the child will be able to make the annuity payments out of the income from the property, less his income tax thereon.

This type of transaction does not appear to be too common in practice, but I have learned of some cases wherein it has been applied with what would appear to be satisfactory results.

GENERAL

In the foregoing portions of this paper I have tried to point out some of the problems inherent in persuading a client to undertake estate planning, some problems presented in valuation, and some problems presented in limiting the estate taxes. We should always remember that at best an estate plan may be a compromise, in that the program offering the greatest benefits strictly from the estate-tax viewpoint may not be in accord with the client's wishes in this area.

In this regard I recall one instance in my own experience where we were requested to review the estate-tax picture of one of our clients. We found that he had not taken complete advantage of the marital deduction and our computations showed than an important savings could be realized in that area. We scheduled a meeting with our client and reviewed our conclusions and pointed out the amount of savings he could achieve if he wished to provide for a transfer to his wife of more property on an unrestricted basis. The client sat at his desk for a few minutes and thought about the matter and then said, "While I have no doubt but that you fellows know the tax law and the consequences of what my will has provided, I know my wife's habits on spending money and I prefer to tie the property up and not save the tax by increasing the marital deduction." That seemed to dispose of the matter, so the will was not revised in accordance with our suggestions.

As a final word of advice, I should like to point out that it is very important for any estate planning undertaken to be kept up to date. Important changes in the financial position of the client might take place, changes might take place in his family situation, and a program complete today may become inadequate in the near future. We should endeavor to cultivate an attitude in our client's mind toward this

subject something like the attitude people have toward the purchase of an automobile. Everyone seems to be interested in obtaining the latest model when it comes out and these same people should be equally interested in obtaining the latest model of an estate-tax plan when their own circumstances change or the pertinent law has changed.