Succession Planning for the Closely-Held Business Owner

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SUCCESSION PLANNING
FOR
THE CLOSELY HELD BUSINESS OWNER
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Program Description
This program will provide a guide to planning the estate of the owner of a closely held business. The program will include a discussion of the unique issues involved which must be faced when a closely held business is part of the estate – including - how to make the owner aware of the problems and concerns - as well as how to motivate the owner to take action.

Also included will be a discussion of the tax, accounting, and legal issues involved in both a lifetime and testamentary transfer of the business – and how to minimize the indirect and direct costs – including the federal estate and gift tax - of making the transfer.
UNIT ONE - The Overview

I. Overview

Estate planning for an estate which involves a closely-held business presents some unique problems and opportunities. The business interest often represents significant value in the estate, is difficult to convert into cash, and is often viewed as a family heirloom. In dealing with the owner the estate planner has to often motivate the owner to let go of control and perhaps ownership as well in order to adequately plan to deal with the potential estate planning issues.

II. Considerations of the Owner

If the owner is selling his business to an outside third party his or her focus will be primarily on maximizing the consideration and minimizing any post sale complications. The tax, business, and legal issues involved in a third party sale are discussed in Tax Issues of a Business Sale, and Legal Issues of a Business Sale. If the owner is transferring his or her business to family members the considerations are different, typically, different. The owner in those situations is typically interested in some or all of the following concerns:

- Retaining control;
- Retaining a sufficient economic interest in the business to sustain his or her lifestyle;
- Removing value from the taxable estate.

If addition the owner may be have certain collateral concerns such as the following:

- How can the owner “equalize” the value given to children not involved in the business.
- If the business is transferred by lifetime transfer can the owner participate in the future sale.

This program will address both the concerns and the solutions involved with planning the estate of a closely held business owner.

III. Developing the Plan

A. Steps

1. Establish goals and objectives
   a. Review current succession plan and reasonableness of achieving desired goals.
   b. Develop a collective vision, goals, and objectives for the business.
   c. What is the dispositional plan – To whom, when and how is the business to be transferred
   d. Determine what the business is worth
   e. Determine the importance of continued family involvement in leadership and ownership of the company, but consider the option to bring in professional management.
f. Establish personal retirement goals and cash flow needs of retiring family owners.
g. Identify goals of next generation management, both personal and business.
h. Identify and retain a team of professional advisors.

2. **Establish a Decision-Making Process**
   a. Identify and establish governance processes for involving family members in decision-making.
   b. Establish a method for dispute resolution if needed.
   c. Document the succession plan in writing.
   d. Communicate succession plan to family/stakeholders.

3. **Establish the Succession Plan**
   a. Identify successors – both managers of the company and owners of the business.
   b. Identify active and non-active roles for all family members.
   c. Identify required additional support for the successor from family members.

4. **Create a Business and Owner Estate Plan**
   a. Address taxation implications to the owner/business upon sale or transfer of ownership, death, or divorce.
   b. Review owner estate planning to minimize taxes and avoid delays in transfer of stock to remaining owners or spouse.
   c. Create a buy/sell agreement that is fair, reflective of the value of the business, and minimizes taxes.

5. **Create a Transition Plan**
   a. Consider options: outright purchase, gift/bequest, or a combination of these.
   b. If the business is to be purchased, consider financing options including financing from an external party or self-financed from the retiring owners on a deferred payout basis.
   c. Establish a timeline for implementation of the succession plan

B. **Key issues include:**

1. **Generational transition.** Only a third of all family businesses successfully make the transition to the second generation.

2. **Alignment of family interests.** Alignment of interests between current owners and others becomes more pronounced as members retire and turn over the reins to the new generation, while at the same time looking to the company for their retirement income.
3. **Balancing of financial returns.** Creating buyout agreements is challenging. When the retiring generation looks to the value of their interest, they sometimes tend to look to a balance sheet number. In fact, the true value of a business should probably be based on an earnings capitalization model, a concept unfamiliar to many smaller family companies.

4. **Interfamily disputes.** The interest of one family member may not be aligned with another family member. These situations can become even more difficult where there is, for example, a divorce of a family owner or a death and the surviving spouse is holding stock (and voting rights) but is not involved in the business.

5. **Estate and Inheritance issues.** These include taxes and probate delays upon the death of a family owner.

C. **What Every Business Owner Needs to Address in their Estate Plan**

1. **Disposition of the business interest**
   a. **Within the family**
      (1) Lifetime gift v. testamentary gift
      (2) Sale
   b. **To third parties**
      (1) Outside sale
      (2) Sale to Employees
      (3) The ESOP option
UNIT TWO – First Step - What’s the Business Worth?

I. Overview

A. The Issue

The value of property for estate tax purposes is its fair market value at death (or as of the alternate valuation date). The value of property for gift tax purposes is the fair market value of property at the time of the transfer. The term “fair market value” is defined by the Regulations to the Internal Revenue Code 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.” Because an equity interest in a closely-held business is not often the subject of actual contemporaneous sales between a willing buyer and a willing seller, the determination of value is often made by applying a valuation method to the financial data of the entity. The debate between the Service and the taxpayer often comes down to which particular method and which particular factors should be applied in making the determination.

B. Potential Methods

1. Book Value/Asset Approach
2. Earnings Approach
3. Dividend Approach
4. The Market Approach
5. Other Approaches

C. For what purpose?

1. For sale purposes
2. For gift purposes
3. For estate tax purposes

II. The IRS View of Valuation.

A. Rev. Rul. 59-60.

Rev. Rul. 59-60 as late augmented by Rev. Rulings 77-287, 80-213, and 83-120, gives insight into the Service’s perspective on how to value equity interests in closely held businesses. Rev. Rul. 59-60 recognizes the process is “not an exact science”.

B. Potential Valuation Methods

The Ruling however analyzes a number of accepted methods of valuation:

1. Book Value

The book value approach is probably one of the easiest methods to use. The cost value of all assets of the corporation is determined. Amortization and depreciation are then subtracted, together with all liabilities. The resulting figure represents the company’s book value. This approach
is simple to apply because these values should be clearly reflected on the corporate balance sheet at any given time. However, because this method does not consider the actual value of assets that may have appreciated in value or have actually depreciated in value at any rate different from the rates used in determining book depreciation under GAAP, or under the Code and relevant regulations under §§167, §168, or §169 if tax rather than GAAP books are used, the “true” value of the assets may not be accurately reflected. In addition, the book value often does not reflect the value of the intangible assets of the corporation such as goodwill, marketing lists, pricing lists, patents and trademarks, etc.

2. **Earnings Approach**

The earnings approach is based primarily upon a projection of the corporation's future earnings in order to determine its current fair market value. The information used to project the future earnings capacity must be based upon the corporation's current financial status.

The earnings approach to valuing closely held companies is, itself, subject to variations. The discounted future returns or discounted cash flow method looks at the previous history of the corporation to determine expected future earnings over a selected period of years — generally five. After future earnings are projected, each future year's expected earnings is discounted back to present value using a reasonable discount rate that should equate to the rate of return an investor would expect from investing in that business. A residual value for the company at the end of the projection period may also be determined and discounted back as an addition to present value. The total of the present values of the corporation's expected future earnings and expected residual value represents the current fair market value of that corporation. This valuation method is based upon the assumption that the price an investor will pay for a share of stock is primarily the present value of the future stream of income he or she expects to receive from the investment.

3. **Dividend Approach**

In this approach, appraisers review the history of the company's dividend payments and dividend-paying capacity, and, typically, capitalize that factor based upon dividend yields provided by comparable public companies. This method is similar to the capitalized earnings approach, and, again, the choice of comparable corporations is critical.

4. **The Market Approach**

The market approach to determining the value of closely held corporations involves an analysis of similarly situated public companies in the same line of business, on the theory that similar companies will have a similar relative value. Factors relevant in determining comparability include: (1) the similarity of the markets in which the companies operate; (2) the depth of the subject's management and their structure; (3) the industry in which they operate and their position within that industry; (4) the companies' earnings; (5) the product lines in which the subjects are actively engaged; and (6) the competition within the industry among the comparable entities.

5. **Other Approaches**
There are numerous other approaches to the valuation of closely held securities, including the excess earnings method, a multiple of revenues method, the replacement cost method, the comparable sales method, and various combinations of the above. Regardless of the valuation method(s) used, most courts also look to the additional intrinsic factors described in Rev. Rul. 59-60 to support or contradict the results obtained with a particular valuation method. In addition, application of most of the above valuation methods requires an analysis of various intrinsic aspects of the company being valued in order to determine the proper factor to use in the translation of the subject company's income, its profits or earnings, its dividend-paying capacity, or the comparability of publicly held corporations into a fair market value determination of the subject. As such, the intrinsic factors of Rev. Rul. 59-60 continue to be vitally important in arriving at the fair market value of closely held stock. These factors are discussed below in section C.

C. Other Factors

1. Overview

Rev. Rul. 59-60 provides that “all available financial data, as well as all relevant factors affecting the fair market value” should be considered in evaluating the stock of a closely held corporation. Among these are eight basic factors that, though not all-inclusive, are considered by the IRS to be fundamental to the determination of the fair market value of any closely held security. The eight factors listed in Rev. Rul. 59-60 are: (1) the nature of the business and the history of the enterprise from its inception; (2) the general economic outlook and the condition and outlook of the specific industry in particular; (3) the book value of the stock and the financial condition of the business; (4) the company's earning capacity; (5) its dividend-paying capacity; (6) the existence or absence of goodwill or other intangible assets; (7) sales of the stock and the size of the block of the stock to be valued; and (8) the market price of stocks of corporations engaged in the same or similar lines of business having their stock actively traded in the free and open market, either on an exchange or over-the-counter.


The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.

3. Economic Outlook

A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied.
4. **Financial Condition**

Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth.

5. **Earning Capacity**

Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years.

6. **Dividend Paying Capacity**

Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity.

7. **Goodwill and Intangibles.**

In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business.

8. **Sales of Stock and Block of Stock**

Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that
control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock

9. Comparables

The Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In

10. Weight of Factors

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in this section. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business

11. Capitalization Rate

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

12. Average Factors

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

13. Restrictive Agreements

a. In general.
A bus sell agreement can be used in certain circumstances to set the valuation of the ownership interest for federal estate tax purposes. See Unit Three section IIB2c, above for a discussion of this issue.

b. Section 2704 – Effect of Restrictive Agreement

Section 2704(a) treats the lapse of certain rights and restrictions attached to an ownership interest in a family business as a taxable transfer of the difference in value of the interest (1) calculated as if the restriction were non-lapsing and (2) calculated after the lapse. Section 2704(a) is applicable to any lapse or termination of voting or liquidation rights in a corporation (or partnership) created after October 8, 1990, if certain family control criteria exist. Note, however, that §2704(a) does not apply to the lapse of a liquidation right to the extent the holder and members of the holder’s family cannot immediately after the lapse liquidate an interest that the holder held directly or indirectly and could have liquidated before the lapse. In addition, §2704(a) does not apply to the lapse of a liquidation right previously valued under §2701 to the extent necessary to prevent double taxation (taking into account any adjustment available under Regs. §25.2701-5).

Pursuant to §2704(b), certain restrictions on an owner’s ability to liquidate an entity are disregarded for valuation purposes if they are more restrictive than applicable state law. Section 2704(b)(3)(A) contains a safe harbor for commercially reasonable restrictions that arise as part of financing by the corporation (or partnership) with a person not related to the transferor, the transferee, or their respective family members.

D. Discounts and Premiums Factors.

Once fair market value has been determined there may be other factors which either depress or increase the value of the interest in question. This section will discuss these so-called “premiums” and “discounts”.

1. Minority Interest Discount - The rationale for recognizing the existence of a minority interest discount relies upon a number of factors, including the inability of a minority owner to realize his or her pro rata share of the entity’s net assets through liquidation, lack of control (e.g., over corporate policy, the payment of dividends, executive compensation, etc.), and other factors. Further, the holders of the controlling shares can, and usually do, elect themselves or members of their families as directors and officers, thus enabling them to draw earnings out of the corporation as salaries and directors’ fees, and to control corporate policy. Whether or not the potential buyer is an insider, the per share price paid for those shares will almost invariably be less than a simple pro rata share of the value of the company.

2. Control Premium - If a share of stock is part of a block of stock that constitutes actual voting control of the corporation, that share may possess an additional measure of value because it, along with the other shares in the block, controls the corporation. The block, therefore, can, at least indirectly, dictate the day-to-day affairs of the corporation, compel the declaration of dividends, and potentially direct the liquidation of the corporation or the sale of its assets as a going
concern. As such, determining the fair market value of a controlling interest may require adjustment to reflect a “control premium.” As with minority interest discounts, discussed above, the appropriateness of a control premium will depend on whether the normative value being used as a base was determined assuming control.

3. **Lack of Marketability** - Courts frequently apply the minority interest discount principle as a factor in arriving at a final valuation, but sometimes fail to specify the actual weight of this discount as opposed to others. For instance, often the minority interest discount principle has been applied together with the lack of marketability principle and a single discount factor allowed, even though the concepts of the two principles are intellectually distinct. The lack of marketability discount is based on the principle that, because the shares are not actively traded or otherwise readily marketable, an adjustment should be made in per share value. Where a marketability discount is permitted, the amount of the discount is often substantial. Expert testimony is required to establish the price that could be obtained for the shares.

4. **Sec. 2032A Valuation** - Under section 2032A, an executor may, for estate tax purposes, make a special election concerning valuation of qualified real property (as defined in section 2032A(b)) used as a farm for farming purposes or in another trade or business. If this election is made, the property will be valued on the basis of its value for its qualified use in farming or the other trade or business, rather than its fair market value determined on the basis of highest and best use (irrespective of whether its highest and best use is the use in farming or other business).

5. **Key Man Discount** - Often the value of a company is based largely on a consideration of its past earnings and its prospects for the future. When a company's management or business reputation is predominately based on the efforts of one or more key persons, the actual loss (e.g., by death) or potential loss of such employees may significantly impact the company’s future prospects and in some cases its continued viability as a going concern. Consequently, the existence of such key employees may well be a significant factor requiring an adjustment to the baseline determination of a company's value.

### III. Defending Valuation

**A. Under Valuation Penalties**

1. **Penalty for Substantial Gift Tax Understatement**

Section 6662(b)(5) imposes an addition to tax of 20% of the resulting underpayment of estate or gift tax attributable to a substantial valuation understatement. A substantial valuation understatement exists if the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be the correct value. Generally effective for returns filed after August 17, 2006, the Pension Protection Act of 2006 amended §6662(g)(1) to provide that the understatement is substantial if the value of any property claimed on the return is 65% or less of the amount determined to be the correct valuation.
The addition to tax under §6662 for a substantial gift tax understatement is equal to 20% of the portion of the underpayment attributable to the substantial gift tax understatement. No penalty is imposed if the portion of the underpayment of tax attributable to a substantial estate or gift tax valuation understatement is $5,000 or less for any taxable period.

2. Penalty for Gross Valuation Misstatement

Section 6662(h) provides that the penalty rate is increased from 20% to 40% of the resulting underpayment of estate or gift tax if there is a “gross valuation misstatement. The term “gross valuation misstatement” is applied to a valuation claimed on a gift tax return that is 25% or less of the amount determined to be the correct amount. Generally effective for returns filed after August 17, 2006, the Pension Protection Act of 2006 amended §6662(h)(2)(C) to define a gross valuation misstatement as a valuation that is 40% or less of the amount determined to be correct.

B. Statement Explaining Determination of Value by IRS for Transfer Tax Purposes Must Be Furnished on Written Request of Taxpayer

If the IRS makes a determination (or a proposed determination) of the value of property for purposes of the estate, gift, or generation-skipping transfer taxes, §7517(a) provides that, upon written request by a taxpayer, the IRS must furnish a written statement explaining the basis on which the IRS determined or proposes to determine the value of the property. The IRS statement also must (1) set forth any computation used in arriving at such value and (2) contain a copy of any expert appraisal made by or for the IRS. Regulations prescribe that the taxpayer's request that a written statement be furnished with respect to the value of a designated item of property must be filed no later than the latest time to file a claim for refund of tax that is dependent on the value for which the determination (or proposed determination) of value was or will be made. The IRS must furnish a statement within 45 days of the later of:(1) the date of the request or (2) the date of the IRS determination or proposed determination.

Except to the extent otherwise provided by law, neither the value determined or proposed by the IRS nor the method used in arriving at such value is binding on the IRS. The statement may be of help to the donor (or the executor of the estate), but it cannot be relied on because the IRS is not bound by it.

C. Negligence or Disregard of the Rules or Regulations

1. Overview.

IRC Sec. 6662(b)(1) imposes a two-pronged 20% taxpayer penalty on (1) negligence or (2) disregard of rules or regulations. In other words, the penalty can apply if the taxpayer is negligent, and it can apply if the taxpayer is not negligent but disregards rules or regulations. For practical purposes, the two prongs function as two separate, nonoverlapping penalties.

Negligence is any failure to make a reasonable attempt to comply with the rules [IRC Sec. 6662(c)]. Taxpayers are exposed to the negligence prong of the accuracy-related penalty when they fail to keep adequate books and records, fail to substantiate items properly, or take positions that are "too good to be true" [Reg. 1.6662-3(b)(1)].

Disregard is a careless, reckless, or intentional disregard of the rules [IRC Sec. 6662(c)].
For the disregard prong, "rules or regulations" include the Code, temporary and final regulations, and revenue rulings and notices published in the Internal Revenue Bulletin [Reg. 1.6662-3(b)(2)]. Proposed regulations do not count as rules or regulations. According to the preamble to the Section 6662 regulations, revenue procedures may or may not be "rules" -- depending on facts and circumstances. However, revenue procedures are not listed as "rules" in the regulations.

2. **Negligence.**

The negligence prong can be avoided if the taxpayer can show a "reasonable basis" for the tax position. Regulations have not yet precisely defined the term *reasonable basis*. It is generally recognized as a 15%-20% likelihood of being sustained upon challenge. Presumably, it is a lower standard than "substantial authority" (approximately 40%) or "a realistic possibility of being sustained on its merits" (approximately 33%), but a higher standard than "not frivolous." The negligence penalty can also be avoided by satisfying the reasonable cause/good faith test (see the earlier discussion). However, adequate disclosure is no longer a defense to this penalty.

3. **Disregard of Regulations.**

If a taxpayer *knowingly* takes a good faith position contrary to a regulation, the only defense, in most cases, against potential assessment of the disregard penalty is to make adequate disclosure [Reg. 1.6662-3(c)]. If a taxpayer *unknowingly* takes a position contrary to a regulation, he or she may be able to mount a reasonable cause/good faith defense. In addition, in limited circumstances, the reasonable cause/good faith defense could apparently apply to a position known to be contrary to a regulation. For example, if a regulation appears to be inconsistent with the statute itself or has been invalidated by a court decision, a taxpayer could apparently argue that the reasonable cause/good faith defense applies -- even though adequate disclosure was not made.

4. **Disregard of IRS Revenue Rulings and Notices.**

A taxpayer can avoid the disregard penalty for positions contrary to revenue rulings and notices by making adequate disclosure or by showing the position has a "realistic possibility of being sustained on its merits" [Reg. 1.6662-3(b)(2)]. Basically, the realistic possibility standard is met if there is approximately a 33% or better chance that the tax position will be sustained on its merits [Reg. 1.6694-2(b)]. Finally, a taxpayer may be able to mount a reasonable cause/good faith defense.

5. **Adequate Disclosure Defense.**

If a taxpayer provides a complete, item-specific disclosure of a position that has a reasonable basis on a return (and in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation), the taxpayer will be excepted from the disregard of rules or regulations prong of the accuracy-related penalty for that position. However, disclosure will not prevent imposition of the penalty if the position disclosed does not have a reasonable basis, or proper books and records were not maintained, or items are not substantiated [Reg. 1.6662-3(c)(1)].
To adequately disclose a position taken on an income tax return (for purposes of the penalty for disregarding rules or regulations), a taxpayer must do the following [Reg. 1.6662-3(c)(2)]:

1. Disclose the position on a properly completed Form 8275 (Disclosure Statement) for positions other than those contrary to a regulation or Form 8275-R (Regulation Disclosure Statement) if a position is contrary to the regulations, and attach it to the return. A separate statement attached to the return is not sufficient.

2. Identify the statutory provision, ruling, or regulatory provision in question on Form 8275 or 8275-R.

6. Exception for Reasonable Cause and Good Faith

Section 6664(c) provides that no penalty shall be imposed under §6662 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for the underpayment and that the taxpayer acted in good faith.

The accuracy-related penalty will not be imposed on an underpayment if the taxpayer had reasonable cause for taking the position on the tax return that caused the underpayment, and acted in good faith [IRC Sec. 6664(c)(1)]. The reasonable cause/good faith rule is applied on a case-by-case (i.e., facts and circumstances) basis. The following are examples of situations that may be reasonable cause [Reg. 1.6664-4(b)(1)]: (a) an honest misunderstanding of fact or law that is reasonable in light of all facts and circumstances including the experience, knowledge, and education of the taxpayer; (b) an isolated computation or transcription error; and (c) reliance on professional advice (i.e., an attorney, accountant, appraiser, etc.); an information return; or other facts if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

For reliance on professional advice (including a professional tax adviser) to be reasonable cause, the advice must be based on all of the material facts and must not rely unreasonably on the representations of the taxpayer [Reg. 1.6664-4(c)]. It must not be based on a representation or assumption that the taxpayer knows, or has reason to know, is unlikely to be true. Note that advice is any communication provided to the taxpayer setting forth the conclusion of a professional about the application of the accuracy-related penalty to the tax treatment of an item. The taxpayer must have reasonably relied on the professional's advice, with the regulations stating that reliance may be unreasonable when the taxpayer knew or should have known the adviser lacked knowledge in the pertinent area of the tax law [Reg. 1.6664-4(b) and (c)].

D. Substantial Valuation Misstatement on Income Tax Returns

The substantial valuation misstatement penalty under IRC Sec. 6662(e) applies to income tax returns, but the overstatement of value of property on an estate, gift, or GST tax return would cause a substantial valuation misstatement on an income tax return if the overstated value is used in computing the asset's basis for income tax purposes.
A substantial valuation misstatement exists if the value or adjusted basis of property claimed on an income tax return is 150% or more of the amount determined to be the correct amount [IRC Sec. 6662(e)(1)]. No penalty is imposed if the underpayment resulting from the valuation misstatement is $5,000 or less.

Generally, the penalty is imposed at the rate of 20% of the underpayment. However, in the case of gross valuation misstatements, the rate is 40% rather than 20%. A gross valuation misstatement exists if the value or adjusted basis of the property claimed on a return is 200% or more of the correct amount [IRC Sec. 6662(h)].

E. Adequate Disclosure on Gift Tax Returns

Section 6501(c) was amended in 1990, effective for gifts after October 8, 1990, to provide that no statute of limitations applies to gifts of property valued under §§2701 and 2702 that are not disclosed in a gift tax return, or in a statement attached to the return, in a manner that is adequate to apprise the IRS of the nature of the transaction. §6501(c) was further amended by the 1997 Taxpayer Relief Act to require adequate disclosure of all gifts, not just gifts valued under §2701 or 2702. Accordingly, the statute of limitations will not begin to run on a gift unless it is adequately disclosed on a gift tax return or on a statement attached to the return.

Valuation of gifts follows the same valuation principles as valuation of assets for an estate tax return. The key point is that the valuation date is the date of the gift. Form 709, Schedule A, requires that the preparer indicate whether the reported values have been calculated by taking advantage of valuation discounts, such as lack of marketability, minority interest, a fractional interest, blockage, or market absorption. If so, the return must include an attachment explaining the factual basis of the claimed discounts and the amount of the discount taken.

Generally, the IRS may not modify the value of a gift that was adequately disclosed on a gift tax return for purposes of determining the value of prior taxable gifts after the expiration of the §6501 limitations period. Thus, the value reported on the gift tax return (or as agreed to by the IRS on audit, or as finally determined by a court) is used for determining the available applicable credit amount and the applicable gift tax bracket. Practitioners have differed as to what level of disclosure will be adequate to protect a transfer from later revaluation, if there is no qualified appraisal.

F. Filing a Qualified Amended Return

A qualified amended return is an amended return filed after the due date of the return and before the taxpayer is first contacted by the IRS regarding an examination of the return. A qualified amended return that shows the proper tax liability or supplies disclosure missing on the original return can eliminate exposure to the 20% accuracy-related penalty [Reg. 1.6664-2(c)].
UNIT THREE - Transferring the Business During Lifetime

I. Overview.

The lifetime transfer of a business entity will either be to family members or to an outside third party. The form of the transfer will be either by sale or if within a family by gratuitous inter vivos transfer. In any case the transfer will have estate tax consequences and either gift or income tax consequences as well. This Unit will highlight the estate, gift, and income tax consequences of each type of inter vivos transfer option. The question of whether a gift giving program should be adopted as a part of the plan to transfer the business is addressed in this section.

The options considered will include the following:

- A straight gift;
- A recapitalization, followed by a transfer.\(^1\)
- The “estate tax freeze”.
- The “charitable remainder trust” bail out.

III. Straight Gifts

A. Overview

The case for making inter vivos gift transfers of interests in the business, whether held in the form of stock, partnership interests, or membership interests in a limited liability company, lie in the opportunity to reduce the value that is ultimately subject to transfer tax. Lifetime transfers can achieve a meaningful and permanent reduction of that value in several ways. First, is the availability of the $14,000, per donee per year (the "annual exclusion") for gifts of “present interests. Second, if the property is appreciating property, a lifetime transfer will remove any post transfer appreciation from the taxable estate. In addition, if the property is income producing property, the post transfer income will also be removed. Another aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base, while in the case of the estate tax, the tax is included and taxed in the tax base. Finally, there is the ability to discount the taxable value transferred by taking advantage of the annual exclusion and certain discounting techniques, discussed below.

The primary disadvantage in making lifetime gifts to be considered is the loss of the step up in basis to fair market value that occurs when assets are retained in the taxable estate until death. The donee of property gifted during the donor’s life takes a carryover of basis from the donor, increased by any gift tax attributable to the amount by which the fair market value of the gifted property exceeds basis at the time of the gift. In situations where the estate tax incurred is less than the tax benefit of a step up in basis, an inter vivos transfer may not be advisable.

\(^1\) The methods of transfer will include straight gift, transfer to a grantor retained annuity trust; transfer to a grantor retained annuity trust; transfer in exchange for a private annuity, and transfer in exchange for a self canceling installment note.
The American Taxpayer Relief Act of 2012 (“ATRA”), combined with the Affordable Care Act of 2010, has dramatically increased the potential impact of capital gains on estate planning, particularly gift giving strategies. The 2012 Act increased the maximum federal capital gain rate beginning in 2013 from 15% to 20% for higher bracket taxpayers (i.e., taxable income above $400,000 for single filers and $450,000 for joint filers). The Affordable Care Act had previously added a 3.8% surtax beginning in 2013 on net investment income for higher income taxpayers (i.e., modified adjusted gross income above $200,000 for single filers and $250,000 for joint filers). This results in a combined federal capital gain rate of 23.8% for higher bracket taxpayers, an increase of 8.8% over the maximum rate that applied prior to 1/1/13. (This represents almost a 60% increase in the combined federal taxes imposed on capital gains.)

B. Step Up in Basis

The basis of property acquired from a decedent by inheritance, bequest, devise, etc., that hasn't been sold, exchanged, or otherwise disposed of before the decedent's death, is generally equal to its fair market value (“FMV”) at the date of the decedent's death.

However, if:

- The fiduciary elects for estate tax purposes to value the decedent's gross estate at the alternate valuation date, the basis of the property is its FMV at that date;
- The fiduciary elects for estate tax purposes the special use valuation method of valuing farm or other closely held business real property included in the decedent's gross estate, the basis of the real property is its value determined for purposes of the special use valuation election (rather than its FMV);
- Land acquired at death is subject to a qualified conservation easement, it is excluded from the decedent's gross estate (an executor may elect (on Form 706, Schedule U) to exclude from the gross estate up to 40% of the value of land subject to a qualified conservation easement meeting certain requirements and subject to a dollar cap of $500,000, and its basis (to the extent that it's subject to the easement) is the basis in the hands of the decedent.

Fair market value on the date of the decedent's death (or the alternate valuation date, if applicable) doesn't apply to determine the basis of property:

- That's appreciated property acquired by the decedent by gift in the 1-year period ending on his death, and that is reacquired by the donor (or the donor's spouse) from the decedent,
- Included in the decedent's estate but disposed of by the taxpayer before the decedent's death,
- That's stock in a domestic international sales corporation (DISC) or former DISC, or of certain foreign entities; or
- That is a right to receive income in respect of a decedent.

The fair market value (FMV) of property at the decedent's death or at the alternate valuation date is the FMV as determined by an appraisal for federal estate tax purposes. If no federal estate tax return is required to be filed, the FMV of the property appraised as of the date of death for purposes of state
inheritance or other transmission taxes (e.g., legacy taxes) is used to determine FMV. However, if no federal estate tax return is filed, the alternate valuation date cannot be used to determine FMV.

The executor can elect (irrevocably, on Form 706) to use an alternate valuation date rather than the decedent's date of death to value the property included in the gross estate. This alternate date is generally six months after decedent's death or earlier date of sale or distribution. The alternate valuation can be elected only if its use decreases both the value of the gross estate and the combined estate and GST tax liability.

C. Basis Adjustment for Gifted Property

The donee's basis for property acquired by gift or transfer in trust is usually the same as the donor's adjusted basis at the time of the gift plus all or part of the gift tax paid on the gift. Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in the property. If property was acquired by inter vivos gift (i.e., by reason other than the death of the donor), whether the gift was made outright or in trust, the basis in the hands of the recipient-donee, at the date of the gift, may be the same basis as it would be in the hands of the donor or it may be the fair market value of the property at the time of the gift. Which basis applies depends on the purpose for which it is determined, namely: . . . for determining gain, and for depreciation, depletion, or amortization, the donee's basis is the same as the donor's adjusted basis, for loss purposes the donee's basis is the lower of the donor's basis or the fair market value, when the gift was made.

The donee's basis for property acquired by gift is increased by all or a portion of the federal gift tax paid on the gift. Any basis increase for gift tax paid is treated as an adjustment to the basis of the property. Thus, the gift tax paid can increase the donee's basis for determining depreciation, depletion, or amortization, as well as for determining gain or loss. The amount of the increase in basis for gift tax paid is the amount of the gift tax attributable to the net appreciation in value of the gift. The tax attributable to the net appreciation is determined by multiplying the gift tax paid with respect to the gift by the net appreciation in value of the gift and dividing the result by the amount of the gift. Net appreciation in value is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift. For purpose of the above computation, the “amount of the gift” is the value of the gift as finally determined for purposes of the gift tax. This means that in making the above computation the value of the gift is to be reduced by any portion excluded or deducted under the applicable: (a) annual exclusion of Code Sec. 2503(b); (b) charitable deduction of Code Sec. 2522; and (c) marital deduction of Code Sec. 2523.

D. Analysis

This makes the essential question “Are the estate tax savings resulting from making a gift greater than the value of a basis step up?” It is an over simplification to assume that since gifts result in loss of the opportunity to realize a basis step up to fair market value, that lifetime gifts should never be recommended. Rather a careful analysis should be made in order to determine the relative benefit of making the gift in terms of transfer tax savings as compared to the benefit of basis step up.

II. Recapitalization and Transfer.

A. Overview.
Transferring an interest in a closely held business to family members during lifetime must inevitably involve either a sale by gift or by sale. In either case the objective of the owner is often to make the transfer at the lowest possible transfer cost – resulting in the lowest gift tax or in the case of a sale the minimal add back to the transferor’s estate. In addition the owner may wish to retain control over the business and may also wish to retain an income stream from the business as well.

B. Step One - The Recapitalization.

There several options available in order to effectuate these objectives - however each of the options should be preceded by a recapitalization of the closely held business. The recapitalization is necessary in order to make valuation discounts available on the subsequent transfers of the equity interests in the closely held business. The recapitalization can achieve such discounts while still allowing the owner to retain control over the closely held business during his lifetime.

Pursuant to the recapitalization - the capitalization of the closely held business is changed to provide voting and non-voting membership interests. After the recapitalization the voting interests are entitled to a pro rata percentage of the cash distributions and a pro rata percentage of the net proceeds in liquidation, but all of the management control. The non-voting interest is also entitled to a pro rata percentage of the cash distribution and a pro rata distribution of the net proceeds in liquidation, but none of the management control. Because the non-voting interest has no right to participate in management decisions and because it is not tradable on a recognized securities exchange, its value for gift tax purposes is discounted for "minority" and "lack of marketability". These discounts will together result in the gift tax value being reduced by 35 to 40%. In order to obtain further discounts in gift value, an additional step should be taken.

C. Step Two - Transferring the Non-Voting Interests to Future Generations.

Once the recapitalization has been completed, the benefit can only be truly realized if the non-voting interests are transferred by the owner to during his children. If this is not done, the entire value of the closely held business will be included in the estate of the client. Several options exist for effectuating this transfer and are discussed below.

1. Option One - Outright Gift

The owner could simply make an outright lifetime gift the non-voting stock in the closely held business to the clients designated heirs. The value of the gift of the non-voting interest would discounted by a 35 to 40% minority and lack of marketability discount below its otherwise pro rata share of the aggregate value of the closely held business.

2. Option Two - Grantor Retained Annuity Trust.

a. Overview

A second option is to make the transfer of the non-voting interest to a Grantor Retained Annuity Trust (“GRAT”). Under the terms of a GRAT, the owner would retain a current income interest in the GRAT for a specified term (anticipated to be shorter than the grantor's life expectancy). At the end of the term the GRAT would terminate and the remainder interest in the trust property (i.e., the non-voting interest in the
closely held business) passes to designated heirs either outright or in further trust. Under the §2702 of the Internal Revenue Code, the value of the gift transfer to the GRAT is determined by subtracting the present value of the retained income right from the fair market value of the property transferred. If the term and the level of retained income interest are set high enough the value of the retained right to income can be equal to the value of the interest transferred. In that case the value of the gift to zero.

Retained interests are generally valued at zero unless they are “qualified interests.” A “retained interest” is an interest retained by the transferor or any “applicable family member,” provided the family member held an interest in the trust before and after the transfer. Section 2702(b) provides that there are three types of qualified interests: (1) an annuity trust interest; (2) a unitrust interest; and (3) any non-contingent remainder interest if all of the other interests in the trust consist of either unitrust or annuity trust interests. Applicable family members are the transferor’s spouse, ancestors of the transferor or the transferor’s spouse, and the spouses of any such ancestors. §§2702(a)(1), 2701(e)(2).

Regs. §25.2702-2(a)(3) provides that “retained” means held by the same individual both before and after the transfer. Thus, an interest can be “retained” by an applicable family member only when property is transferred to an existing trust in which an applicable family member holds an interest both before and after the transfer to the trust. When the transfer creates the term interest, §2702 applies if the transferor holds the term interest immediately after the transfer.

Unless the retained interest in the GRIT constitutes a qualified interest under §2702, it will be given a zero value, resulting in a gift to the remainder beneficiaries under the GRIT in an amount equal to the total fair market value of the property transferred. To transfer stock to the next generation at a reduced transfer tax cost, while retaining an interest in the transferred stock for a period of time, the transferor must now use a trust with a qualified interest: a grantor retained annuity trust (“GRAT”) or a grantor retained unitrust (“GRUT”).

b. Excluded Transfers

Section 2702 does not apply to incomplete gifts, including transfers to revocable trusts, 239 or to transfers to a trust qualifying as a personal residence trust or to a qualified personal residence trust 240 under Regs. §25.2702-5. Transfers to charitable remainder trusts and pooled income funds are also not subject to §2702 since the retained interests in such trusts are either annuity or unitrust interests. 241

Another safe harbor (sometimes called the “art” exception) excludes non-income-producing tangible property from application of §2702.

c. Example

Here’s an example of how this works: assume the client’s interest in the closely held business is worth $1,000,000, before it is recapitalized. After the recapitalization the owner now holds a voting interest which is entitled to 1% of the net cash flow and 1% the net proceeds in liquidation but 100% of the vote; the non-voting interest is entitled to 99% of the net cash flow and the net proceeds in liquidation but 100% of
the vote. By reason of the minority and lack of marketability discounts calculated at 35% - the value of the non-voting interest would be $643,500 – calculated as follows: ($1,000,000\(^2\) \times 0.99^3 \times (1 - 0.35) = $643,500.

Assume further that the owner makes a transfer of the entire non-voting interest to a GRAT retaining the right to a $76,985.57 annual distribution from the GRAT for 10 years. Under the §2704 of the IRC the gift value of this transfer would be determined to be zero. As result of the two step transaction (i.e., the recapitalization followed by the transfer of the 99% non-voting interest in the closely held business to the GRAT), property currently worth $990,000 can be transferred to the clients heirs and removed from the taxable estate without gift or estate tax.

<table>
<thead>
<tr>
<th>Assumed Value</th>
<th>$643,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumed Term</td>
<td>10 years</td>
</tr>
<tr>
<td>Income Interest Retained</td>
<td>$76,985.57</td>
</tr>
<tr>
<td>Gift Value</td>
<td>$0</td>
</tr>
<tr>
<td>Gift Tax Due</td>
<td>$0</td>
</tr>
<tr>
<td>Value of Underlying Asset</td>
<td>$8,068,170(^5)</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>$0</td>
</tr>
</tbody>
</table>

The GRAT has obvious estate planning benefits but there are certain aspects of the GRAT planning which should be pointed out. In our example, assuming a trust term of ten years, in order to “zero out” the gift tax, the owner must actually be paid the annual payments of $76,985.57. It is assumed that the funding for this payment comes from distributions made by the closely held business in relation to the interest held by the GRAT. While the distribution of $76,985.57 from the GRAT is not taxable, because a GRAT is for income tax purposes a "grantor trust", the owner will be taxed on the income earned by the non-voting the closely held business interest held by the GRAT.

In addition, in order for the GRAT to realize the tax benefits described, the owner must actually survive for the ten-year period during which he has retained the distribution rights from the GRAT. If the owner dies within that period the value of the non-voting the closely held business interests held by the GRAT will included back in his taxable estate - thereby reversing the tax benefit initially created by the GRAT.

3. **Option Three- Intentionally Defective Grantor Trust/Private Annuity**

An alternative to a transfer by gift to a GRAT is a transfer by sale to an “Intentionally Defective Grantor Trust” (IDGT) in exchange for a lifetime annuity payment. Under this option, the owner would first establish a trust, the IDGT. The owner would then transfer funds with a value equal to approximately 10% of the value of the non-voting interest of the closely held business, in this case approximately $64,350.00.

\(^2\) Total Value of the closely held business
\(^3\) Pro rata value of Non-voting interest
\(^4\) Calculation of 35% discount for minority and lack of marketability
\(^5\) This assumes that the non-voting interest will grow at 5% annually for the remainder of the client's life expectancy
This amount will be taxed as a gift to the remainder beneficiaries of the trust. Because in the eyes of the IRS the trust needs to have economic substance before it can validly issue debt, the cash transfer is a necessary step in order to qualify the annuity as a bona fide debt.

After the trust is established, the owner would then “sell” the non-voting interest in the closely held business to the trust in exchange for an annuity payable for life (i.e., a “private annuity”). Normally a sale creates taxable income to the seller based on the gain realized. In this case, however, because the IDGT is designed to be “grantor trust” the sale is not taxable. If a trust is determined to be “grantor trust” the creator of the trust remains taxable on the income realized by assets held by the trust. A collateral consequence is that the IRS essentially looks at the grantor trust and the trust creator as one taxpayer – therefore the gain realized on the “sale” is not recognized for tax purposes.

Under this option, because the transfer is an exchange for fair value in money and moneys worth, there no gift tax consequences result from the transaction. Upon the death of the transferor the private annuity stops and there is nothing to tax in the transferor’s estate. From an estate tax point of view, the non-voting stock is removed from the taxable estate without gift or estate tax consequences. The owner on the other hand, receives a lifetime annuity funded by distributions from the closely held business to the IDGT. The amount of the annuity payment is calculated by using a prescribed interest rate and the client’s life expectancy to cause the annuity’s value to be equal to the value of the interest transferred. The amount of the annuity required in this case would be $ ... .

The advantage of the IDGT/Private Annuity is first that unlike the GRAT there is no danger of assets being pulled back into the estate if the owner dies prematurely. Also the level of the required payment is significantly less under this option. However, the number of payments is unknown so the overall amount of the payments may be greater if the owner survives past his life expectancy. On the other hand, they may be significantly less if the owner dies prematurely.

4. **Option Four – Use a Self Canceling Installment Note or SCIN**

Under Option Four is similar to Option Three except that instead of a private annuity the transferor receives from the IDGT is installment note that cancels by its terms at the time of the transferor’s death, i.e., a “self cancelling installment note” or SCIN.

Generally, the note is established for a term just short of the life expectancy of the seller, but it can be any period as long as it is less than the client’s life expectancy. This will relieve the problem of uncertainty associated with a private annuity, i.e. you can calculate the greatest amount that can be paid under the note. The SCIN, however, shares the advantage of the private annuity in that the obligation to make annual payments ends at the death of the transferor. Another benefit the unpaid balance of the SCIN is not included in the clients estate should he die prior to it being paid in full.

There are certain drawbacks associated with utilizing a SCIN which should be pointed out however. In order to avoid gift tax, the amount of the note and the interest rate provided under the note must be reasonable in relation to the value of interest exchanged. Since amount of the note and the interest rate are a function of actuarial determinations based on the life expectancy of the transferee, if the client’s actual life expectancy is shorter than his actuarial life expectancy the IRS may challenge the
transaction. Another issue is that there must be a premium placed upon the cancellation provision. The SCIN must therefore have either a premium interest rate or inflated principal amount. Finally upon the death of the client, the deferred gain may be recognized as income in respect of a decedent. The IRS has taken the position that any deferred gain should be recognized by the estate. The Tax Court has disagreed with this opinion, but the Eighth Circuit overturned that decision and sided with the IRS. As such, it appears that upon the death of the client, their estate must recognize the deferred gain.\textsuperscript{6}

III. The Estate Tax Freeze.

A. Overview.

Prior to the enactment of section 2701 of the IRC in 1990, a “estate tax freeze” was often used to allow a business owner to “freeze” the value of his ownership interest at current levels and gift the claim on the future value of the entity to his heirs without gift tax consequences. Pursuant to this planning a closely held corporation with only common stock outstanding, would be recapitalized. Pursuant to the recapitalization the corporation would issue a class of common and a class of preferred stock to the sole shareholder in exchange for all of the outstanding common stock. The preferred stock would be specifically granted liquidation and dividend preferences which will result in most or all of the corporation’s current value being allocated to the preferred stock. These same preferences would also be designed to limit the future value of the preferred stock. As a consequence, the common stock would at that point in time have a minimal or zero value, but have a claim on all the future appreciation in the corporation.

Example: P, an individual, holds all of the stock of X Corp. The fair market value of P’s stock is $1,500,000. X Corp. is recapitalized. Following the recapitalization, P holds 1,000 shares of preferred stock bearing an annual preferred dividend of 10% of par value, and a par value and liquidation preference of $1,500,000. This means that if the corporation pays a dividend the first $150,000 but no more will be paid to the preferred stock holders- any excess will be paid to the common shareholder; if the corporation is liquidated the first $1,500,000 of the liquidation proceeds but no more will be paid to the preferred shareholders – again the excess if any will be paid to the common shareholders.

At the time of the recapitalization the aggregate value of P’s preferred stock is by reason of these preferences equal to $1,500,000, the full value of the corporation - the common stock is hypothetically worth nothing. Because the dividend and liquidation preferences set the ceiling on what the preferred stock can receive in the way of dividend distributions and liquidation proceeds the preferred stock value is “frozen” - all of the future appreciation in the corporation’s value will accrue to the benefit of the common stock holders.

The IRS was never comfortable that the conclusion that the common stock interest was worthless for gift tax purposes even though at the time of the recapitalization the common stock could lay claim to none of the value of the corporation. It was the Service’s position that since the common stockholders

\textsuperscript{6} It should be noted that there is considerable debate over this position so there does exist at least some possibility that the gain would be recognized by the individual.
would have the right to all future appreciation in the corporation it had to have a value for purposes. Like many situations where the Service cannot sustain its position in Court – the Code was amended to reach that result.

B. Valuation of Transferred Interest Through Subtraction of Retained Qualified Payment Right

Section 2701 now addresses the typical estate freeze transaction, the preferred stock recapitalization, and the corresponding partnership transaction, the “partnership freeze.” Section 2701 generally deals with the valuation for gift tax purposes of intra family transfers of corporate or partnership interests where the transferor retains certain rights. Section 2701 provides a specific method for valuing the transferred interest. The value of the transferred interest is determined by subtracting from the value of the transferred property the value of the transferor's retained interest.

In determining the value of the retained interest, all attributes of the preferred stock are ignored except for a “distribution right” that consists of the right to receive a §2701(c)(3) qualified payment. A distribution right, in general, is a right to a distribution from a corporation with respect to its stock. A qualified payment, in general, means “any dividend payable on a periodic basis under any cumulative preferred stock… to the extent that such dividend… is determined at a fixed rate.” No value is accorded to a retained preferential right to receive liquidating distributions.

Under IRC Sec. 2701(a)(4), the “junior equity” 
7 in a corporation or partnership, such interest shall in no event be valued at an amount less than the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of the total value of all of the equity interests in such entity, plus the total amount of indebtedness of such entity to the transferor (or an applicable family member).

Section 2701 only applies to a distribution right if, immediately before the transfer, the transferor and applicable family members (as defined in §2701(b)(2)(C), to include any lineal descendant of any parent of the transferor or the transferor's spouse) in the aggregate hold “control” of the entity. §2701(b)(1)(A). “Control” means the holding of at least half of the vote or value of the stock of a corporation. §2701(b)(2).

Example: P, an individual, holds all of the stock of X Corp. The fair market value of P's stock is $1,500,000. X Corp. is recapitalized. Following the recapitalization, P holds 1,000 shares of preferred stock bearing an annual cumulative dividend of $100 per share. The aggregate value of P's preferred stock is $1,000,000. P also holds 1,000 shares of voting common stock after the recapitalization. P transfers the common stock to P's child. Section 2701 applies to the transfer because P has transferred an equity interest (the common stock) to a member of P's family and immediately thereafter holds an applicable retained interest (the preferred stock). P's right to

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7 The term “junior equity interest” means common stock or, in the case of a partnership, any partnership interest under which the rights as to income and capital (or, to the extent provided in regulations, the rights as to either income or capital) are junior to the rights of all other classes of equity interests. The term “equity interest” means stock or any interest as a partner, as the case may be.
receive annual cumulative dividends is a qualified payment right and is valued for purposes of §2701 at its fair market value of $1,000,000. The amount of P’s gift, determined using the subtraction method of Regs. §25.2701-3, is $500,000 ($1,500,000 minus $1,000,000).

If the preferred stock is noncumulative preferred stock, on the other hand, the value of the retained preferred stock will be zero. Thus, application of §2701 results in a gift of the common stock to the children with a value equal to the full fair market value of the corporation.

Example: P, an individual, holds all of the stock of X Corp. The fair market value of P’s stock is $1,500,000. X Corp. is recapitalized. Following the recapitalization, P holds 1,000 shares of preferred stock with a noncumulative dividend right. P also holds 1,000 shares of common stock after the recapitalization. P transfers all of the common stock to P’s child. Under Regs. §25.2701-2, P’s preferred dividend right is valued at zero because it is not a qualified payment right. The amount of P’s gift, determined using the subtraction method, is $1,500,000 ($1,500,000 minus $0).

C. Excluded Transactions

There are a number of transactions to which the §2701 special valuation rules do not apply. Transfers to family members who are not included in the definition of “family members” under §2701(e)(1), i.e., collateral family members, are not subject to §2701. The value of the retained interest is not deemed to be zero where market quotes are readily available on an established securities market for the value of the transferred or the retained interest.

IV. The Charitable Remainder Trust Stock Bail Out.

A. Overview.

Pursuant to a “charitable remainder trust stock bail out” a business owner contributes his or her stock to a charitable remainder trust which in turn sells the stock to a third party or has the stock redeemed by the issuing corporation. The proceeds are invested by the trust an income stream provided in the trust is paid to the owner and/or his designated beneficiaries. At the end of the trust term the balance in the trust reverts to a designated charity. A business owner needing an income stream should consider a charitable stock bail-out.

By establishing a charitable remainder trust and contributing the corporate stock to the trust the donor: (1) enables the trustee to reinvest the proceeds from the sale of the closely held stock in higher yielding investments, without capital gains tax on the appreciation, to provide retirement income for the donor through the donor’s retention of a life income interest; (2) fulfills the donor’s charitable intentions by creating a remainder interest in the trust, for which the donor receives the benefit of an immediate income tax charitable deduction; and (3) freezes the value of the donor’s stock for estate tax purposes. Although the value of the stock’s appreciation will be included in the donor’s estate under §2036, there will be an offsetting charitable deduction under §2055. For gifts to a charitable remainder trust to qualify for income, gift, and estate tax charitable deductions, the trust must meet the requirements of a charitable remainder annuity trust or a charitable remainder unitrust under §664.

B. Charitable Remainder Trusts.
There are basically two types of charitable remainder trust – charitable remainder annuity trusts and charitable remainder unitrusts. A trust must satisfy six requirements in order to qualify as a charitable remainder annuity trust: (1) the trust must be an irrevocable trust from which a fixed dollar amount is paid at least annually to one or more named beneficiaries, at least one of which is not a charity, for a period of not more than 20 years or for the lives of the income beneficiaries; (2) the fixed dollar amount must not be less than 5% of the initial net fair market value of all the property placed in trust; (3) additions may not be made to the charitable remainder annuity trust; (4) on the death of the beneficiary (or the survivor beneficiary, if there is more than one income beneficiary) a charity described in §170(c) must receive the remainder; (5) the annuity payment to the noncharitable beneficiary may not exceed 50% of the value of the trust assets; (6) at the time property is transferred to a charitable remainder annuity trust, the value (determined using the applicable §7520 rate) of the charitable remainder interest must be at least 10% of the initial net fair market value of all property placed in the trust.

Section 664(d)(2) provides that a charitable remainder unitrust is an irrevocable trust that provides for an annual payment to income beneficiaries of a fixed percentage (not less than 5% but no more than 50%) of the net fair market value of the assets of the trust as determined annually instead of only at the initial transfer of the property to the trust. In addition, at the time property is transferred to a charitable remainder unitrust, the value (determined using the applicable §7520 rate) of the charitable remainder interest must be at least 10% of the transferred property. The unitrust terms may limit the income beneficiary’s distribution to trust income in the event the total trust income is less than the unitrust amount. If this income-only exception is used, the trust may also contain a provision requiring the trustee to make up deficiencies from years in which income was less than the unitrust amount; the trustee pays the deficiencies along with the unitrust amount in later years when trust income exceeds the stated percentage. On the death of the beneficiary (or survivor beneficiary, if there is more than one income beneficiary) a §170(c) charity gets the remainder. Additions may be made to a charitable remainder unitrust. Section 664(d)(4) provides that if an additional contribution to a unitrust would cause the trust to fail the 10% requirement, then the additional contribution will be treated as a separate trust; thus, the new contribution will not qualify under §664 or §170, but the existing trust will not lose its qualification. Reformation procedures also are available for trusts failing the 10% requirement.

C. Tax Implications of Charitable Contributions — Charitable Deductions

The gift of stock to a charity generates an income tax charitable deduction for the business owner subject to certain percentage limitations, with a five-year carry-over for the excess. In the event a charitable remainder trust is used, an income tax charitable deduction is allowed in the amount of the present value of the remainder interest. A stock gift to a charity also generates a gift tax charitable deduction. The computation of the gift tax charitable deduction for a gift to a charitable remainder trust is the same as the computation of the income tax charitable deduction, except that the gift tax deduction is not subject to percentage limitations. In the event one or more individuals other than the grantor have income interests in the trust, the grantor may incur a gift tax liability for the value of such income interests, pursuant to §2511.

When the grantor and the grantor’s spouse are the only noncharitable lifetime beneficiaries and the spouse survives, §2056(b)(8) allows an estate tax marital deduction for the value of the surviving spouse’s
interest. If the trust is includible in the grantor's estate, the grantor will receive an estate tax charitable deduction for the fair market value of the charitable remainder interest at the date of death (or alternate valuation date). The computation is the same as for the income tax charitable deduction, without percentage limitations. An inter vivos gift of stock to a charitable remainder trust of which the donor is the only non-charitable beneficiary generates the same estate tax savings as an outright charitable gift by will. Even though the entire value of the remainder interest will be included in the donor's gross estate if the donor is the sole life income beneficiary of the trust, the estate of the donor receives an estate tax charitable deduction equal to the value of the entire trust.

Income, gift and estate tax charitable deductions for transfers to charitable remainder trusts are available only if the interest of the charitable organization is a guaranteed annuity interest or a unitrust interest and certain other requirements are met. If the grantor receives an income tax charitable deduction for a gift to such a trust and ceases to be taxable on the trust income during the trust term — for example, if he or she dies before the termination of the term interest — the charitable deduction is recaptured.

D. Using Private Foundations.

A private foundation can be used to meet retirement and other estate planning goals. However, the current tax laws favor individual contributions to public charities over gifts to private foundations. Among other differences, an income tax deduction of up to 50% of adjusted gross income is allowed for gifts to public charities, versus up to 20% or 30% of adjusted gross income for contributions to private foundations. 268 Also, private foundations are prohibited from engaging in "self-dealing" transactions. Redemption of stock that has been donated to a private foundation may constitute self-dealing, resulting in the imposition of excise taxes on the corporation and possibly the foundation manager. The use of a private foundation in a charitable bail-out is further limited by the rule that a private foundation may not hold more than 20% of the voting shares of any corporation. In addition, if non-publicly traded stock is contributed to a private foundation, the income tax charitable deduction will be limited to the stock's basis in the hands of the donor.

If stock is transferred to a private foundation, a market quotation must be readily available for the stock on an established securities market; otherwise, the charitable deduction will be limited to the donor's adjusted basis in the stock. Market quotations are considered to be "readily available on an established securities market" if the securities are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis. In addition, the full deduction for publicly traded stock contributed to a private foundation is available only to the extent the amount of stock contributed, when taken together with all prior contributions to a private foundation by the donor or members of the donor's family of stock in the same corporation, does not exceed 10% in value of all the outstanding stock of the corporation.

E. Structuring the Charitable Stock Bail-Out

1. Overview.

In a charitable stock bail-out, the shareholder contributes the stock to a qualified charity, either by direct gift or indirectly by means of a charitable trust. The charity may be qualified under
§2055(a) with respect to the estate tax charitable deduction, §2522(a) with respect to the gift tax charitable deduction, or §170(b) with respect to the income tax charitable deduction.

Comment: The charitable stock bail-out may not be available to an S corporation shareholder, because the transfer of S corporation stock to a charitable organization other than one described in §501(c)(3) or to a charitable remainder trust will terminate the S election. The Small Business Job Protection Act of 1996 also amended §170(e)(1) to require that, in computing the amount of the charitable deduction available for the contribution of S corporation stock, rules similar to the §751 partnership rules be applied to determine whether gain on the S corporation stock would have been long-term capital gain if the taxpayer had sold it. Also, charities may be discouraged from accepting such gifts because an interest in S corporation stock is treated as an interest in an unrelated trade or business and all income that flows through to the charity and any gain on the disposition of the stock is treated as unrelated business taxable income under §512(e), even if the type of income would otherwise be excepted from unrelated business income treatment (e.g., passive income).

After the business owner contributes the stock to the charitable organization, the charity or the trustee of the trust presents the stock to the corporation for redemption pursuant to an informal arrangement. In the event of an outright gift to the charity, the charitable bail-out accomplishes the shareholder's charitable intent with no adverse tax consequences since the charity is exempt from income tax on the redemption amount in excess of the basis of the stock. When a charitable trust is used, the charitable bail-out enables the trust, and indirectly the shareholder through his or her retained income interest, to exchange the stock for higher yielding investments without being taxed on the gain.

The charitable stock bail-out may be particularly useful to a shareholder whose children also own shares in the corporation. In such a case, the parent not only secures income tax savings by contributing stock to a charity and having the corporation redeem the stock at its fair market value, but the number of outstanding shares of the corporation's stock is reduced after the redemption. Consequently, the children's equity interests in the corporation are proportionately increased as part of the owner's interest is effectively passed to them free of estate and gift taxes.

2. Corporation May Be Unable to Redeem

A charitable stock bail-out is feasible only if the corporation has the necessary cash to redeem the stock donated to the charity and is permitted by state law to make the redemption. A charitable stock bail-out may enable a shareholder to get cash out of a C corporation without paying taxes at the corporate and individual levels, or may enable a shareholder to transfer control of the corporate entity to the next generation in a manner that limits adverse gift and estate tax consequences.

3. Risk That Redemption from Charity Will Be Recharacterized as Redemption from Shareholder.
It is crucial that the charity or trustee not be legally bound to surrender the shares for redemption, i.e., that the corporation not have the ability to compel the charity to surrender the shares for redemption. Otherwise, the gift of stock to the charity may be ignored for tax purposes, in which case the transaction will be treated as a redemption by the corporation of the taxpayer's stock, possibly subjecting the taxpayer to taxable gain.

Rev. Rul. 60-370, 1960-2 C.B. 203, provides that if the trustee of a charitable trust is under an obligation, either express or implied, to sell or exchange the property transferred to the trust and to reinvest the proceeds in tax-exempt securities, any gain realized on the sale will be taxed to the grantor. The Tax Court sanctioned the charitable stock bail-out in Palmer v. Comr. In Palmer, the taxpayer had voting control of a corporation and also of a tax-exempt private foundation as a result of provisions in the bylaws of the foundation allocating voting power to certain certificates, most of which were held by the taxpayer and his wife. The taxpayer donated his stock in the corporation to the private foundation and then caused the corporation to redeem the stock from the foundation.

V. Inclusion to Achieve Basis Advantages

A. Transfer Property to the Dying Spouse

A donor (or the spouse of the donor) of “appreciated property” may reacquire the property from the donee if the donee later dies. If the conditions described below are met, the basis of the reacquired property to the donor (or spouse) is the adjusted basis of the property to the donee-decedent immediately before the death of the donee-decedent. This “adjusted basis rule”—rather than the “stepped-up basis” rules—applies only if: (1) the property was acquired by the donee-decedent by gift and the donee dies within one year of the gift; and (2) the property is acquired from the donee-decedent by—or passes from the donee-decedent to—the donor (or the donor's spouse). If these conditions do not apply the transfer of property to the first of a married couple to pass away can achieve basis step up without by reason of the marital deduction incurring additional federal estate tax.

B. Inclusion Techniques

The Estate Tax has historically included certain “string provisions” which bring back into the gross estate of a transferor, property transferred by lifetime gift but pursuant to which the transferor retained an interest or control over the property until death. In the current environment of a significantly increased Basic Exclusion Amount, these provisions can be used in situations where the client wishes to make a lifetime gift of property, and at the same time realize a step up in basis at death.

1. Sec. 2036

a. Overview.

Sec. 2036 requires that property once owned by the decedent and gifted during lifetime be included in the decedent's gross estate if the decedent retained a life interest in the property.
Sec. 2036 provides that a decedent's gross estate includes value of any interest in property transferred by the decedent whether in trust or otherwise if the following elements of sec. 2036 are present:

(1) **Transfer Requirement.** The decedent must have made a transfer of property during lifetime for less than adequate return consideration in money or money's worth.

(2) **Retention Requirement.** The decedent must have retained either: (i) the right to the income, (ii) the right to use or enjoy the property transferred, or (iii) the right to control the income, use or enjoyment of the property.

(3) **The Period Requirement.** The retention of the right or control must be either: (i) for the decedent's lifetime, (ii) a period which does not end before the decedent's death, or (iii) for a period which cannot be ascertained without reference to the decedent's death.

c. **Retention of Voting Rights.**

Sec. 2036(b) provides that a retention of voting rights in the shares of stock of a "controlled corporation" transferred after June 22, 1976, will cause the stock to be included in the decedent's gross estate if:

(1) The voting rights are retained for the decedent's life or for a period that cannot be ascertained without reference to the decedent's death or for any period that does not in fact end before the decedent's death.

(2) A "controlled corporation" is defined as one in which the decedent and his or her relatives owned at least 20 percent of the total combined voting power of all classes of stock at any time after the transfer of the property or within three years of the decedent's death.

d. **Examples.**

(1) W transfers $100,000 into trust retaining the right to the income from the property for life. W's retention of the income from the transferred property for life requires inclusion of the full value of the property transferred in W's gross estate under sec. 2036.

(2) Z transfers ownership of his house to R, but retains the right to live in the house for ten years. Z dies within 5 years of the transfer. Z's retention of the enjoyment from the transferred property for a period, which did, not in fact end prior to Z's death requires inclusion of the full value of the property transferred in his gross estate under sec. 2036.

(3) Q transfers $100,000 in trust retaining the right to allocate the income between R and S, until death. Q's retention of control over the income from the transferred property for life requires inclusion of the property transferred in her gross estate under sec. 2036.

2. **Sec. 2038**

a. **Overview.**
Sec. 2038 requires inclusion of the property or property interest when the decedent has made a gratuitous lifetime transfer but retained the right to revoke the transfer or alter the nature of the transfer until death.

b. The Elements of Sec. 2038.

In order for sec. 2038 to apply the following elements must be present:

1. **Transfer Requirement.** The decedent made a transfer of property for less than adequate consideration in money or money's worth.

2. **Right to Alter or Revoke.** The decedent retained the right to revoke or alter the transfer.

3. **Power Exists at Death.** Such power must exist at the time of death.

c. Example:

E transfers property into trust for the benefit of F, but retains the right to revoke the trust for life. Sec. 2038 will require inclusion of the trust property in E's estate, whether or not the property would be returned to E or E's estate upon revocation.

d. Nature of the Power to Alter or Revoke.

The key to the applicability of sec. 2038 is whether the enjoyment of an interest in property transferred by the decedent during his or her lifetime is subject to "any change" prior to his or her death by reason of a power retained by the decedent over the property. Almost any authority retained by the decedent to tamper with the enjoyment of interest transferred during lifetime will constitute a power to "alter or amend, revoke or terminate".

1. **Power to Revoke.** The broadest power that the decedent might hold is the power to revoke the transfer. A power to terminate a trust is expressly described in sec. 2038.

2. **Power to Alter or Amend.** It is long recognized that sec. 2038 is not limited to powers that can be exercised to the benefit of the decedent.

   a. **Power over Beneficial Interests.** The power to alter or amend under sec. 2038 encompasses a power generally to name new beneficiaries of a trust and the power to change beneficial interest among a limited group of beneficiaries.

      For example, if D transfers property and trust income to A for life or remainder to B or B's estate, but reserves the right to invade corpus for the benefit of either A or B, invasion for the benefit of either will affect the enjoyment of the interest of the other and so both interests are subject to change within the meaning of the section.

   b. **Power over the Time or Manner of Enjoyment.** The IRS's position is that if the "time or manner" of enjoyment of an interest may be altered, the interest is subject to sec. 2038. Thus, the retained right to accelerate a property interest is within sec. 2038.
For example, F transfers property in trust for the benefit of G. The trust is to last until G attains age 30, at which time the trust will terminate and be distributed to G. F retains the right to terminate the trust and distribute the trust property to G prior to age 30. The property is subject to sec. 2038.

(c) **Administrative Powers.** It is probably now a settled principal that holding a mere administrative or managerial power over trust assets does not constitute powers to alter beneficial interest within sec. 2038. On the other hand, an unrestrained power to make investments of trust property is within sec. 2038.

(d) **Gift to Minors.** As discussed above in regard to sec. 2036, a transferor who acts as custodian of property transferred to a Uniform Transfers to Minors Account or Uniform Gift to Minors Account has retained the power to "alter" the gift, and sec. 2038 will apply.

e. **Power in Whatever Capacity.**

Sec. 2038 applies to a power, whatever capacity; i.e., whether as a trustee or otherwise. Powers held by a third party will not be ascribed to the transferor. However, if the decedent holds the unrestricted power to remove or discharge a trustee at any time and appoint himself trustee, the decedent is considered to have all the powers of the trustee.

f. **Powers Restricted by Standard.**

A power to "alter or amend" restrained by an ascertainable standard such as "health, education, support, or maintenance", will preclude the application of sec. 2038 to the transfer. For example, assume L transfers property to a trust, reserving the discretion as trustee to make distributions of income to his son, M, or accumulate income in the trust. If the discretion of the trustee can only be exercised if a need for "health, education, or maintenance" of the child is present, then sec. 2038 does not apply. On the other hand, if the discretion can be exercised by the trustee without restraint, then sec. 2038 will apply.

g. **Source of Power.**

Sec. 2038 provides that it makes no difference, whatever, whenever or from whatever source the power the decedent acquired the prescribed power.

h. **Whether Held Alone or with Another.**

The fact that the power to "alter or amend" the gift is held in conjunction with another is not considered in determining whether sec. 2038 will apply to a particular transfer of property.

i. **When Power Must Exist.**

The power must exist at the time of the decedent's death. A release, unless it occurs within three years of death, precludes inclusion.

j. **Amount to be Included.**
Sec. 2038 includes in the gross estate, the value of any interest in property transferred by the
decedent, which was subject on the date of the decedent's death to being changed through one of the
prescribed powers. The value of the estate includes only the value of the property subject to change. For
example, if the decedent had the power to change only an income interest, sec. 2038 requires that there be
included in the estate only the value of that interest.

3. Sec. 2041

a. Overview.

Sec. 2041 requires property to be included in the decedent's gross estate if the decedent held a
"general power of appointment" over the property at the time of death.

b. The Elements of Sec. 2041.

(1) General Rule. Sec. 2041 provides that all property over which a decedent
possessed a "general power of appointment" at his or her death is includible in his or her gross
estate.

(2) Possession of the Power at Death. It is the possession of the general power of
appointment by the decedent, not its exercise, which triggers inclusion under sec. 2041.

(a) A general power created after October 21, 1942 and held by the donee
will result in taxability of the subject property in his or her estate if he or she merely holds
the power until his or her death.

(b) Also, it is not required that the decedent ever actually own the property
which is the subject of the power, for inclusion to result.

(3) Only "General Powers of Appointment" Covered. Only powers defined as "general
powers of appointment" can result in includibility under sec. 2041. A "general power of
appointment" is one which can be exercised by the person to whom it was given in favor of himself,
his or her estate, or the creditors of himself or his or her estate. The term includes all powers,
which are substance and effect powers of appointment regardless of the nomenclature used in
creating the power. The power to consume or appropriate trust principal exercisable without
restriction in favor of the person holding the power is a general power of appointment. A power
exercisable for the purpose of discharging a legal obligation of the decedent or for his pecuniary
benefit is considered a power exercisable in favor of the decedent or his or her creditors and is
therefore considered a taxable general power of appointment.

C. Defective Grantor Trust

If many cases clients have made gift transfers or perhaps private annuity sales to IDGT. A common
power used to achieve grantor trust status is the power retained by the grantor, in a non-fiduciary capacity,
to reacquire the trust corpus by substituting other property of an equivalent value. For income tax purposes,
transactions between the grantor and the IDGT will be disregarded. As such, grantors may exercise the
power to swap high-basis assets for low-basis assets without jeopardizing the estate tax includibility of the
assets and without having a taxable transaction for income tax purposes. To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

D. Discounts and Premiums

Generally there are two discounts which may be appropriate when valuing an equity interest in a closely-held business entity, the discount for “lack of marketability” and the “minority interest” discount. The “lack of marketability” discount is based on the premise that equity in any closely-held business cannot be readily sold on an established market. The lack of marketability discount is generally available whether the interest is transferred at death or by inter vivos gift. The “minority interest” discount is a discount in the value of an interest in a closely held business representing a lack of control in terms of vote. The “minority discount” is based on the premise that a non-controlling or “minority” interest has less value than an interest representing an otherwise equal interest that has the ability to vote.

If a client’s estate plan has designed to take advantage of minority discounts by retaining non-controlling interest in the estate, you might consider either transferrin, or creating a controlling interest back to the client, reversing the effect of the minority discount. In addition, interest in the client’s estate will qualify for a control premium, further increasing the value of the interest and the step up in basis.
II. Initial Stage.
A. Deciding to Sell.
   1. The Seller should prepare his business for sale by addressing issues that may create concern to a potential Buyer. These could include:
      a. Locking in key employees
      b. Potential or existing lawsuits
      c. Labor issues
      d. Dissident minority shareholders,
      e. IRS and other tax issues,
      f. Firming up necessary contracts and agreements.
   2. If the Seller can improve the bottom line by trimming unnecessary expenses or increasing revenue that will have a positive impact on the purchase price.
   3. The Seller should early on determine a realistic value of the company by appraisal or other means.
B. Deciding to Buy.
   1. A Buyer will typically target the Seller.
   2. Then proceed with a preliminary investigation.
   3. Followed by a preliminary negotiation with the Seller.
C. What is the Deal?
   1. Form of the Deal - Asset Purchase or Stock Purchase
      a. Stock Sale v. Asset Sale
         (1) Generally a Seller will prefer a Stock sale for several reasons:
             (a) Seller receives capital gain, as opposed to the “double tax” potential which results when a corporation sells assets and subsequently liquidates.
             (b) The Seller can select the assets to be sold.
             (c) Seller’s liabilities are generally assumed by the Buyer.
         (2) A Buyer will prefer an Assets transaction because the Buyer will receive a step-up in basis in the assets acquired equal to the purchase price, and the Buyer is more insulated from the liabilities of the Seller. Also the Buyer may pick and choose the assets to be acquired.
(1) In an Asset Sale it is generally assumed that the Buyer assumes none of the liabilities of the Seller, There are a number of exceptions to this rule, however. See discussion at Section VI, *Buyer’s Liability Exposure*.

(2) Liability obligations of a selling corporation may be imposed on the Buyer in many situations. See Section II, *Buyer’s Liability in Asset Transactions*.

2. **What is the Price?**
   a. Is the price a fixed amount?
   b. Is the price subject to adjustments?
   c. Has the Seller considered the after tax price?

3. **Is the any Consideration outside the Purchase Agreement?**
   a. Employment Agreements;
   b. Lease or licensing agreements

4. **How will the Buyer Pay?**
   a. All cash;
   b. Stock;
   c. Deferred Payment Arrangements
   d. Assumption of Debt.

5. **What are the Seller’s Post Closing Obligations?**
   a. Consulting agreements;
   b. Representations and Warranties;
   c. Indemnities;
   d. Lease or licensing agreements

6. **What are the Buyer’s Post Closing Obligations?**
   a. Deferred Payment;
   b. Assumption of debt;
   c. Representations and Warranties;
   d. Indemnities;
   e. Earn outs.

III. **Investigation Stage – Buyer’s Due Diligence.**

   The following is a review of the areas of concern for the Buyer in a business acquisition which should be addressed in its due diligence investigation of the Seller:

   A. **Organization and Good Standing.**
1. The Seller’s Articles of Incorporation and all amendments thereto. The Seller’s Bylaws and all amendments thereto.

2. The Seller’s minute book, including all minutes and resolutions of shareholders and directors, executive committees, and other governing groups.

3. The Seller’s organizational chart.

4. The Seller’s list of shareholders and number of shares held by each.

5. Copies of agreements relating to options, voting trusts, warrants, puts, calls, subscriptions, and convertible securities.

6. A Certificate of Good Standing from the Secretary of State of the state where the Seller is incorporated. Copies of active status reports in the state of incorporation for the last three years.

7. A list of all states where the Seller is authorized to do business and annual reports for the last three years.

8. A list of all states, provinces, or countries where the Seller owns or leases property, maintains employees, or conducts business. A list of all of the Seller’s assumed names and copies of registrations thereof.

B. **Financial Information.**

1. Audited financial statements for three years, together with Auditor's Reports.

2. The most recent unaudited statements, with comparable statements to the prior year. Auditor's letters and replies for the past five years.

3. The Seller's credit report, if available.

4. Any projections, capital budgets and strategic plans.

5. Analyst reports, if available.

6. A schedule of all indebtedness and contingent liabilities.

7. A schedule of inventory.

8. A schedule of accounts receivable.

9. A schedule of accounts payable.

10. A description of depreciation and amortization methods and changes in accounting methods over the past five years.

11. Any analysis of fixed and variable expenses.


13. The Seller's general ledger.


C. **Physical Assets.**

1. A schedule of fixed assets and the locations thereof.

2. All U.C.C. filings.
3. All leases of equipment.
4. A schedule of sales and purchases of major capital equipment during last three years.

D. **Real Estate.**
   1. A schedule of the Seller's business locations.
   2. Copies of all real estate leases, deeds, mortgages, title policies, surveys, zoning approvals, variances or use permits.

E. **Intellectual Property.**
   1. A schedule of domestic and foreign patents and patent applications. A schedule of trademark and trade names.
   2. A schedule of copyrights.
   3. A description of important technical know-how.
   4. A description of methods used to protect trade secrets and know-how.
   5. Any "work for hire" agreements.
   6. A schedule and copies of all consulting agreements, agreements regarding inventions, and licenses or assignments of intellectual property to or from the Seller.
   7. Any patent clearance documents.
   8. A schedule and summary of any claims or threatened claims by or against the Seller regarding intellectual property.

F. **Employees and Employee Benefits.**
   1. A list of employees including positions, current salaries, salaries and bonuses paid during last three years, and years of service.
   2. All employment, consulting, nondisclosure, no solicitation or noncompetition agreements between the Seller and any of its employees.
   3. Resumés of key employees.
   4. The Seller's personnel handbook and a schedule of all employee benefits and holiday, vacation, and sick leave policies.
   5. Summary plan descriptions of qualified and non-qualified retirement plans. Copies of collective bargaining agreements, if any.
   6. A description of all employee problems within the last three years, including alleged wrongful termination, harassment, and discrimination.
   7. A description of any labor disputes, requests for arbitration, or grievance procedures currently pending or settled within the last three years.
   8. A list and description of benefits of all employee health and welfare insurance policies or self-funded arrangements.
10. A description of unemployment insurance claims history. Copies of all stock option and stock purchase plans and a schedule of grants thereunder.

G. Licenses and Permits.
1. Copies of any governmental licenses, permits or consents.
2. Any correspondence or documents relating to any proceedings of any regulatory agency.

H. Environmental Issues.
1. Environmental audits, if any, for each property leased by the Seller.
2. A listing of hazardous substances used in the Seller's operations.
3. A description of the Seller's disposal methods.
4. A list of environmental permits and licenses.
5. Copies of all correspondence, notices and files related to EPA, state, or local regulatory agencies.
6. A list identifying and describing any environmental litigation or investigations.
7. A list identifying and describing any known superfund exposure.
8. A list identifying and describing any contingent environmental liabilities or continuing indemnification obligations.

I. Taxes.
1. Federal, state, local, and foreign income tax returns for the last three years. State and sales tax returns for the last three years.
2. Any audit and revenue agency reports.
3. Any tax settlement documents for the last three years.
4. Employment tax filings for three years.
5. Excise tax filings for three years.
6. Any tax liens.

J. Material Contracts.
1. A schedule of all subsidiary, partnership, or joint venture relationships and obligations, with copies of all related agreements.
2. Copies of all contracts between the Seller and any officers, directors, 5-percent shareholders or affiliates.
3. All loan agreements, bank financing arrangements, line of credit, or promissory notes to which the Seller is a party.
4. All security agreements, mortgages, indentures, collateral pledges, and similar agreements.
5. All guaranties to which the Seller is a party.
6. Any installment sale agreements.
7. Any distribution agreements, sales representative agreements, marketing agreements, and supply agreements.
8. Any letters of intent, contracts, and closing transcripts from any mergers, acquisitions, or divestitures within last five years.
9. Any options and stock purchase agreements involving interests in other companies.
10. The Seller's standard quote, purchase order, invoice and warranty forms.
11. All nondisclosure or noncompetition agreements to which the Seller is a party.
12. All other material contracts.

K. **Product or Service Lines.**
1. A list of all existing products or services and products or services under development.
2. Copies of all correspondence and reports related to any regulatory approvals or disapprovals of any Seller's products or services.
3. A summary of all complaints or warranty claims.
4. A summary of results of all tests, evaluations, studies, surveys, and other data regarding existing products or services and products or services under development.

L. **Customer Information.**
1. A schedule of the Seller's twelve largest customers in terms of sales thereto and a description of sales thereto over a period of two years.
2. Any supply or service agreements.
3. A description or copy of the Seller's purchasing policies.
4. A description or copy of the Seller's credit policy.
5. A schedule of unfilled orders.
6. A list and explanation for any major customers lost over the last two years.
7. All surveys and market research reports relevant to the Seller or its products or services.
8. The Seller's current advertising programs, marketing plans and budgets, and printed marketing materials.

M. **Litigation.**
1. A schedule of all pending litigation.
3. Copies of insurance policies possibly providing coverage as to pending or threatened litigation.
4. Documents relating to any injunctions, consent decrees, or settlements to which the Seller is a party.

5. A list of unsatisfied judgments.

N. **Insurance Coverage.**

1. A schedule and copies of the Seller's general liability, personal and real property, product liability, errors and omissions, key-man, directors and officers, worker's compensation, and other insurance.

2. A schedule of the Seller's insurance claims history for past three years.

O. **Professionals.**

1. A schedule of all law firms, accounting firms, consulting firms, and similar professionals engaged by the Seller during past five years.

P. **Articles and Publicity.**

1. Copies of all articles and press releases relating to the Seller within the past three years.

IV. **The Letter of Intent -**

A. The LOI should state the basic terms of the deal:

1. What is being sold;

2. Who is buying;

3. What is the price,

4. What is the form of the consideration and

5. The time line of the transaction.

B. Generally, the LOI serves the Buyer's purposes more than the Seller, since it will allow access to additional information and prevent negotiation with other parties. It may also the Seller to commit to sell and set the price.

C. The LOI should work to narrow the issues before the process goes too far.

D. It should provide an escape clause; otherwise it may constitute a binding agreement of sale.

E. It is important also that the LOI also protects confidentiality of the Seller's information.

F. The LOI should also set a time line on acceptance of the letter and other important dates, such as investigation, closing, etc.

G. An alternative is to go right to a formal full agreement.

H. The signing of a LOI of intent will end the "Initial Stage".

V. **Formal Agreement Stage.**

A. **Issues to be Resolved**

1. **Price**
The determination of the Price is seldom a scientific process in the mind of the Seller.

A Buyer, on the other hand tends to be more analytical in its approach.

In determining the price remember in both Asset deals and Stock deals the price may be subject to adjustment at or close to the Closing Date (see discussion below)

In determining the price both parties should consider closely the “after tax” economic purchase price.

(1) Seller should be schooled not to look at the number as much as the “after tax” number; also the time value of money in a deferred payment transaction should also be considered, as well as the inherent risk in becoming the Buyer’s bank.

(2) Buyer should also be concerned with the economic cost and method of payment.

Both parties should also calculate the cost of doing the deal (attorney’s fees, acquisition audit, professional inventory, etc.), in determining the price.

Unfortunately in many transactions the price is agreed to by the parties before the professionals are involved.

2. Form of the Consideration.

a. All Cash

b. Deferred Payment Notes.

c. Assumption of Debt

d. Stock of the Purchaser

e. Earn Outs

f. Rental Agreements

g. Employment Agreements

3. Collateral Issues.

a. Contingencies

b. Representations and Warranties

c. Indemnity Provisions

d. Covenants Not to Compete

1. Introduction.

A. The primary concern of both the Buyer and the Seller is generally the price.

B. To both parties this should mean “after tax price”.

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C.  The parties should also be concerned with creating a “clean” deal, i.e., with as few post-closing entanglements as possible.

II. Non-Tax Issues to be Resolved

A. Overview

1. Price;
2. Form of the Deal;
3. Form of the Consideration; and
4. Post-Closing Obligations

B. The Price

1. The determination of the Price is seldom a scientific process in the mind of the Seller.
2. A Buyer on the other hand tends to be more analytical in its approach.
3. In determining the price remember in both Asset deal and a stock deal the price may be subject to adjustment at or close to the Closing Date (e.g., inventory on hand, accounts receivable, cash, level of liabilities assumed, etc.)
4. In determining the price both parties should consider closely the “after tax” purchase price.
   a. Seller should be schooled not look at the number as much as the “after tax” number; also the time value of money in a deferred payment transaction should also be considered, as well as the inherent risk in becoming the Buyer’s bank should also be considered.
   b. Buyer is of course most concerned with the basis of assets acquired.
5. Both parties should also calculate the cost of doing the deal (attorney’s fees, acquisition audit, professional inventory, etc.), in determining the price.
6. Unfortunately in many transactions the price is agreed to by the parties before the professionals are involved.

C. The Form of the Deal.

1. Stock Sale v. Asset Sale
   a. Generally a Seller will prefer a Stock sale for two reasons.
      (1) Seller receives capital gain treatment of the sale proceeds, as opposed to the “double tax” potential which results when a corporation sells assets and subsequently liquidates.
      (2) Seller’s liabilities are generally assumed by the Buyer.
b. A Buyer will prefer an Assets transaction because the Buyer will receive a step-up in basis in the assets acquired equal to the purchase price, and the Buyer is more insulated from the liabilities of the Seller.

2. **Liability Aspects of Stock v. Asset Sale.**
   a. In an Asset Sale it is generally assumed that the Buyer assumes none of the liabilities of the Seller, there are a number of exceptions to this rule, however.
   b. Liability obligations of a selling corporation may be imposed on the purchasing corporation if:
      1. There is an express or implied assumption of the liability.
      2. The transaction amounts to a de facto merger or consolidation.
      3. The purchasing company is merely a continuation of the selling corporation.
      4. The transfer is without adequate consideration and there has not been adequate provision for the creditors of the seller,
      5. The purchasing corporation undertakes essentially the same manufacturing operation as the selling corporation (the “product-line” exception)

D. **The Form of the Consideration.**
   1. **All Cash** - All cash is the preferred form of consideration from the Seller’s perspective. This will of course lessen risk and the need to prove the credit worthiness of the Buyer.
   2. **Deferred Payment Notes.**
      a. This form of consideration makes the Seller at least in part the Buyer’s bank.
      b. Will of course increase Seller’s risk and require the Buyer prove its creditworthiness.
      c. The increased risk of necessity means a higher price.
      d. Seller should realize a Note secured by the business assets is poor security in deed since the ability to take back a failing business will mean the assets are already dissipated and will not be consistent with plans of retirement.
      e. Further if a bank is providing financing they will most likely take a priority position.
      f. Also there is a certain inherent anxiety associated with being a Note holder.
   3. **Assumption of Debt.** The assumption of debt of the seller will of course count as additional consideration; but may not be easy to accomplish to the satisfaction of the seller.
4. **Stock of the Buyer.** If the buyer is a publically traded company the stock of the buyer may be a good alternative to cash consideration; see Unit Six for a discussion of the favored tax treatment that may be available for mergers, and consolidations, stock for asset, and stock for stock reorganizations.

5. **Employment Agreements and Rental Agreements.**

Post-closing employment agreements and consulting agreements are in certain situations a good way to compensate the selling ownership group; even if the consideration is classified as ordinary income, since in the context of a C corporation the consideration will not be subject to “double taxation”, which results from a sale of assets and subsequent liquidation.

E. **Post-Closing Obligations**

1. Both the buyer and the seller will generally want a deal which limits there post-closing entanglements with each other.

2. These type of entanglements include could include assumption of debt, indemnification of loss resulting from pre-closing activities of the seller; payments under installments agreements and employment contracts, and contingent sales prices and earn out agreements.

II. **Taxation of a Business Sale**

A. **Overview**

1. **Taxation of the Sale of Stock-**

   a. Since the shares, partnership, and LLC membership interest are generally capital assets, and the owner generally realizes capital gain or loss [see IRC Sec. 1221].

   b. Buyer must generally accept carry over basis in the assets owned by the entity acquired.

   c. However, there are important exceptions to capital gain treatment, and also carry over basis treatment as well.

2. **Taxation of an Asset Sale**

   a. The sale of the business assets normally results in the recognition of gain or loss measured by the difference between the amount realized and the basis of the assets in the hands of the seller [see IRC Secs. 336, 337, 1001].

   b. The character of the gain will depend on the type of asset sold, i.e., whether it is ordinary income property, a capital asset, or a Code Sec. 1231 asset; on the hands of the seller.

      (1) Ordinary income results from gain resulting from the disposition of inventory, consideration allocated to covenant not to compete, and consulting agreements.
“Section 1231 property” is business property or any depreciable property used in a trade or business.

(a) If a taxpayer’s gain on sale of Sec. 1231 assets exceeds its section 1231 loss, then all Sec. 1231 gains and losses are treated as capital gains or capital losses to the extent of depreciation recapture.

(b) If a taxpayer’s losses on sale of Sec. 1231 assets exceeds its section 1231 gains, then all Sec. 1231 gains and losses are treated as ordinary gains or ordinary losses.

(c) When Sec. 1231 property is subject to depreciation recapture, the amount of the Sec. 1231 gain is an amount by which the gain exceeds the amount recaptured; the recaptured amount is taxed at ordinary income tax rates.\(^8\)

(d) A taxpayer who has a net section 1231 gain for the tax year must treat the current year’s net section 1231 gain as ordinary income to the extent of recaptured net section 1231 losses realized in the five preceding tax years.

(3) Capital assets are any assets other than inventory and property held primarily for the sale to customers in the ordinary course of business; note or account receivable acquired in the ordinary course of business, depreciable business property, real property used in a trade or business, a copyright or similar property in the hands of the person who created it or whose basis is determined by reference to the taxpayer who created.

c. If the Seller is a C corporation the income from the sale will be taxed at the corporate level.

d. If the seller is a “pass through entity” (i.e., an S Corporation, partnership, or LLC taxed as a partnership), the income realized pursuant to the sale of assets will pass-through to the owners based on their individual ownership interest; the character of their individual shares of the gain realized will be the same as the character in the hands of the entity.

\(^8\) Gain realized from the disposition of Section 1245 (depreciable personal property used in a trade or business) property is treated as ordinary income to the extent that the adjusted basis of the property exceeds the recomputed basis of the property (cost less depreciation allowed or allowable); In regard to Section 1250 property (depreciable real property used in a trade or business) gain realized is treated as ordinary income to the extent that post 1969 depreciation allowances exceed straight line depreciation; also note that under MACRS, all depreciation on real property must be computed under the straight line method; and as result all depreciation claimed is classified as “un-recaptured Section 1250 gain” and subject to a maximum capital gains rate of 25 percent.
e. A subsequent distribution of the proceeds of the sale in liquidation of a corporation normally results in the recognition of gain or loss to a shareholder measured by the difference between the amount distributed and the basis of the shareholder’s shares; however, it should be noted that in the case of pass through entities the gain realized pursuant to the asset sale will increase the shareholder offsetting the gain realized upon liquidation. [see IRC Sec. 331 (a), 1001; see also Treas. Reg. Sec. 1.331-1].

f. If a limited liability company or partnership is liquidated, no gain or loss is realized by the members or partners except to the extent the “money” received in the liquidation exceeds the member’s or partner’s adjusted basis in the partnership immediately prior to the liquidation. If a distribution of money exceeds the member’s or partner’s adjusted basis the excess is treated as gain received as though the partner had sold or exchanged his or her partnership interest.

B. The Taxation of the Sale Proceeds.

1. The Taxation of Income Realized Taxed to Individuals.

a. Tax on Ordinary Income

(1) Ordinary income is taxed to individual taxpayers by applying the appropriate tax rate to their taxable income. There are seven tax rates for individuals they are 10, 15, 25, 28, 33, 35 and for individuals with taxable income in excess of applicable thresholds 39.6%.

(2) The applicable threshold amounts for 2013 are $450,000 for married filing jointly and surviving spouse filers, $425,000 for head of household filers, $400,000 for unmarried taxpayers other than head of household and surviving spouse filers, and $225,000 for married taxpayers filing separately. All threshold amounts are subject to an inflation adjustment.

b. Tax on Capital Gain.

(1) Individuals pay income tax on the net total of all their capital gains.

(2) Short-term capital gains are taxed at a higher rate: the ordinary income tax rate. The tax rate for individuals on "long-term capital gains", which are gains on assets that have been held for over one year before being sold, is lower than the ordinary income tax rate, and in some tax brackets there is no tax due on such gains.

(3) The tax rate on long-term gains capital gains rate on net capital gains is 20%, if the taxpayer is in the 39.6% income tax bracket; 15% if the taxpayer is in the 25%, 28- 33- or 35% tax bracket, and 0 if the taxpayer is in the 10- 15% tax bracket.
c. **Tax on “Net Investment Income” of Individuals.**

(1) Individual taxpayers are subject to a “net investment income tax” (“NIIT”), also known as the unearned income Medicare contribution (UIMC) tax.

   (a) For each tax year, the tax is equal to 3.8% of the lesser of: (i) net investment income for the tax year; or (ii) the excess (if any) of: modified adjusted gross income (MAGI, defined below) for the tax year, over the “threshold amount.”

   (b) The “threshold amount” which is: (i) $250,000 for joint returns and surviving spouses, (ii) $125,000 for separate returns, and (iii) $200,000 for all other individuals.

   (c) For this purpose, “MAGI” means adjusted gross income (AGI), increased by the excess of: (i) the amount of income excluded under the foreign earned income exclusion over (ii) the amount of any deductions (taken into account in computing AGI) or exclusions with respect to the excluded income in (I) that are disallowed under Code Sec. 911(d)(6).

(2) For purposes of the 3.8% net investment income tax (“NIIT”), “net investment income” (NII) is the excess, if any, of:

   (a) the sum of:

      (i) gross income from interest, dividends, annuities, royalties, and rents collectively, “Sec.1411(c)(1)(A)(I) income”—unless those items are derived in the ordinary course of a trade or business to which the NIIT doesn't apply (i.e., a non-passive, non-trading activity),

      (ii) other gross income derived from a trade or business to which the NIIT applies (“other passive or trading income,” and

      (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the NIIT doesn't apply; over

   (b) the allowable deductions that are properly allocable to that gross income or net gain

(3) Gain or loss from disposition of partnership or S corporation interest under the net investment income tax.
(a) For purposes of the 3.8% net investment income tax in case of a disposition of an interest in a partnership or S corporation that gain or loss from the disposition is included in "net investment income" (NII) only to the extent of the net gain that the transferor would take into account if the partnership or S corporation had sold all its property for fair market value ("FMV") immediately before the disposition.

(b) The purpose of Code Sec. 1411(c)(4) is to allow gain attributable to non-passive activities to be excluded from the calculation of the NIIT on the disposition of an interest in a partnership or S corporation.

(c) Proposed regs, which are proposed to apply to tax years beginning after Dec. 31, 2013, but which taxpayers may apply to tax years beginning after Dec. 31, 2012, under Reg § 1.1411-1(f) provide rules for calculating how much of the recognized income tax gain or loss from a disposition of an interest in a partnership or S corporation is taken into account under the NIIT.

2. The Taxation of Income Realized Taxed to C Corporations.

a. Taxation in General –

(1) A C Corporation is taxed on the taxable income of the corporation according to the following tax table:

<table>
<thead>
<tr>
<th>Taxable Income Over</th>
<th>But Not Over</th>
<th>Pay</th>
<th>% on Excess of the amount over -</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>$50,000</td>
<td>$0</td>
<td>15% $0</td>
</tr>
<tr>
<td>50,000</td>
<td>75,000</td>
<td>7,500</td>
<td>25% 50,000</td>
</tr>
<tr>
<td>75,000</td>
<td>100,000</td>
<td>13,750</td>
<td>34% 75,000</td>
</tr>
<tr>
<td>100,000</td>
<td>335,000</td>
<td>22,250</td>
<td>39% 100,000</td>
</tr>
<tr>
<td>335,000</td>
<td>10,000,000</td>
<td>113,900</td>
<td>34% 335,000</td>
</tr>
<tr>
<td>10,000,000</td>
<td>15,000,000</td>
<td>3,400,000</td>
<td>35% 10,000,000</td>
</tr>
<tr>
<td>15,000,000</td>
<td>18,333,333</td>
<td>5,150,000</td>
<td>38% 15,000,000</td>
</tr>
<tr>
<td>18,333,333</td>
<td></td>
<td></td>
<td>35% 0</td>
</tr>
</tbody>
</table>

(2) A "personal service corporation" is taxed at a flat rate of 35%.

b. Taxation of Capital Gain –
(1) A C Corporation must include both long term and short term capital gain in its gross income to the extent the gains exceed capital losses for the tax year.

(2) As a result the capital gains of a C corporation are generally taxed at ordinary income tax rates.

(3) A corporation may pay an alternative tax of 35% on net capital gain in any year the top corporate tax rate exceeds 35% (determined without regard to the additional tax on a corporation with taxable income over $100,000, and over $15 million; since the maximum corporate tax rate is currently 35% this provision has no immediate impact on corporations.
UNIT THREE – Buy Sell Agreements

I. Overview and Uses

A. Overview.

A buy-sell agreement is a contractual agreement among the owners of a business (the shareholders of a corporation, the partners of a partnership, or the members of an limited liability company) which restricts the right to transfer the ownership interests and establishes certain purchase and sale rights and obligations upon the occurrence of certain events.

B. Uses of the Buy Sell Agreement.

A buy-sell agreement may serve achieve one or more of the following objectives:

1. Restriction of Transfer - By restricting the transfer of an ownership interest outside the ownership group, a buy-sell agreement can help the owners control and restrict who is part of the ownership group.

2. Provides Liquidity - If the agreement provides a purchase obligation in the event of death of an owner and that obligation is funded with life insurance the agreement can be used to convert the deceased owner’s equity interests into cash.

3. Fixes Value - By fixing the price which applies in the event of a purchase under the terms of the agreement, the estate tax value of the equity can be fixed in the estate of a deceased owner.

II. The Mechanics of the Buy Sell Agreement.

A. The Form Agreement.

The buy sell agreement can take one of the following forms: (i) a “Cross Purchase” Agreement; (ii) a “Redemption Agreement”; or (iii) a hybrid agreement. No matter what the form of the agreement the purposes of the agreement are the same as provided in subparagraph B. above. The difference generally lies in how the purchase options and obligations are allocated between the entity and the owners.

1. The Cross Purchase Agreement

A “Cross Purchase” Agreement is an agreement solely among the owners of the entity, i.e., the shareholders, partners, or members. The entity itself is not directly involved in the purchase rights or obligations. The funding of the obligation under this type of agreement must occur at the owner level.

Example: A and B are the sole shareholders of XYZ, Inc. They entered into a Buy Sell Agreement. Under the terms of the agreement A and B agree that neither will transfer his stock in XYZ without first offering to the other shareholder. In the event either of them dies the survivor has agreed to purchased the deceased shareholder’s stock at an agreed upon price.
2. **Redemption Agreement**

A “Redemption Agreement” is similar to a Cross Purchase Agreement with the difference being that the purchase obligations fall to the entity rather than the owners.

*Example: Same facts as in the Example in C.2., above. In the event either of A or B dies the Corporation has the obligation to purchase the deceased shareholder’s stock.*

Under a stock redemption plan, the corporation must have sufficient assets to redeem the shareholder’s stock when required under the stock purchase agreement. This may be accomplished through the retention by the corporation of liquid assets.

3. **Hybrid Agreement**

Under a “Hybrid Agreement” the purchase rights and obligations are shared by the entity and the owners.

*Example: Same facts as in the Example in C.3., above. In the event either A or B dies the Corporation has the first option to purchase the deceased shareholder’s stock at an agreed upon price; if the corporation does not exercise its option the surviving shareholder has the obligation to purchase the stock of the deceased shareholder.*

**B. Triggering Events and Restrictions on Transfer.**

1. **Overview.**

   One of the primary purposes of the buy sell agreement is to provide a market and a source of liquidity for an ownership interest of a closely-held business in the event of the death or, in some cases the disability of an owner. In addition the agreement will often serve to restrict the transfer of ownership interests in order to allow the ownership group to choose to whom an interest may be transferred. In order to effectuate this objective the agreement will generally provide that upon the occurrence of certain “triggering events” – for example, the attempted transfer of an ownership interest to a non-owner – the other owners will have the first option to purchase that interest, upon terms provided in the agreement. It is up to the buy sell agreement to define (i) the events which trigger the purchase rights, (ii) the nature of the purchase rights (who holds it – is it an option or an obligation), and (iii) the purchase price and the terms of the purchase.

2. **Death of an owner.**

   a. **The Event.**

      In the event of the death of an owner the buy sell agreement generally will provide that the ownership interest of the deceased owner must be sold and must be purchased.

   b. **The Purchase Rights.**

      The purchase right is normally stated in terms of a mandatory obligation to sell on behalf of the estate of the deceased owner and surviving mandatory obligation to purchase on behalf of
the surviving shareholder in the case of a cross purchase agreement, and the entity in the case of a redemption agreement.

c. The Price.

The determination of the purchase price in the event of the death of an owner may depend on the context in which the agreement is adopted and the identity of the individuals holding the purchase option. For instance, if the triggering event is the death of a founding shareholder – the objective may be to buy out that individual at a figure which represents the full realization of value created by years of hard work. On the hand if that sale is to that same owner’s family members who are to take over and continue the business the price may be set at a lower level in order to achieve an estate planning objective.

(1) Fixing the Value for Estate Planning Purposes.

A buy sell agreement may be used to fix the value of the business interest for estate tax purposes. Generally, this will require that the agreement fix the price by agreement of the parties or formula rather than by appraisal. See section , below for a discussion of the various methods of how value and price can be determined within the agreement.

In order for the agreement to fix the estate tax value the following requirements must be met: (i) the decedent's estate must be obligated to sell, (ii) the agreement must prohibit the owner during life from disposing of the interest stock without first offering it to the prospective purchaser at the contract price (i.e., a right of first refusal), and (iii) the purchase price at death must have been established through an arm's-length business bargain (and not as a device to pass the decedent's shares to the natural objects of his or her bounty for less than an adequate and full consideration in money or money's worth).

(2) IRC Sec. 2703.

Under § 2703, in spite of meeting the requirement stated above any agreement may be disregarded for valuation purposes, unless the agreement: (i) is a bona fide business arrangement; (ii) is not a device for transferring property to members of the transferor's family for less than full and adequate consideration; and (iii) has terms that are comparable to similar arrangements entered into by persons in an arms' length transaction. See §2703(b); Regs. §25.2703-1(a), (b). These requirements are deemed satisfied if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. Regs. §25.2703-1(b)(3).

d. Terms.

If the triggering event is the death of an owner the funding of the purchase obligation is generally involves life insurance on the life of the owners.

Example: Again consider, A and B are the sole shareholders of XYZ, Inc. In the event either of them dies the survivor has agreed to purchase the deceased shareholder’s stock
at an agreed upon price of $100,000. In order the purchase obligation A has taken out an insurance policy on B life on the face amount of $100,000.

If life insurance funding is being maintained the payment terms should require that an amount equal to the life insurance proceeds should be paid at the time of the closing of the transfer. If the purchase price exceeds that amount the excess should be paid in the form of the purchaser’s installment note over a period of stated time period; e.g., in sixty equal monthly installments.

3. **Voluntary Transfers and Involuntary Transfers**

   a. **The Event.**

      A “voluntary transfer” is an attempted or proposed voluntary lifetime transfer of the ownership interest by an owner - generally by sale or gift. Sometimes a transfer to so-called “permitted transferees” under the agreement made exempt from the restriction. “Permitted Transferees” may be defined to include spouses and descendants, and trusts for their benefit.

      An “involuntary transfer” is generally any transfer made on account of a court order or otherwise by operation of law, including any transfer incident to any divorce or marital property settlement and also including an owner filing a voluntary petition under any federal or state bankruptcy.

   b. **The Purchase Rights.**

      A voluntary or involuntary transfer will mean that an option to purchase by the other owners or the entity rather than an obligation is the appropriate purchase right. Sometimes an “either or option” clause might be used, i.e., the first option may fall to the other owners, with the second option following to the entity. Here’s some sample language:

      “Each other Member shall have thirty (30) days from such notice of a Voluntary or Involuntary Lifetime Transfer in which to elect to buy all or any of the Offered Interest. The other Members may elect to buy the Offered Interest in proportion to their respective Membership Interests (excluding the Offered Interest) or in such other proportion, as they shall agree upon.

      If the other Members do not agree to buy in the aggregate all of the remaining Offered Interest within such option period, then the Company shall have an additional thirty (30) days in which it may elect to buy any of the Offered Interest not purchased by the other Members.

      If the other Members and/ or the Company does not agree to buy in the aggregate all of the Offered Interest within such option periods, such Lifetime Transfer may be completed.”

   c. **Purchase Price.**

      The purchase price should be based on the actual fair market value of the interest to be transferred. Whether the figure is discounted may depend on how the parties view the circumstances which trigger the buy out. An attempt to voluntarily transfer an interest may be
viewed as an attempt to abandon the enterprise which should not be rewarded with a full value cash out. In addition, the owners who choose to carry on with their involvement may not want to be put in a position of choosing between buying the owner or accepting a unknown third party as their business partner. On the other hand, others may feel that if they choose to sell their interest they should not be forced to accept less than full value for the interest.

d. Terms

The form of payment should be in the form of the purchaser’s installment note over a period long enough so that the purchaser is not placed in a difficult cash flow position.

4. Disability

a. The Event.

Normally a buyout based on “disability” is only appropriate if the owner’s individual service contributions are vital to the business of the entity. Defining when a condition of “disability” occurs to the degree which would result in a buyout of an owner’s interest is a determination to be made by each ownership group.

As a guideline there are generally three stages of disability. First, a period during which the owner is not able to work but it is foreseeable that he or she will return to work in the short term. During this period wages are usually paid in full and ownership in not affected. In the second stage the condition has been prolonged to the point that full wages are no longer considered appropriate. During this period disability income insurance could take up some of the income short fall for the disabled owner. In this second stage the ownership interest is again left unaffected. Finally, the third level of disability occurs at the point the disability is considered permanent – at that point the buyout is triggered. Again defining this point is difficult. If disability income or buy out insurance is in place reference to the definition in those policies may be appropriate.

Generally, the determination of the condition of “disability” should not be made by the board of directors or managing partner or member. A better alternative is to have the condition determined or confirmed by one or more physicians.

b. The Purchase Rights.

Whether the other owners or the entity should be obligated to purchase the ownership interest of the disabled owner is an individual choice. Sometimes the remaining owners are given an option with the entity given an obligation to the extent the other owners do not elect to pick up the option. Here is some sample language:

If the other Members do not agree to buy in the aggregate all of the remaining Offered Interest within such option period, then the Company shall have the obligation to buy any of the Offered Interest not purchased by the other Members.

c. Purchase Price and Terms
The purchase price should equal the actual fair market value of the interest to be transferred and should be paid in the form of the purchaser's installment note over a period of stated time period.

5. **Termination of Employment.**

a. **The Event.**

The triggering event is the termination of employment of an owner by the entity. This may occur because an owner/employee retires voluntarily at a certain age, is involuntarily terminated for cause, or simply quits. Whether termination of employment is included in an agreement as a triggering event at all is an interesting question. The answer depends on several factors including the basis for the termination and the nature of the owner’s employment by the entity. If the termination is voluntary that may or may not be reason to trigger a buy out depending on owner’s relationship to the company. If the owner’s is an integral contributor to the day to day operation of the business, then termination of employment may be considered a basis for a buy out. If on the other hand the owner is only a passive investor this type of restriction might not be appropriate.

A most difficult issue involves termination based on “cause”, that is an owner-employee commits some act considered detrimental to the entity. Generally, most would agree such an act if extreme enough should constitute a fair basis for both termination of employment and the triggering of the buy out provisions. The difficulty comes in defining the term “cause” is such a way that it cannot be used as a carte blanche to force a buy out of an owner’s interest at the whim of the other owners. This may be particularly a contentious issue if the purchase price is affected adversely by the circumstances of the termination.

Just as critical as the question as to how to define the term is the question of who is to make the determination of whether or not the definition has been fulfilled. The definition should be specific enough that it cannot be used as an arbitrary basis for terminating employment and triggering the buy out, but broad enough to encompass the full range of activity that would justify such termination.

Here’s some sample language:

“*Cause*” *is defined as conviction of or plea of guilty to a felony or misdemeanor, dishonesty, any other criminal conduct against the XYZ, Inc., a continued breach of the owner’s duties and obligations arising under an employment contract with XYZ, Inc or any written policy, rule, regulation of XYZ, Inc., for a period of five (5) days following his or her receipt of written notice from any officer of XYZ, Inc.”

c. **Price.**

The price should be determined by the circumstances which results in the termination. In the case of termination of employment, other than retirement, the purchase right is generally stated in terms of an option. In the case of retirement, the entity and/or the other owners should have an obligation to purchase the interest of the retiring owner.
If the termination occurs because of retirement based on an anticipated voluntary retirement the price should equal full fair value. Unless the payment has been prefunded in some fashion the price should be paid over term of years so that an unfair cash flow burden is not placed on the entity or the other owners.

If the termination occurs because of termination based on “cause” the price is often at something significantly less than full fair value. Often in the case of voluntary and involuntary termination not for cause the purchase price will be less than full value. If such termination occurs within a stated period – say five years – of the date the ownership interest was acquired the price may be limited to the amount invested by the owner in the ownership interest.

d. Terms.

The form of payment should be in the form of the purchaser’s installment note over a period long enough so that the purchaser is not placed in a difficult cash flow position.

C. Income Tax Consequences

1. Tax Considerations of Stock Redemption Plan

a. By a C Corporation.

(1) To the Corporation- Unless the C Corporation distributes appreciated property in exchange for its stock the corporation will experience no gain or loss as the result of the redemption.

(2) To the Shareholder – Generally the transfer of the stock by a shareholder in exchange for a corporate distribution in redemption of the stock, will result in treatment as a dividend to the extent of the shareholder’s allocable share of the corporation’s earning and profits. To the extent the distribution exceeds such share the excess will be treated as return of basis to the extent it does not exceed the shareholder’s basis in his or her stock, and then capital gain to the extent of the excess.

However, a redemption can be treated as an “exchange” if it is:

(i) “not essentially the equivalent to a dividend”;
(ii) a “substantially disproportionate” redemption of stock;
(iii) a “complete termination” of the shareholder's interest; or
(iv) a partial liquidation distribution.

b. By an S Corporation

(1) To the Corporation – Like a C Corporation, unless the S Corporation distributes appreciated property in exchange for its stock the corporation will experience no gain or loss as the result of the redemption.
To the Shareholder — Since the corporate earnings are taxed to the shareholders as earned whether or not they are distributed, a redemption of S corporation stock will generally be treated as a sale or exchange of the shareholder stock.

c. By a Partnership

(1) To the Partnership —

(2) To the Partner - The tax consequences to the selling partner are dictated under Sec. 736 of the Code and the form of the agreement. Under 736 payments are either Sec. 736(b) payments or sec. 736 (a) payments. Sec. 736(b) payments are treated as liquidating distributions. They fall into two categories the part attributable to appreciated inventory is treated as distributed to the shareholder and resold to the partnership — producing ordinary income. The balance is treated as made in exchange for the partnership interest — producing capital gain to the extent the cash received (including reduction of the partner’s share of debt) exceeds basis.

The remaining payments are deemed to have been paid for unrealized receivable and goodwill. If the payments are in fixed amount they are deemed to be guaranteed payments (ordinary income to the partner, and deductible by the partnership). If they are not fixed in amount they are deemed to be a distribution of partnership profit — taxable to the redeemed partner, and also reducing the profits taxed to the remaining partner. The IRS will generally recognize an allocation between sec. 736(b), and sec. 736(a), distribution if agreed at arms length between the partners.

2. Tax Considerations of a Cross Purchase Plan

a. By a C or S Corporation.

(1) To the Corporation - The corporation will not experience any gain or loss on the sale of its stock pursuant to a cross purchase obligation.

(2) To the Shareholder – A shareholder that sells its stock to another shareholder pursuant to a cross purchase agreement will realize capital gain to the extent the purchase price exceeds the stockholder’s basis in the stock sold. If the sale is made by the estate of a deceased shareholder the basis of the estate will be stepped up to fair market value at the date of death.

b. By a Partnership

(1) To the Partnership - The partnership will not experience any gain or loss on the sale a partnership interest pursuant to a cross purchase obligation. The sale of more than 50 percent of the partnership interests within any twelve-month period will cause the constructive termination of the partnership however. Normally this constructive termination will be without tax effect.
(2) To the Partner - A partner that sells its partnership interest to another partner pursuant to a cross purchase agreement will realize gain to the extent the purchase price exceeds the partner’s income tax basis in the interest sold. To the extent of the partner’s share of the partnership’s share of substantially appreciated inventory and unrealized receivables the gain will be considered ordinary rather than capital gain. The purchasing partners will be allowed to obtain a step up in basis in both its “outside” basis in its partnership interest and its share of “inside” basis – its basis in the assets of the partnership.

D. Funding Mechanisms.

1. Overview.

Purchase obligations under a buy sell agreement will either occur either during the lifetime of the owner or at his or her death. The available options in regard to the source of funding will depend primarily on the triggering event.

In the case of death life insurance maintained on the lives of each of the owners can be an important source of funding. In the event of disability – disability buy out insurance is available as well. However, is all other cases – voluntary and involuntary lifetime transfer, and termination of employment – the buyer must depend on its own current ability to fund the purchase. In many cases this may place an significant burden on the purchaser. In cases when the obligation is stated in terms of an option – it may cause the potential purchaser to decline the option altogether. To avoid placing an undue burden on the purchaser the agreement should provide for a payment of the purchase obligation in installments over an extended period of time.

2. Life Insurance.

a. Overview.

In a redemption agreement life insurance is purchased by the entity on the lives of the owners in order to fund the purchase obligation. In a cross purchase agreement each owner will individually purchase life insurance on the lives of the other owners.

b. Number of Policies Required.

Under a redemption agreement when the entity purchases the life insurance the number of policies required will equal the number of owners. On the other hand, under a cross purchase agreement, when the owners purchase the insurance the number of policies required will increase exponentially. If the are two shareholders two policies are all that are required; however, of the are three six policies will be needed, if four then 12, and so forth. In order to deal with this issue sometimes a trustee will hold the policies, one on each owner in a face amount equal to the aggregate buy out obligation of all the owners. On death of a particular owner, the life insurance on his or her life is paid to the trustee who pays out the proceeds to each of the surviving shareholders in direct proportion to their individual purchase obligation.

c. Premium Payments.
The payment of the life insurance premiums will not be tax deductible in any circumstances whether paid by the entity or the individual owners.

d. **Taxation of Proceeds.**

The receipt of the proceeds of the life insurance should be tax free whether paid to the entity under a redemption agreement or the individual owners under a cross purchase agreement. One exception - when life insurance is paid to a C corporation the proceeds may in certain cases create alternative minimum tax consequences. Increases in cash surrender value and certain life insurance proceeds are among the tax benefits added to a corporation’s ordinary taxable income in order to determine its alternative minimum tax liability.

3. **Disability Buy Out Insurance**

Disability Buy Insurance is insurance that pays a lump sum payment in the event the insured is determined to be “disabled”. The tax treatment of this type of insurance is rather straightforward – the premiums are not deductible and the benefit is not taxed.

4. **Installment Note**

Absent insurance funding, an installment note issued by the purchaser is the most common form of payment. The note should provide along enough term so that the purchaser is not placed in difficult cash flow position. The note should also for adequate security. If the note is issued by the entity it should ideally be guaranteed by the individual owners. On the other hand if the purchase right falls to the entity it should be guaranteed by the owners, individually. At the very least the interest being sold should serve as collateral for the obligation. Therefore In the case of a default the interest can be reclaimed. Interest should be provided at a level at least equal to the Applicable Federal Rate.

When stock or a partnership interests is sold in exchange for an installment note will generally qualify for installment sale treatment. In the case of the sale of partnership interests the portion of the gain that is attributable to substantially appreciated inventory or unrealized receivables will not qualify for installment sales treatment and will be treated as ordinary income.

E. **Setting the Price.**

1. **Overview.**

There are several methods that can be used to determine the price at which an owner’s interest is to be set under a buy sell agreement. As a general premise the apparent objective in all circumstances may appear the same – to determine a fair value for the interest which is the subject of the purchase. However, at discussed above the nature of the triggering event may suggest different approaches to the question, and even call for different purchase prices in different circumstances. For instance, if the triggering event is the death of a founding shareholder – the objective may be to buy out that individual at a figure which represents the full realization of value created by years of hard work. On the hand if that sale is to that same owner’s family members who are to take over and continue the business the price may be set at a lower level in order to
achieve an estate planning objective. And if the triggering event is the termination of employment for cause for example a punitive price – well below fair market value - should be considered. A discussion of the appropriate price level under each type of triggering event is provided above in section .

In this section we will review three of the most commonly used methods in determining the purchase price: (i) agreed upon price, (ii) price determined by formula, and (iii) price determined by appraisal.

2. **Agreed Upon Price.**

The price may be simply agreed upon by the parties. This method assumes that the parties have a realistic idea of what their business is actually worth. In addition, the agreement should provide that the stated price will be reviewed and agreed to on at least an annual basis by the parties. Further if the price has not been updated with the stated time frame the price will be determined by an alternative measure such as appraisal.

3. **Price Determined by Formula.**

A second method that is sometimes employed is a price determination based on a formula such as the capitalization of net earnings determined by a stated capitalization rate. Alternatively, the net value of the enterprise might be used to determine the price. Normally if this method is used certain of the assets are valued at book value and certain other assets – such as real estate and investment property at fair market value. Sometimes the owners will have their own formula which is completely unique to their company or their industry to determine the fair market value of the business. Whatever the formula used - the buyer and the seller both have some assurance that the price will reflect a current value of the business. In addition, the use of a formula makes it easy to track that value by simply applying the formula to current economic data, making adjustments in the levels of insurance and other funding sources such as sinking funds.

4. **Price Determined by Appraisal.**

a. **In General** - An appraisal of the business will generally provide an accurate assessment of the value of the business. However, there are a number of issues which should be addressed in the agreement in regard to the appraisal and how it should be conducted.

b. **Who Chooses?**

One of the questions involved in using this method is who chooses the appraiser. Obviously the side that chooses the appraiser may have significant input into the result. Sometimes the agreement will provide that the buyer and seller will each choose an appraiser, with provision that if the two appraisals differ by a stated percentage a third appraiser, agreeable to both parties, will be engaged to make the final determination of value.

c. **Who Pays?**
The agreement should provide who pays for the appraisal, the entity, the owner whose interest being appraised or are the costs to be shared.

d. **What if there is a Short Fall?**

One problem with using an appraisal, other than expense, involved is that the value of the company is generally not determined until the event triggering the buy sell obligations is triggered. This may create a situation where the source of funding may fall short of the actual purchase price.

c. **How is Value Determined?**

(i) **Life Insurance** – In the case of a redemption agreement the purchase obligation triggered on the death of an owner is in most cases funded with life insurance owned by the entity. A question which should be addressed in the agreement is how the life insurance itself should be taken into account for purposes of the appraisal. Specifically, is the life insurance value to be included as an asset of the entity in determining its fair market value and if included it should be valued at its book value or at the face value of the policy.

Generally, since the appraisal is measuring the value of the business both the asset value of the life insurance and the liability represented by the obligation to the redeem the deceased owners interest should be disregarded by the appraiser in the valuing the entity.

(ii) **Other Factors**

In valuing an interest in a closely held business whether it is a corporation, partnership, or limited liability company two of the possible approaches to determining the value of an interest are as follows: Under the first method the value of the entire entity is determined and the percentage of ownership held by the owner is then applied to that figure to reach a pro rata share of that value. Under a second method the appraiser simply determines an appraised value of the particular interest actually held by the owner. It may on first blush appear that the two methods would arrive at the same figure – however under the second method there are several factors that could depress or in some cases increase the value over its otherwise pro rata share of the value of the entire company. If the interest represents a “minority interest” in terms of vote, discounts of anywhere from thirty to forty percent could be justified. If the interest represents a controlling interest a “control premium” might be applied. If the owner represents an essential part of the management team or if he or she adds significantly to the goodwill of the entity - a “key man” discount could apply.

III. **Collateral Issues to be Covered.**

A. **Disposition of Insurance Policies.**

In a cross purchase agreement, the document should provide that on the buy out of an owner the insurance owned on by that owner on the lives of the other owners can be purchased by the insured or perhaps the other owners.

B. **Covenant not to Compete.**
The agreement should provide that an owner whose interest if bought out are bound by a covenant not to compete with the entity.

C. Preserving the S Election

The agreement should contain a provision that binds the owners to do nothing which will endanger the S Election.

D. Conflicts of Interest

In drafting a buy sell agreement, the attorney should recognize that there may be an inherent conflict of interest. The parties should be asked to acknowledge and waive the conflict.

E. Spouses Signature

The same types of restrictions that can be used to restrict other transfers, including other involuntary transfers, can be applied to restrict transfers pursuant to a divorce or a division of community property. However, restrictions contained in a separate buy-sell agreement (as opposed to those contained in a corporate charter or bylaws or in a partnership or LLC agreement) may not apply to a spouse who never saw or approved of the agreement. Such a spouse was not party to the agreement and neither gave nor received consideration for participation in it. Therefore, it is useful for each party’s spouse to sign a buy-sell agreement, acknowledging that he or she has read it and agrees to be bound by it. A spouse's signature on the agreement does not make the spouse a party to the agreement, but it raises serious equitable arguments against the spouse’s contention that the agreement should not apply to him or her.
UNIT FIVE – The ESOP Option

I. Overview

An ESOP is a qualified defined contribution plan that is either a stock bonus plan, or a combination stock bonus and money purchase plan, that invests primarily in employer securities, and is formally designated as an ESOP.

The ESOP enjoys a number of tax and financial advantages not enjoyed by other types of buyout alternatives, including the following:

- Under Section 1042 of the Internal Revenue Code, if the ESOP acquires 30% or more of the outstanding stock of a privately-held company, any capital gains tax on the transaction is deferred indefinitely, provided that the seller reinvests the proceeds in “qualified replacement property” within 12 months of the date of sale.
- Unlike a sale or merger, the ESOP enables the seller to sell any portion of his or her stock. A sale or merger usually requires the seller to sell 100% control.
- The ESOP enables the company to repay principal with tax-deductible dollars.
- Dividends paid on stock held by an ESOP are fully tax-deductible, provided that such dividends are either passed through to participants or are used to make principal or interest payments on an ESOP loan.
- In the case of an S corporation, the ESOP’s share of S corporation earnings is not subject to federal or state* corporate taxation or to taxation as “unrelated business income tax,” unless the ESOP runs afoul of certain “anti-abuse” provisions. Thus, in the case of an S corporation that is 100% owned by its ESOP, the company’s earnings will be entirely tax-exempt.
- An ESOP enables an owner to keep control until he is ready to fully retire. When the owner does retire, the ESOP enables the owner to pass control to his key employees.
- An ESOP enables an owner to provide for business continuity for the business that he has grown and nurtured over many years. Unlike a sale or merger, an ESOP enables a company to retain its separate identity rather than become a branch or division of a larger company.
- An ESOP enables a company to attract, retain and motivate key employees.
- Studies have shown that ESOP-owned companies become more productive and profitable than comparable firms in the same industry that are not ESOP-owned.
- An ESOP can be used to enable a company to make acquisitions of other companies with tax-deductible dollars. In addition, by using an ESOP the sellers can receive their proceeds tax-free under the provisions of Section 1042 of the Code.

ESOPs serve a variety of corporate objectives in addition to the primary objective of providing employees with a retirement benefit. ESOPs also serve as a technique of corporate finance. In particular, ESOPs can serve the following corporate finance objectives:
- Borrowing at reduced after-tax cost;
- Refinancing existing debt;
- Solving ownership succession issues;
- Eliminating federal income tax at both corporate and shareholder levels;
- Estate planning and charitable giving;
- Facilitating an acquisition or divestiture; or
- Providing employees with incentives for productivity.

An ESOP may also be used to refinance existing corporate debt and to repay it with pre-tax dollars, thereby lowering the borrowing cost. Under this structure, the sponsoring company would refinance its existing debt by issuing new shares of stock to the ESOP equal in value to the amount of debt assumed by the ESOP. This effectively makes the repayment of debt tax deductible (within the limits of §404(a)(9)).

If stock of a closely held corporation is sold to an ESOP under circumstances where the sale would otherwise qualify as a long-term capital gain, the selling shareholder pays no tax at the time of sale on all or part of the realized gain, provided that certain requirements are satisfied.

II. General Benefit Plan Requirements

ESOPs must satisfy several statutory requirements. An ESOP normally must:

1. Be a defined contribution plan, which is a stock bonus plan or a combination stock bonus and money purchase pension plan, in accordance with §4975(e)(7);
2. Meet the requirements of §401(a);
3. Be designed to invest primarily in employer securities, as defined in §409(l);
4. Meet the requirements of §409(e) (providing participants with certain voting rights) and §409(h) (providing participants the right to demand that benefits be distributed in the form of employer securities and to require the employer to repurchase them if they are not readily tradable on an established securities market);
5. Meet the requirements of §409(o) (establishing benefit distribution requirements);
6. Meet the non-allocation requirements of §409(n) and (p), restricting allocations to participants in certain situations; and
7. Satisfy certain miscellaneous requirements of §4975(e)(7) and the Treasury Department regulations thereunder.

III. Specific ESOP Requirements

A. Designed to Invest Primarily in Qualifying Employer Securities —

The most fundamental definition of an ESOP at §4975(e)(7) is that it is a qualified stock bonus (or combination stock bonus and money purchase plan) that is “designed to invest primarily in qualifying
employer securities." However, the phrase "designed to invest primarily" has not been interpreted by the IRS or the courts. The phrase implies that an ESOP must be intended to permit the plan trustees to invest or hold the major portion of the plan's assets in employer securities, without requiring that such investment be in place at all times during the life of the plan. Otherwise, the language would have read "must be invested primarily." Absent a more restrictive IRS or judicial interpretation, this phrase apparently denotes a qualitative standard relating to the ESOP's purpose as an employee benefit plan, and no "bright-line" quantitative test applies.

DOL Advisory Opinion 83-6A does not establish a fixed, quantitative standard for the "primarily invested" requirement but, instead, emphasizes that the applicable requirements are flexible and varied according to surrounding facts and circumstances. The facts in the opinion involved a simple majority of trust assets invested in employer stock, which DOL held to be satisfactory under the circumstances presented. As the DOL opinion states, "[n]either ERISA nor the applicable regulations promulgated thereunder contain maximum or minimum percentages of plan assets which must be invested in employer securities over the life of an ESOP in order to satisfy the 'primarily' requirement of §407(d)(6) of ERISA."

B. Qualifying Employer Securities —

"Qualifying employer securities" are employer securities within the meaning of §409(l). Section 409(l) defines "employer securities" as common stock issued by the employer which is readily tradable on an established securities market. Under Notice 2011-19, which may be relied on for periods after March 14, 2011, and generally is effective for plan years beginning on or after January 1, 2012, for purposes of §409(l), a security is readily tradable on an established securities market if: (1) it is traded on a national securities exchange that is registered under §6 of the Securities Exchange Act of 1934, 15 U.S.C. §78f; or (2) it is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and is deemed by the Securities and Exchange Commission (SEC) to have a ready market under SEC Rule 15c3-1, 17 C.F.R. §240.15c3-1. If such common stock does not exist, "employer securities" generally means common stock issued by the employer having a combination of voting power and dividend rights equal to or exceeding that class of common stock of the employer having the greatest voting power and the class of common stock having the greatest dividend rights. "Employer securities" also include non-callable preferred stock if such stock is convertible at any time into the qualified common stock described above, at a conversion price which (as of the date of acquisition by the ESOP) is reasonable. The use of the term "non-callable" in the statute is misleading because §409(l) stock can in fact be callable — so long as the holder has a reasonable opportunity to convert the preferred stock into common stock after the call.

C. Voting Rights

In general, if the employer has a class of securities required to be registered under §12 of the Securities Exchange Act of 1934 (the "Exchange Act") or a class of securities that would be required to be so registered except for the exemption from registration provided by §12(g)(2)(H) of the Exchange Act, then the ESOP must permit each participant to direct the voting of the securities of the employer allocated to his account. Apparently, this requirement applies to the voting rights of all securities of the employer (not just
employer securities within the meaning of §409(l)) allocated to a participant's account, even if they are not part of the class of securities that must be registered under the Exchange Act.

D. Distribution Requirements —

An ESOP must provide that a participant may elect (with the consent of the participant's spouse, if the plan is subject to the requirements of §§401(a)(11) and 417) that distribution of his/her vested account balance will begin not later than one year after the end of plan year during which he/she terminates employment because of retirement on or after the plan’s normal retirement age, disability, or death or, if he/she resigns or is dismissed, not later than one year after the end of the fifth plan year following the plan year during which he/she terminates employment (unless the employer reemploys him/her before such distribution). An ESOP must further provide that, unless the participant elects otherwise, his/her account balance must be distributed in substantially equal periodic payments (not less frequently than annually) over a period not exceeding five years. However, if a participant has an account balance exceeding $800,000, the distribution may take place over a period not exceeding five years plus one year (not exceeding five additional years) for each $160,000 (or fraction thereof) by which a participant's account balance exceeds $800,000. The $800,000 and $160,000 limits are adjusted at the same time and manner as the defined benefit and defined contribution plan dollar limits under §415. Subject to these requirements, an ESOP may modify its distribution options in a nondiscriminatory manner without violating the anti-cutback rule of §411(d)(6).

E. Right to Demand Employer Securities; Put Option

An ESOP must provide that a participant may elect (with the consent of the participant's spouse, if the plan is subject to the requirements of §§401(a)(11) and 417) that distribution of his/her vested account balance will begin not later than one year after the end of plan year during which he/she terminates employment because of retirement on or after the plan’s normal retirement age, disability, or death or, if he/she resigns or is dismissed, not later than one year after the end of the fifth plan year following the plan year during which he/she terminates employment (unless the employer reemploys him/her before such distribution). An ESOP must further provide that, unless the participant elects otherwise, his/her account balance must be distributed in substantially equal periodic payments (not less frequently than annually) over a period not exceeding five years. However, if a participant has an account balance exceeding $800,000, the distribution may take place over a period not exceeding five years plus one year (not exceeding five additional years) for each $160,000 (or fraction thereof) by which a participant's account balance exceeds $800,000. The $800,000 and $160,000 limits are adjusted at the same time and manner as the defined benefit and defined contribution plan dollar limits under §415. Subject to these requirements, an ESOP may modify its distribution options in a nondiscriminatory manner without violating the anti-cutback rule of §411(d)(6).

F. Allocation of Shares Acquired with Loan Proceeds —

Employer securities acquired by the plan are to be allocated in accordance with the standards generally applicable to other types of qualified defined contribution plans, unless the securities are acquired with the proceeds of an exempt loan. Securities that are acquired with the proceeds of an exempt loan are
placed in a suspense account. As the principal and interest of the exempt loan is repaid, a pro rata amount of securities must be released from the suspense account and allocated to the accounts of participants for such year in accordance with a schedule that is at least as rapid as one of two schedules in the regulations: the principal-and-interest method or the principal-only method. Under the principal-and-interest method, the number of shares released is the total number of shares in the suspense account multiplied by a fraction. The numerator of the fraction is the principal and interest paid during the year, and the denominator of the fraction is the sum of the numerator plus the total remaining principal and interest to be paid over the life of the loan (assuming, in the case of a variable interest rate, that the rate in effect at the end of the year remains in effect for the duration of the loan). The principal-only method is similar, except that interest is excluded from both the numerator and the denominator of the fraction. However, the principal-only method, which produces a slower rate of release, may be used only in a case in which the loan provides for annual repayments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments of such amounts over a period of 10 years.

G. Other Regulatory Requirements —

The plan must be formally designated as an employee stock ownership plan in the plan document. The plan terms must also formally provide participants with certain protections and rights with respect to plan assets acquired with the proceeds of an exempt loan. Principally, these protections relate to the "put option" requirement discussed above, and to a requirement that no security acquired with the proceeds of an exempt loan may be subject to a put, call, or other option, or other buy-sell or similar arrangement while held by, and when distributed from, the plan, regardless of whether the plan is then an ESOP. This rule, however, contains exceptions for the put options that ESOPs must grant to distributees and for rights of first refusal that ESOPs may elect to grant in favor of the employer and/or the ESOP.

The ESOP's terms must also formally provide that these protections and rights are non-terminable. Thus, if a plan holds or has distributed securities acquired with the proceeds of an exempt loan and either the loan is repaid or the plan ceases to be an ESOP, these protections and rights must continue to exist under the plan's terms. However, the protections and rights will not fail to be non-terminable merely because they are not exercisable under regulatory and statutory requirements. For example, if, after a plan ceases to be an ESOP, securities acquired with the proceeds of an exempt loan cease to be publicly traded, the normal put option periods include the time when the securities are publicly traded.

IV. The ESOP Loan Exemption

ERISA §406(a)(1)(B) and Code §4975(c)(1)(B) include as a prohibited transaction any "direct or indirect… lending of money or other extension of credit between a plan and a party in interest" (or disqualified person). Without an exemption, this provision would prohibit any debt financing for the acquisition of employer stock by an ESOP where a party in interest extends credit through a direct loan, a loan guarantee, or an installment sale.112

The ERISA Conference Committee Report states that "a prohibited transaction generally will occur if a loan to a plan is guaranteed by a party-in-interest [disqualified person], unless it comes within the special exemption for employee stock ownership plans." H.R. Rep. No. 1280, 93d Cong., 2d Sess. 308
However, ERISA §408(b)(3) and Code §4975(d)(3) provide an exemption from the prohibited transaction rules. This exemption permits an ESOP (but not any other eligible individual account plan) to borrow money using a direct loan, loan guarantee, or installment sale from a party in interest to effect its acquisition of employer stock. This exemption distinguishes an ESOP from other plans which invest in employer stock and characterizes an ESOP as a technique of corporate finance.

V. Tax-Deferred Rollover Treatment on Sales to ESOPs

Provided that an ESOP owns 30% or more of company stock and the company is a C corporation, owners of a private firm selling to an ESOP can defer taxation on their gains by reinvesting in securities of other companies. Section 1042 generally provides that no gain will be recognized by a taxpayer on certain sales of stock to an ESOP if the seller reinvests an amount equal to the proceeds of the sale in other specified types of “qualified replacement property.” Because the seller’s basis in the stock sold to the ESOP will carry over to the qualified replacement property, this is actually a deferral of tax, not a forgiveness of tax.

To constitute qualified replacement property, the securities must be issued by a domestic operating corporation (e.g., one whose assets are used in the active conduct of a trade or business) other than the corporation that issued the stock involved in the §1042 transaction or any of its parent-subsidiary controlled group members. Stock of a “brother-sister” corporation that is in the same controlled group merely because it is owned by a majority owner of the corporation sponsoring the ESOP should qualify.

The replacement period is a 15-month period beginning three months before the date of the sale of qualified securities and ending 12 months thereafter.

VI. Deduction of Employer Dividend Payments

A C corporation may deduct dividends paid on employer securities held by an ESOP maintained by the corporation or a controlled group member, provided that the dividends paid are either: (1) paid in cash directly or through the ESOP-to-ESOP participants or their beneficiaries; (2) reinvested in employer securities, if participants have been given the election to receive the dividends in cash; or (3) used to repay an ESOP loan. However, the IRS has the authority to disallow a dividend deduction that constitutes an avoidance or evasion of taxation.

VII. S Corporation ESOPs

S corporations can have ESOPs as well. Earnings attributable to the ESOP’s ownership share in S corporations are not taxable. Section 1361 permits qualified plan trusts and §501(c)(3) organizations to be S corporation shareholders. As a result, ESOPs may be S corporation shareholders. However, the following tax benefits applicable to ESOP sponsors will not apply to an S corporation: (1) the special contribution deduction rules under §404(a)(9);339 (2) the deduction of dividends paid on employer securities held in an ESOP; and (3) the rules on the rollover of gain on the sale of stock to an ESOP under §1042.341
UNIT FIVE - Transferring the Business at Death

I. When is it Better to Keep the Business in the Estate - Retaining the Closely Held Stock

A. Relative Tax Considerations

In approaching any valuation problem, the estate planner must analyze both the potential overall estate tax impact and the related income tax implications. A higher value for estate tax purposes could generate an increased federal estate tax liability. A higher estate tax value may enable, however, an estate to satisfy the percentage qualification tests for §303 stock redemption treatment and the deferred tax payment options.

A higher estate tax value would cause a higher income tax basis for the property, since the property passing through an estate will have a tax basis equal to the fair market value of that property as of the date of death (or as of the alternate valuation date). The increase in income tax basis would correspondingly decrease capital gain on a later sale of that property. A higher estate tax value may be preferable, consequently, where the unified credit will eliminate any estate tax liability. If the unlimited marital deduction is also used so that estate taxes on all asset transfers are deferred, incentives will exist to establish the highest value which can be reasonably supported. The approach of asserting a higher value would only be useful when the value is protected from estate tax, since a subsequent capital gains tax (at the rates specified in §1(h)) will be less than any estate tax assessed at a higher rate.

B. Alternate Valuation Date

Section 2032(c) provides that the alternate valuation date election may be made only if the election will decrease both the value of the gross estate and the amount of the tax. Before the amendments to §2032 made by the Deficit Reduction Act of 1984, P.L. 98-369, §1023, and the Tax Reform Act of 1986 (1986 TRA), P.L. 99-514, §1432, the alternative valuation date might have been elected (if, as of the date of death, the value of the gross estate exceeded a specified minimum amount), so as to achieve a higher income tax basis.

II. Essential Estate Planning

A. The Business as an Asset of the Estate

1. Trustee’s Power to Operate the Business

VI. Business Powers.

With respect to any interest I may have at my death in any closely-held business whether as partner, stockholder or otherwise and any business with which such closely-held business may merge or consolidate, I give my Executor the authority to deal with any business interest as freely as I could have done during my lifetime. This authority shall be subject to any Agreement binding upon my estate which affects such interest. Without limiting the general authority granted under this Paragraph, I give my Executor the following specific authority:
A. To do anything my Executor considers advisable with respect to the incorporation, operation or liquidation of any such business and with respect to any change in its purpose, nature or structure, including but not limited to the following:

1. To enter into partnership agreements and amendments thereto.

2. To organize a corporation, without leave of court, to carry on any business alone or with others, and to contribute all or part of the assets of such business as capital to such corporation and to accept stock in the corporation in exchange therefor.

3. To vote the shares of any closely-held corporate stock and to determine the advisability of, fix the terms of, and participate in, any corporate reorganization, merger, consolidation, dissolution, public offering, pooling of interest, exchange of stock or similar transaction.

B. To elect or employ as director, officer, employee or agent of any such business, any person, including my Executor and to delegate authority to, compensate and remove or discharge any such person.

C. To create or cause to be created within any such business such deferred compensation or other employee benefit plan as my Executor considers advisable.

D. To extend to any employee of any such business an option to participate in the ownership thereof, or profits therefrom, upon such terms and conditions as my Executor considers advisable.

E. To cause to be made and to consent to the making or the continuation of any loans to such business, and to pledge assets of such business as collateral therefor, with any bank or other financial institution.

F. The fact that my Executor may be an officer, director or employee of any such business and may own an interest in such business in an individual capacity shall not, insofar as my estate is concerned, constitute an adverse or conflicting interest, and the acts of my Executor as such shall be considered as if my Executor owned no stock and did not serve as an officer, director or employee of said business.

G. I release my Executor from any liability for any depreciation in value or loss by reason of the retention of any such business interest except for depreciation or loss resulting from fraudulent acts of my Executor in connection therewith.

IX. Administrative Powers.

In addition to the powers conferred on the Trustee under Pa.C.S. Sec. 7780.5, which shall include all of the illustrative powers provided in Pa. C.S. Sec. 7780.6, the Trustee shall have the following powers until all property is distributed:
A. To retain any real or personal property (including stock of any corporate Trustee or of a company controlling it) in the form in which it is received.

X. Business Powers.

In addition to any powers conferred on the Trustee under Pa.C.S. Sec. 7780.6(a)(29), I grant to the Trustee the following powers.

A. With respect to any interest I may have at my death in any closely-held business whether as partner, stockholder or otherwise and any business with which such closely-held business may merge or consolidate, I give my Trustee the authority to deal with any business interest as freely as I could have done during my lifetime. This authority shall be subject to any Agreement binding upon this Trust which affects such interest.

B. To do anything my Trustee considers advisable with respect to the incorporation, operation or liquidation of any such business and with respect to any change in its purpose, nature or structure, including but not limited to the following:

1. To enter into partnership agreements and amendments thereto.

2. To organize a corporation, without leave of court, to carry on any business alone or with others, and to contribute all or part of the assets of such business as capital to such corporation and to accept stock in the corporation in exchange therefore.

3. To vote the shares of any closely-held corporate stock and to determine the advisability of, fix the terms of, and participate in, any corporate reorganization, merger, consolidation, dissolution, public offering, pooling of interest, exchange of stock or similar transaction.

C. To elect or employ as director, officer, employee or agent of any such business, any person, including my Trustee, or any employee of a corporate Trustee, and to delegate authority to, compensate and remove or discharge any such person.

D. To create or cause to be created within any such business such deferred compensation or other employee benefit plan as my Trustee considers advisable.

E. To extend to any employee of any such business an option to participate in the ownership thereof, or profits therefrom, upon such terms and conditions as my Trustee considers advisable.

F. To cause to be made and to consent to the making or the continuation of any loans to such business, and to pledge assets of such business as collateral therefor, with any bank or other financial institution.

G. The fact that my Trustee may be an officer, director or employee of any such business and may own an interest in such business in an individual capacity shall not, insofar as this Trust is concerned, constitute an adverse or conflicting interest, and the acts of my Trustee as
such shall be considered as if my Trustee owned no stock and did not serve as an officer, director or employee of said business.

H. I release my Trustee from any liability for any depreciation in value or loss by reason of the retention of any such business interest except for depreciation or loss resulting from fraudulent acts of my Trustee in connection therewith.

2. Preserving the S Election

a. General Eligibility Requirements

An S corporation is a corporation that satisfies all of the requirements of §1361 and makes a §1362(a) election. The corporation must be a domestic corporation and, as required by §1361(b)(1), may not: (1) have more than 100 shareholders; (2) have as a shareholder a person who is not an individual, an estate during the period of administration, a trust of a specified type, and (in taxable years beginning after 1997) an exempt organization of a specified type; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock.

These are the types eligible S corporation shareholders: (1) an individual, other than a nonresident alien; (2) an estate during the period of administration; (2) a qualified retirement plan trust described in §401(a) or a §501(c)(3) charity, in taxable years beginning after 1997; and (4) certain types of trusts.

b. An Estate During the Period of Administration

Where the decedent's stock in the S corporation is properly subject to the possession of the executor or administrator of his estate for purposes of administration, the estate is an eligible shareholder even if under state law legal title to the stock passes directly to the legatees under the decedent's will or to his legal heirs.

c. Trusts as S Corporation Shareholders: Generally

Only five types of trusts are eligible S corporation shareholders: (1) a voting trust; (2) a "grantor" trust (3) a qualified subchapter S trust ("QSST"); (4) a testamentary trust with respect to stock transferred to it pursuant to the terms of a will (a "will recipient trust") or (5) an electing small business trust ("ESBT").

(1) Voting Trust – The Regulations define a qualified voting trust that is a permitted S corporation shareholder as a trust that (a) delegates to one or more trustees the right to vote; (b) requires that all distributions with respect to the stock owned by the trust be paid to or on behalf of the beneficial owners; (c) requires title and possession of the stock to be transferred to the beneficial owners on the trust's termination; and (d) terminates on or before a specific date or event.

(2) Grantor Trust - A trust that is treated as wholly owned by one individual who is a U.S. citizen or resident, for purposes of taxing the person on the income of the trust, may be a shareholder of an S corporation. Therefore, the trust may be a shareholder if the person includes
all the trust's items in determining his taxable income and credits. The deemed owner does not have to be the grantor. To be eligible, the trust must meet the above requirements only during the period it holds S corporation stock.

(3) **QSST - A Qualified Subchapter S Trust** is a trust: (a) that distributes (or is required to distribute) all of its income currently to one individual who is a U.S. citizen or resident, (b) that requires that: (i) during the life of the current income beneficiary there will be only one income beneficiary of the trust, (ii) any corpus distributed during the term of the trust must be distributed to the current income beneficiary, (iii) the current income beneficiary's income interest terminates on the earlier of termination of the trust or the death of that income beneficiary, and (iv) upon trust termination during the life of the current income beneficiary all corpus and income must be distributed to that beneficiary.

(4) **A Will Recipient Trust** - A testamentary trust, i.e., a trust which receives stock under a will, is allowed to own S corporation stock during the two-year period beginning on the day the S corporation stock is transferred to it. In addition, a trust that receives stock under the terms of an “electing Code Sec. 645 qualified revocable trust” during the election period9 or is deemed to receive stock at the close of the election period is allowed to own S corporation stock during the two-year period beginning on the day the S corporation stock is transferred or deemed to be distributed. If the trust continues to hold the stock after the two-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(5) **ESBT** - (1) The trust must not have any beneficiaries other than individuals, estates, or charitable organizations described in Code Sec. 170(c)(2), (2) no interest in the trust may have been acquired by purchase; (3) an election to be an ESBT must apply to the trust., (4) A qualified Subchapter S trust (“QSST”) election must not have been made with respect to any stock held by the trust. (5) The trust must not be a tax-exempt trust,

d. Trust Provisions

XII. Special Provisions for S Stock.

A. The Trustee may at any time hold stock of an S Corporation as defined in the Internal Revenue Code (hereinafter "S Stock"), make an election to have any corporation treated as an S Corporation, enter into agreements with other shareholders relating to transfers of S Stock or the management of the S Corporation, and allocate amounts received and the tax on undistributed income between income and principal.

B. The Trustee may allocate the tax deductions and credits arising from ownership of S Stock between income and principal. In making any such allocations, the Trustee shall consider that the income beneficiary is to have enjoyment of the property at least equal to that ordinarily

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9 For purposes of the election to treat a qualified revocable trust (QRT) as part of a decedent's estate, the “election period” is the period of time during which an electing trust is treated and taxed as part of its related estate. The election period begins on the date of death of the decedent and terminates on the earlier of (i) the day on which both the electing trust and related estate, if any, have distributed all their assets, or (ii) the day before the applicable date.
associated with an income interest and in all events shall provide the required beneficial enjoyment to the income beneficiary.

C. The Trustee may make an election to have the Trust, or any trust share provided hereunder that is eligible to make an affirmative election to be treated as Electing Small Business Trust as defined in Sec. 1361(e)(1) of the Code.

D. Notwithstanding anything herein to the contrary, as an alternative to subparagraph C, above, the Trustee may at any time divide any trust hereunder which has a single income beneficiary into two separate trusts, one trust consisting of all S Stock and the other trust consisting of the remaining assets.

1. Each such trust shall be held under the terms hereunder applicable to the trust so divided, except that (i) there shall be no power in the trust consisting of S Stock to make payments of principal during the lifetime of the income beneficiary to any person other than the person then entitled to receive the income, (ii) all income of the trust consisting of S Stock shall be paid to the income beneficiary at least annually and (iii) all income of such trust accrued or undistributed at the death of the income beneficiary shall be payable to his or her estate.

2. The trust consisting of S Stock shall at all times have only one current beneficiary and shall not be recombined with the other trust upon the exchange of any S Stock for other assets, but shall at all times after its creation permit payments of principal only to the then-current income beneficiary.

E. Any provision of this Agreement which may appear to conflict with my intention that any trust containing S Stock qualify as a Qualified Subchapter S Trust as defined in Sec. 1361(d) of the Internal Revenue Code shall be construed so as to accomplish that intention.

F. If the Trustee, in the Trustee’s sole discretion, determines that such intention might not be accomplished, the Trustee shall have the power to amend the trust to accomplish said intention, subject to the following conditions and limitations:

1. No such amendment shall be made except to accomplish the intentions set forth in this subparagraph F.

2. All such amendments shall be in the form of a decree of the court having jurisdiction over the trust, upon petition by the Trustee and after such notice to the parties in interest as such court may direct.

3. The Trustee shall have the power to request that any such amendment take effect as of the effective date of this trust, or any subsequent date, in the Trustee’s sole discretion.

B. Business Power of Attorney

“SPECIAL POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that I, RICHARD A. SMITH, (referred to as the “Principal”) of Chester County, Pennsylvania do hereby appoint my wife, KATHLEEN M. SMITH (referred to hereinafter as “my Agent”), my true and lawful Agent for me and my behalf to perform all such acts as my Agent in my Agent’s absolute discretion may
I. SPRINGING POWER.

This power of attorney shall only become effective upon my “incapacity”. My incapacity shall be deemed to exist as of the date of a certificate executed by two (2) licensed physicians, one of whom is my personal physician, such certificate to state that I am physically or mentally incapable of managing my financial affairs. The physicians’ certificate shall be attached to the original power of attorney or filed of record if the power of attorney has been filed of record, if permitted by applicable law. Upon any attempt by my Agent to obtain such a certificate determining my incapacity from two (2) physicians, notice shall be served upon me of such actions taken by my Agent.

I will be deemed to have regained capacity by a certificate executed by two (2) licensed physicians and delivered to my agent, which certificate states that I am physically and mentally capable of managing my financial affairs. The physicians’ certificate shall be attached to the original power of attorney or filed of record if the power of attorney has been filed of record, if permitted by applicable law.

Upon my regaining capacity, this power of attorney shall not be revoked but shall become effective again upon my subsequent disability or incapacity proved by physicians’ certificate as set forth above.

All acts done by my Agent pursuant to this power during any period of my disability or incapacity shall have the same effect and inure to the benefit of and bind me and my successors in interest as if I were competent and not disabled.

II. SUPPLEMENTAL NATURE.

This special power of attorney is intended to supplement any existing Durable General Power of Attorney executed by me and to further authorize my agent named therein to specifically exercise the powers granted herein. Nothing in this power of attorney shall operate as, or be deemed to be, a revocation of such existing power of attorney, and shall in no way limit the powers of my Agent acting thereunder.

III. SPECIFIC POWERS INCLUDED.

My Agent shall have the following specific powers:

A. To continue the operation of any business belonging to me, or in which I have an interest, to the extent that I could otherwise do so, whether such business is conducted as a proprietorship, partnership, corporation, limited liability company, or in any other form. It is my intention that my Agent shall have the broadest powers in dealing with any such business and therefore my Agent is hereby empowered from time to time, without leave of court, in her discretion:

1. To direct, control, supervise, manage and operate any business.

2. To sell or liquidate any business, at such time and on such terms as my agent deems advisable and in my best interest;

3. To incorporate any business at such time and on such terms as my agent deems advisable and in my best interest.

4. To handle all matters pertaining to any loan to any business, including loans which I signed as guarantor, including executing non-recourse mortgages on real property, guaranteeing construction mortgages, guaranteeing the non-recourse obligations of mortgages, or providing any other legal rights to a lender for any purpose.

5. To discharge and to perform any duty or liability and to exercise any right, power, privilege or option which any business has, or claims to have, under any partnership agreement, whether as a general or limited partner thereunder, limited liability company operating agreement, or shareholder’s agreement, to enforce the terms of any such agreement by action, proceeding or otherwise, as my Agent shall think to be desirable or necessary, and to
defend, submit to arbitration, settle or compromise any action or other legal proceeding to which a business is a party because of membership in said entity;

6. To continue, modify, renegotiate, extend, and terminate any contractual arrangement made by a business with any person, firm, association, or corporation whatsoever

7. To determine the policy of each business as to the location of the site or sites to be utilized for its operation, as to the nature and extent of the business to be undertaken by it, as to methods of financing, accounting, and advertising to be employed in its operation, as to the amount and types of insurance to be carried, as to the mode of securing, compensating and dealing with accountants, attorneys, servants, and other agents and employees required for its operation, to agree and to contract, in any manner, and with any person and on any terms, which my Agent deems desirable or necessary to effectuate any or all of her decisions as to policy, and to perform, rescind, reform, release, or modify any such agreement or contract made by or on behalf of a business;

8. To change the name or form of organization under which an entity’s businesses are operated and to enter into such partnership agreement with other persons or to organize such corporation to take over the operation of such business, or any part thereof, as my Agent shall think to be desirable or necessary;

9. To demand and receive all moneys which are, or may become due to a business in the operation of such enterprise, and to control and disburse such funds in the operation of such enterprise in any way which my Agent shall think to be desirable or necessary, and to engage in all banking transactions which my Agent shall deem to be desirable or necessary to effectuate the execution of any power described in this instrument;

10. To prepare, sign, file and deliver all reports, compilations of information, returns or other papers with respect to any business operating transaction of a business, which are required by any governmental agency, department or instrumentality or which my Agent shall deem desirable or necessary for any purpose, and to make all payments with respect thereto;

11. To pay, compromise or contest taxes or assessments and to do all act or acts which my Agent shall think to be desirable or necessary to protect a business from illegal or unnecessary taxation, fines, penalties, or assessments in connection with the business operations, including the power to attempt to recover, in any manner permitted by law, sums paid before or after the date of this instrument as taxes, fines, penalties, or assessments;

12. To demand, receive, obtain by action, proceeding or otherwise, any money, or other thing of value to which a business is, or may become, or may claim to be entitled as the proceeds of any business operation, to conserve, invest, disburse, or utilize anything so received for purposes enumerated in this instrument, and to reimburse my Agent for all expenditures properly made by him in the execution of the powers conferred upon him by this instrument;

13. To execute, acknowledge, seal and deliver any deed, assignment, mortgage, lease, notice, consent, agreement, authorization, check, or other instrument on behalf of a business which my Agent may think useful for the accomplishment of any purpose enumerated in this instrument;

14. To prosecute, defend, submit to arbitration, settle and propose or accept a compromise with respect to, any claim existing in favor of, or against, a business on or involving any business operating transaction or to intervene in any action or proceeding relating thereto;

15. To hire, discharge, and compensate any attorney, accountant, expert witness, manager, agent, partner, employee, or other assistant for a business whenever my Agent shall deem such action to be desirable to properly execute any power herein described, and to keep needed records thereof;

16. To carry out any agreements a business may have entered into with respect to the purchase, sale or alienation of said businesses or their assets, including shares of stock or other securities of same;

17. To delegate authority to any director, shareholder, manager, agent, partner or employee of a business, and to approve payment from the business of adequate compensation to any such person;
18. To sell or exchange any part or asset of a business, or all of such interest, at such time or times, at public or private sale, for such price or prices, and upon such terms as to cash or credit, with or without security for the purchase price, to such persons as my Agent, in her discretion, may deem best;

19. To cause a business to borrow money from any person or institution, upon such terms as my Agent shall, in her sole discretion, deem advisable, and, in connection therewith, to pledge the assets thereof, regardless of any rule of law with respect to conflict of interest;

20. To enter into agreements with other partners or shareholders of a business respecting the purchase, sale and alienation of any interest therein or securities thereof, held by my Agent hereunder;

21. In general, and in addition to all of the specific acts herein enumerated, to do and perform all other acts and things which I could do through an agent, in connection with a business, which my Agent shall deem to be desirable or necessary.

B. To handle my ownership interest in any business belonging to me, whether such business is conducted as a proprietorship, partnership, corporation, limited liability company, or in any other form. It is my intention that my Agent shall have the broadest powers in dealing with any such business interest and therefore my Agent is hereby empowered from time to time, without leave of court, in her discretion:

1. To represent me at shareholders, members, and partnership meetings and voting proxies;

2. To sell or liquidate any business, or interest therein, at such time and on such terms as my agent deems advisable and in my best interest;

3. To discharge and to perform any duty or liability and to exercise any right, power, privilege or option which I have, or claim to have, under any partnership agreement, whether as a general or limited partner thereunder, limited liability company operating agreement, or shareholder’s agreement, to enforce the terms of any such agreement by action, proceeding or otherwise, as my Agent shall think to be desirable or necessary and in my best interest, and to defend, submit to arbitration, settle or compromise any action or other legal proceeding to which I am a party because of membership in said entity;

4. To demand and receive all moneys which are, or may become due to me, or which may be claimed by me or on my behalf, in the operation of any enterprise, and to control and disburse such funds in the operation of such enterprise in any way which my Agent shall think to be desirable or necessary, and to engage in all banking transactions which my Agent shall deem to be desirable or necessary to effectuate the execution of any power described in this instrument;

5. To demand, receive, obtain by action, proceeding or otherwise, any money, or other thing of value to which I am, or may become, or may claim to be entitled as the proceeds of any business operation, to conserve, invest, disburse, or utilize anything so received for purposes enumerated in this instrument, and to reimburse my Agent for all expenditures properly made by him in the execution of the powers conferred upon him by this instrument;

6. To carry out any agreements I may have entered into with respect to the purchase, sale or alienation of any businesses, including shares of stock or other securities of same;

7. To sell or exchange any part or asset of any business, or all of such interest, at such time or times, at public or private sale, for such price or prices, and upon such terms as to cash or credit, with or without security for the purchase price, to such persons as my Agent, in her discretion, may deem best;

8. To enter into agreements with other partners or shareholders of any business I have an interest in respecting the purchase, sale and alienation of any interest therein or securities thereof, held by my Agent hereunder;

9. In general, and in addition to all of the specific acts herein enumerated, to do and perform all other acts and things which I could do through an agent, in connection with any business interest I hold, which my Agent shall deem to be desirable or necessary.
IV. GENERAL PROVISIONS.

A. My agent shall have the right to seek court orders mandating appropriate acts if a third party refuses to comply with actions taken by my agent which are authorized by this document, or enjoining acts by third parties which my agent has not authorized. In addition, my agent may bring legal action against any third party who fails to comply with actions I have authorized my agent to take and demand damages, including punitive damages, on my behalf for such noncompliance.

B. This power shall not expire by reason of lapse of time.

C. I hereby ratify and confirm all that my Agent shall do or cause to be done under this Special Power of Attorney. I specifically direct that my Agent shall not be subject to any liability by reason of any of my Agent's decisions, acts or failures to act, all of which shall be conclusive and binding upon me, my personal representatives, heirs and assigns. Furthermore, except in the case of malfeasance of office, I agree to indemnify my Agent, and hold my Agent harmless, from all claims that may be made against my Agent as a result of my Agent's service hereunder and I hereby agree to reimburse my Agent in the amount of any damages, costs and expenses that may be incurred as a result of any such claim.

D. I recognize that the agents I have named may be in a conflict of interest position either because of a business or professional relationship they have with me. I waive any right I may have to object to their acting notwithstanding the conflict, because I believe they will act in my best interests.

E. This power of attorney shall be revoked by my giving to my Agent written notification of the revocation, which notice shall not be considered binding unless actually received.

F. Questions pertaining to the validity, construction and powers created under this instrument shall be determined in accordance with the laws of the Commonwealth of Pennsylvania.

This power of attorney is executed in three (3) counterparts, of which this is counterpart No._____.

IN WITNESS WHEREOF, and intending to be legally bound, I have hereunto set my hand and seal this __________________, 2014.

___________________________________
RICHARD A. SMITH

Signed, sealed and delivered
in the presence of:

___________________________________

III. Post-Mortem Recapitalizations

The management of a corporation may consider a recapitalization in order to shift control from a surviving spouse or other inactive beneficiaries of the estate of a deceased shareholder to shareholders operating the business. A recapitalization may also be a suitable solution when the decedent's surviving spouse, a primary beneficiary of the decedent's estate, needs a source of fixed income, but the corporation is unable or unwilling to purchase the spouse's stock outright. In both situations, the corporation could create a second class of stock, either nonvoting common or nonvoting preferred stock, paying fixed annual dividends, which would be distributed to the spouse in exchange for the spouse's voting common stock. Such a recapitalization would provide the spouse with a fixed income and assure the surviving shareholders that they would be able to operate the corporation without interference from the spouse. If the
corporation wished to be in a position to eliminate the spouse’s interest when it was financially able to do so, the corporation could make the new stock callable

IV. Dealing with Liquidity Issues

A. The Irrevocable Insurance Trust

The irrevocable insurance trust or “ILIT” can prove a valuable estate planning tool and a source of funding for estate taxes and other costs of s dying. If properly structured, the ILIT can effectively remove life insurance form an insured’s taxable estate with very little or no gift tax consequence.

If an individual dies owning the incidents of ownership on a life insurance policy, the face value of the policy is fully includable in their federal gross estate. As an alternative to naming one or more individuals or the insured’s estate as the beneficiary of the life insurance policy, consideration should be given to having the policy owned by an irrevocable life insurance trust. An individual who already owns a life insurance policy may transfer that policy to an inter vivos trust or, if an individual has not already acquired a policy, he or she could create a trust and have the trustee acquire one or more policies on his or her life.

Under either scenario, the life insurance policy will be the property of the trust. The trust will be both the owner of the life insurance policy and the beneficiary of the proceeds, and therefore it will not be taxed as part of the insured estate. In the case of an existing policy, this does require that the transferor survives for three years after the transfer. From a gift tax point of view, the transfer of the policy is generally a taxable gift, but its value is based on the cash surrender value of the policy and not is face value. The trust instrument then designates the intended beneficiaries of the policy and the nature and extent of their interests in the proceeds. This allows the insured to control the use and enjoyment of the funds through the trust.

B. Estate Tax Deferral – Sec 6166

1. Overview.

Section 6166 provides for an extension of time for the payment of estate tax where an estate consists of a specified percentage of one or more interests in a closely held business. The payment of estate tax can be deferred for as long as 14 years from the date the estate tax return is due to be filed if the benefits of Section 6166 are elected in a timely manner by the taxpayer and the IRS approves the election.

2. Requirements of Section 6166.

If the gross estate of a U.S. citizen or resident includes an interest in a closely held business valued at more than 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not more than 10) equal installments. 26 U.S.C. §6166(a)(1). The "adjusted gross estate" is the value of the decedent's gross estate reduced by deductions allowable under §2053 and §2054 of the Internal Revenue Code. Interests in two or more "closely held business" may be combined and treated as a single business interest for the
purposes of the 35% test if at least 20% of the total value of each business is included in the
decedent's gross estate. Section 6166(c).

In general, such an estate may defer that portion of the estate tax, as reduced by the
credits against the estate tax, in proportion that the amount of the interest in the closely held
business bears to the adjusted gross estate. The first installment payment of estate tax may be
made on or before a date selected by the executor; however, the date selected cannot be more
than 5 years after the due date for the payment of estate tax. Each succeeding installment
payment must be made on or before the next anniversary of the initial payment date selected by
the executor. The deferred estate tax can always be prepaid without penalty at any time before it is
due. However, if an election is made for a period that is less than the maximum allowable deferral
period, a longer period cannot be elected after the election has passed. The estate's payment of
the first required installment five years after the decedent's death is allocated proportionately in the
following order: (1) first to the required installments of deferred tax; (2) next to the interest on the
deferred tax; and (3) finally to any unpaid balance of deferred tax. An election under Section 6166
must be made no later than the date prescribed by §6075(a) for filing the estate tax return,
including extensions.

If an election was made under Section 6166(a) to pay estate tax in installments and a
deficiency is later assessed, under Section 6166(e) that part of the deficiency attributable to the
closely held business interest qualifying for Section 6166 deferral is payable pro rata with the
installments of the estate tax that has not then been paid on the respective due dates of such
installments. Section 6166(e) only applies if the deficiency is not due to negligence, intentional
disregard of rules and regulations, or fraud with intent to evade tax.

Section 6166(g) sets forth the rules for determining when an estate forfeits the right to
continue to defer the payment of estate tax under Section 6166. There are four situations that can
accelerate the deferred obligation of an estate to pay estate taxes. These situations are: (1) a
disposition of the business interest or a withdrawal of funds from the business; (2) a distribution
of insufficient income by the estate; (3) a default in the payment of installment amounts or interest;
and (4) a violation of a lien condition under Section 6324A. Section 6166(g).

If an executor did not previously make an election under Section 6166, but the estate
qualifies under Section 6166 after a deficiency in the estate tax is assessed, the executor may
elect to pay the deficiency in installments under Section 6166(h)(1). Section 6166(h) only applies if
the deficiency is not due to negligence, intentional disregard of rules and regulations, or fraud with
intent to evade tax. This election must be made no later than sixty days (60) after a notice and
demand for payment of the deficiency has been issued.

3. The "Closely Held Business" Requirement Under Section 6166(b)(1)

Under Section 6166(b)(1), "closely held business" is defined as (i) an interest in a trade or
business carried on as a sole proprietorship; (ii) an interest in a partnership carrying on a trade or
business if either the partnership has 45 or fewer partners or 20% or more of the total capital
interest in the partnership is included in the decedent's gross estate; or (iii) an interest in a corporation carrying on a trade or business if either the corporation has 45 or fewer shareholders or 20% or more in value is included in the decedent's gross estate. Section 6166(b)(1). The business interest does not have to be included in the probate assets to qualify for Section 6166.

4. The "Trade or Business" Requirement Under Section 6166(b)(1)

As stated above, the definition of "closely held business" includes a requirement that the partnership, corporation or sole proprietorship carry on a "trade or business." Section 6166(b)(1). There is no definition of "trade or business" in Section 6166. However, "passive investments", as defined under Section 6166(b)(9)(B), will not qualify as a business. Here, Section 6166 is interpreted to mean that for an interest in a business to qualify as interest in a closely held business, the decedent must conduct an active trade or business, or must hold an interest in a partnership, limited liability company, or corporation that itself carries on an active trade or business. To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the IRS will consider all the facts and circumstances, including the activities of agents and employees, the activities of the management companies or other third parties, and the decedent's ownership interest in any management company or other third party.

In Revenue Ruling 2006-34 ("Rev. Rul. 2006-34"), the IRS stated that it will consider the following non exclusive factors in determining whether the decedent's interest in real estate was an active trade or business immediately before his death: (1) the amount of time devoted to the trade or business; (2) whether an office was maintained during regular business hours; (3) involvement in finding new tenants and negotiating leases; (4) the provision of landscaping, grounds care, and other services; (5) involvement in repairs and maintenance; and (6) handling tenant repair requests and complaints. The IRS indicated that, in evaluating these factors, it would look to the involvement of the decedent, as well as that of the employees and agents of the decedent and any management company. Rev. Rul. 2006-34. No single factor is dispositive of whether a decedent's activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166.Rev. Rul. 2006-34.

Rev. Rul. 2006-34 also contains five hypothetical situations that are used to illustrate the use of the guidelines. In Situation 2, the IRS determined that the decedent was not carrying on an active trade or business with respect to a small office park, because all services to the tenants were provided by a management company in which the decedent had no ownership interest. In the other four situations, the IRS concluded that the decedent had been carrying on an active trade or business, because the services to tenants were provided by the decedent or by the employees and agents of entities in which he had a 20% or greater ownership interest. Rev. Rul. 2006-34.

No single factor is dispositive of whether a decedent's activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166.
5. **Making the Section 6166 Election**

In order to make a Section 6166 election, the individual preparing the estate tax return may check "Yes" on line 3 of Part 3 of IRS Form 706. Attached to the timely filed Form 706 must be a notice of election containing the following information: (1) the decedent's name and taxpayer identification number as each appears on the Estate Tax Return; (2) the amount of the estate tax to be paid in installments; (3) the date selected for the payment of the first installment; (4) the number of annual installments, including the first installment, in which tax is to be paid; (5) the property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and (6) the facts that serve as the basis for executor's conclusion that the estate qualifies for payment of the estate tax in installments.

An election under Section 6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions. In many estates consisting of closely held business interests, an executor will not know if the IRS will accept the valuations originally set forth in an estate tax return. These returns typically have a high probability of audit because such estates consist of substantial interests in one or more closely held businesses. Any adjustment by the IRS in the value originally reported on an estate tax return could affect the ability of an estate to qualify for Section 6166 deferral. Thus, if the IRS increases the value of a closely held business interest it will increase the likelihood that the interest will qualify under the 35% of adjusted gross estate limitation previously discussed. On the other hand, if the IRS includes assets in an estate not included by the executor, such as a transfer with certain retained interests (under Sections 2036-2038), it could decrease the likelihood that the closely held business interest will meet the threshold 35% limitation. Similarly, an adjustment in the value of another asset in an estate, such as an interest in a limited partnership consisting of marketable securities and cash, could also decrease the likelihood that a closely held business interest will meet the threshold 35% limitation. Therefore, an executor may make a protective election to defer estate tax payments under Section 6166 if the values originally reported on an estate tax return do not qualify under the threshold 35% limitation or the estate tax return as originally filed shows that no tax is due.

The IRS decides in examination whether an election meets the requirements of Section 6166. An executor will be notified of a determination only if an election is not accepted by the IRS. If the election is rejected, the executor may request consideration by the Appeals Office. The appellate determination will be regarded as the IRS's final decision.

While the election is under consideration in examination of Appeals, an executor may request that the case be referred to the National Office for technical advice, either because a lack of uniformity exists as to the disposition of the issue or the issue is so unusual or complex as to warrant review by the National Office.

C. **Other Means of Deferral**

1. IRC. Sec. 6161
The IRS can exercise discretion in permitting the deferral of estate tax liabilities in circumstances that do not qualify for postponement under the elective provisions described above. The IRS can extend the time for paying the tax for a “reasonable period” not to exceed 12 months. The effect of a 12-month extension is to make the tax due 21 months after death. Upon the expiration of the extension period, the estate may apply for another extension. The IRS can grant an extension of the time to pay estate taxes for up to 10 years if “reasonable cause” exists.

Reasonable cause might exist, for example, because estate assets cannot produce sufficient present cash to pay estate tax liabilities and a significant economic loss would be inflicted on the estate if these assets were required to be sold at distress prices. The assets might be located in several different jurisdictions and not be otherwise immediately subject to the control of the executor. Alternatively, a claim to substantial assets might not be collectible without litigation, thereby postponing liquidity in the estate and the availability of cash for estate tax payments. The Service will want to examine all the relevant facts and circumstances to verify that reasonable cause does exist for a payment extension.

2. Reversions and Remainders

An extension of the time for the payment of estate tax attributable to inclusion of the value of a reversionary or remainder interest in property is available. The right to elect this tax payment extension is limited to reversionary and remainder interests. It does not apply, for example, to any post-mortem installment payments of deferred compensation (although the same policy considerations would seem to be pertinent).

At the election of the executor, the estate tax payment can be postponed until six months after the precedent interest in property is terminated. The postponement is limited to the estate tax attributable to the interest in the property. A further deferral is permitted for no more than three years when the IRS finds "reasonable cause."
UNIT FIVE - Transferring the Business at Death - Administrative Issues

I. The Business as an Asset of the Estate

A. Rights and Duties of the Personal Representative

1. The Duties of the Personal Representative

The representative of the estate, whether called an executor, administrator, personal representative, or other title, is a fiduciary to the estate and its beneficiaries. The representative must comply with the various duties imposed on a fiduciary, including, among others: the duty of care and prudence; the duty of loyalty; the duty not to delegate; the duty to collect the assets of the estate; the duty not to commingle assets of the estate with the representative's own or others; and the duty to maintain accurate records.

2. The Personal Representatives Liability

The representative may be held personally liable if his or her actions harm the estate and are a breach of his or her fiduciary duties to the estate. He or she is also liable for any acts of fraud or willful default or neglect with regard to his or her obligations. The representative is obligated to observe the standards of care applicable to trustees. In general, the representative must act as a prudent person would act when dealing with the property of another; if the representative is an expert or has special skills, he or she may be held to the higher standard of one with special skills or one who is an expert. If a personal representative's conduct fails to meet the appropriate standard, she is subject to surcharge. Surcharge is the penalty imposed against the fiduciary for failure to perform the representative's functions adequately, and is intended to compensate the beneficiaries for their resulting loss. Waste and mismanagement are grounds for the removal of a personal representative. However, there must be a clear showing to justify removal on either of these grounds.

3. Conflicting Fiduciary Duties
   a. Overview-

   The executor of an estate and the trustee of a trust both occupy a fiduciary in relation to the estate or trust as the case maybe. The majority shareholders of a corporation, as well as its officers and directors, also have a fiduciary duty to those holding minority interests.

   b. Executors and Trustees

   (1) An executor's duty is to take custody of the estate and to administer it so as to preserve and protect the property for distribution to the proper persons within a reasonable time. In the discharge of this duty, an executor "is regarded as a fiduciary and is held to the highest degree of good faith." He or she will be required to exercise the same degree of judgment, skill, care, and diligence that a reasonable or prudent person would ordinarily exercise in the management of his or her own affairs.
When a valid trust is created, the “trustee” holds legal title to the trust property, but manages that property for the sole benefit of the trust beneficiary or beneficiaries. In that capacity, the trustee stands in a “fiduciary relationship” to the trust property and the trust beneficiaries. Fundamental to that fiduciary relationship is under a duty to act for the benefit of the beneficiaries within the scope of the relationship; i.e., in performing its duties the trustee is held to a “fiduciary standard” of conduct. The fiduciary standard requires a duty of loyalty and a duty of prudence – that is the trustee must act for the sole benefit of the trust beneficiaries and in a prudent manner in administering the trust. The trustee must also exercise the same care and skill as a man of ordinary prudence would exercise in dealing with his own property, and act in a manner which makes the trust property productive.

Even though same person or entity is named as executor and as trustee, respective fiduciary capacities of executor and trustee are legally distinct.

c. Corporations

Ordinarily, the will of the majority of the stockholders should be the controlling factor in determining when the property of a solvent corporation is to be sold. For example, minority stockholders cannot prevent a sale of the corporate assets, even in the case of a solvent corporation, unless there is fraud or collusion. On the other hand, majority stockholders occupy a quasifiduciary relation toward the minority stockholders, and may not, as against minority stockholders, dissipate or waste the corporate funds, or fraudulently dispose of them in any way. So also, the majority stockholders of a solvent corporation cannot hold the corporate property from the market indefinitely when they do not intend to carry out the corporate business; yet the minority stockholders cannot insist on a sale of the corporate property when the fair value thereof cannot be obtained.

Officers and Directors

(a) Directors - A director of a domestic corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he or she may serve, in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

(b) Officers. — Except as otherwise provided in the articles, an officer shall perform his duties as an officer in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances. A person who so performs his duties shall not be liable by reason of having been an officer of the corporation.

d. Partnerships
Partners stand in a fiduciary relationship to each other, each being under a duty to act for the benefit of all.

e. **Limited Liability Companies**

Members acting as Managers of a limited liability company act in a fiduciary capacity.

B. **What is the Effect of Death of an Owner on the Legal Integrity of the Entity?**

1. **Corporations**

Generally, corporate existence may be perpetual or may be limited in time by provisions in the charter or articles of incorporation.¹⁰

2. **General Partnerships**

Although the death of a partner generally operates to dissolve a general partnership, it is not legally terminated until the winding up of the partnership affairs is completed. Unless otherwise agreed, it is the right and duty of a surviving partner to wind up the partnership affairs on the death of a copartner, and the surviving partner becomes the agent of the firm for the purpose of winding it up, with the right and duty to take possession of and control the partnership assets. The surviving partner, having the right to close up the partnership affairs, has the sole right to dispose of the partnership property in order to wind up the whole business of the partnership.

3. **Limited Partnerships**

15 Pa.C.S. § 8571 provides as follows:

“(a) General rule. — A limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:

(1) At the time or upon the happening of events specified in the certificate of limited partnership.

(2) At the time or upon the happening of events specified in writing in the partnership agreement.

(3) Written consent of all partners.

(4) An event of withdrawal of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so. The limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal if, within 180 days after the withdrawal, a majority in interest, or such greater number as shall be provided in writing in the partnership agreement, of the partners agree in writing to continue the business of the limited partnership or to the appointment of one or more replacement general partners.

¹⁰ 15 Pa.C.S. § 1306(a) (6)
(5) Entry of an order of judicial dissolution under section 8572 (relating to judicial dissolution).

(b) Interim management. — In the case of an event of withdrawal by a sole remaining general partner, the court may, upon application of a limited partner or his assignee, appoint a person to manage the business of the limited partnership subject to such terms as the court shall find are in the best interests of the partnership, until the earlier of:

(1) the expiration of the 180-day period specified in subsection (a)(4); or

(2) the appointment of one or more replacement general partners."

4. Limited Liability Companies

15 Pa.C.S. § 8971 provides the following:

“(a) General rule. — A limited liability company is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following events:

(1) At the time or upon the happening of events specified in the certificate of organization.

(2) At the time or upon the happening of events specified in writing in the operating agreement.

(3) Except as otherwise provided in the operating agreement, by the unanimous written agreement or consent of all members.

(4) Except as otherwise provided in writing in the operating agreement, upon a member becoming a bankrupt or executing an assignment for the benefit of creditors or the death, retirement, insanity, resignation, expulsion or dissolution of a member or the occurrence of any other event that terminates the continued membership of a member in the company unless the business of the company is continued by the vote or consent of a majority in interest, or such greater number as shall be provided in writing in the operating agreement, of the remaining members given within 180 days following such event.

(5) Entry of an order of judicial dissolution under section 8972 (relating to judicial dissolution).

(b) Perpetual existence. — The certificate of organization may provide that the company shall have perpetual existence, in which case subsection (a)(4) shall not be applicable to the company.”

C. The Right to Continue to Operate the Business

1. Personal Representative Power to Operate the Business

a. PEF Code § 3314. Continuation of business. [Effective January 1, 2017]

PEF Code § 3314 provides as follows:
“Giving due regard to the provisions of the governing instrument and any other factor that the court deems relevant, and aided by the report of a master if necessary, the court may authorize the personal representative to continue any business of the estate for the benefit of the estate. The order may be with or without notice.”

b. The Last Will and Testament.

The last will and testament may authorize the personal representative to continue a business with language such as the follows:

“The Last Will and Testament.

The last will and testament may authorize the personal representative to continue a business with language such as the follows:

“VII. Business Powers.

With respect to any interest I may have at my death in any closely-held business whether as partner, stockholder or otherwise and any business with which such closely-held business may merge or consolidate, I give my Executor and Trustee the authority to deal with any business interest as freely as I could have done during my lifetime. This authority shall be subject to any Agreement binding upon my estate which affects such interest. Without limiting the general authority granted under this Paragraph, and in addition to any powers conferred on the Trustee under Pa.C.S. Sec. 7780.6(a)(29), I give my Executor and Trustee the following specific authority:

A. To do anything my Executor or Trustee considers advisable with respect to the incorporation, operation or liquidation of any such business and with respect to any change in its purpose, nature or structure, including but not limited to the following:

1. To enter into partnership agreements and amendments thereto.

2. To organize a corporation, without leave of court, to carry on any business alone or with others, and to contribute all or part of the assets of such business as capital to such corporation and to accept stock in the corporation in exchange therefor.

3. To vote the shares of any closely-held corporate stock and to determine the advisability of, fix the terms of, and participate in, any corporate reorganization, merger, consolidation, dissolution, public offering, pooling of interest, exchange of stock or similar transaction.

B. To elect or employ as director, officer, employee or agent of any such business, any person, including my Executor or Trustee, and to delegate authority to, compensate and remove or discharge any such person.

C. To create or cause to be created within any such business such deferred compensation or other employee benefit plan as my Executor or Trustee considers advisable.

D. To extend to any employee of any such business an option to participate in the ownership thereof, or profits therefrom, upon such terms and conditions as my Executor or Trustee considers advisable.
E. To cause to be made and to consent to the making or the continuation of any loans to such business, and to pledge assets of such business as collateral therefor, with any bank or other financial institution.

F. The fact that my Executor and/or Trustee may be an officer, director or employee of any such business and may own an interest in such business in an individual capacity shall not, insofar as my trust or estate is concerned, constitute an adverse or conflicting interest, and the acts of my Executor and/or Trustee as such shall be considered as if my Executor and/or Trustee owned no stock and did not serve as an officer, director or employee of said business.

G. I release my Executor and Trustee from any liability for any depreciation in value or loss by reason of the retention of any such business interest except for depreciation or loss resulting from fraudulent acts of my Executor and/or Trustee in connection therewith.”

D. Testamentary Disposition of the Business Interest

1. Overview –
   a. The alternative forms of testamentary disposition of a business interest are as follows: (1) an outright gift; (2) a transfer in trust; (3) a sale to either a third party or an affiliate; or (4) fire sale of the assets and liquidation.
   b. Issues may include (1) right to transfer; (2) rights of the transferee; (3) rights of minority owner.

2. An Outright Testamentary Gift, and Transfers in General –
   a. Stock in a Business Corporation –
      (1) As a general rule stock in a business corporation is freely transferable, however 15 Pa.C.S.A § 1529(a)(b), provide the transfer of such stock may be regulated by any provisions of the bylaws the bylaws or by an agreement among any number of shareholders or among them and the corporation.
      (2) Except as otherwise provided in the articles, a business corporation may issue shares, option rights or securities having conversion or option rights, or obligations without first offering them to shareholders of any class or classes.11
      (3) Any restriction on the transfer of the shares of a business corporation for the purpose of maintaining its status as an electing small business corporation under Subchapter S of the Internal Revenue Code of 1986 or a comparable provision under state law shall be conclusively presumed to be for a reasonable purpose.12
      (4) Unless noted conspicuously on the security or in the notice provided by section 1528(f) or in an equivalent notice with respect to another uncertificated security, a

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11 15 Pa.C.S.A § 1530
12 15 Pa.C.S.A § 1529(d)
restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.  

b.  Partnership Interests

(1) The interest of a partner in the partnership is his share of the profits and surplus and that interest is personal property.

(2) Except as otherwise provided in the partnership agreement: (a) a partnership interest is assignable in whole or in part; (b) an assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner; (c) an assignment entitles the assignee to share in such profits and losses, to receive such distributions, and to receive such allocations of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and (d) a partner ceases to be a partner and to have the power to exercise any rights or powers of a partner upon assignment of all of his partnership interest.

(3) A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership nor, as against the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books. It merely entitles the assignee to receive, in accordance with his contract, the profits to which the assigning partner would otherwise be entitled.

c.  Membership Interests in a Limited Liability Company

(1) The interest of a member in a limited liability company constitutes the personal estate of the member and may be transferred or assigned as provided in writing in the operating agreement.

(2) Unless otherwise provided in writing in the operating agreement, if all of the other members of the company other than the member proposing to dispose of his interest do not approve of the proposed transfer or assignment by unanimous vote or written consent, which approval may be unreasonably withheld by any of the other members, the transferee of the interest of the member shall have no right to participate in the management of the business and affairs of the company or to become a member.

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13 15 Pa.C.S.A § 1529(f)
14 15 Pa.C.S.A § 8843
15 15 Pa.C.S.A § 8562
16 15 Pa.C.S. § 8344
(3) The transferee shall only be entitled to receive the distributions and the return of contributions to which that member would otherwise be entitled. 17

3. A Transfer in Trust -
   a. Trustee’s Power to Operate the Business -
      (1) PEF Code § 7780.5 - Powers of trustees.

PEF Code § 7780.5. provides as follows:

“(a) Exercise of power. — Except as otherwise provided in the trust instrument or in other provisions of this title, a trustee has all the powers over the trust property that an unmarried competent owner has over individually owned property and may exercise those powers without court approval from the time of creation of the trust until final distribution of the assets of the trust.

§ 7780.6. Illustrative powers of trustee

(a) Listing. — The powers which a trustee may exercise pursuant to section 7780.5 (relating to powers of trustees — UTC 815) include the following powers:

(29) To continue or participate in the operation of any business or other enterprise and to effect incorporation, merger, consolidation, dissolution or other change in the form of the organization of the business or enterprise.

(2) Trust Provisions

See section II.B.1.b., above.

(3) Preserving the S Election

(a) General Eligibility Requirements

An S corporation is a corporation that satisfies all of the requirements of §1361 and makes a §1362(a) election. The corporation must be a domestic corporation and, as required by §1361(b)(1), may not: (1) have more than 100 shareholders; (2) have as a shareholder a person who is not an individual, an estate during the period of administration, a trust of a specified type, and (in taxable years beginning after 1997) an exempt organization of a specified type; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock.

These are the types eligible S corporation shareholders: (1) an individual, other than a nonresident alien; (2) an estate during the period of administration; (2) a qualified retirement plan trust described in §401(a) or a §501(c)(3) charity, in taxable years beginning after 1997; and (4) certain types of trusts.

(b) An Estate during the Period of Administration

17 15 Pa.C.S. § 8924
Where the decedent's stock in the S corporation is properly subject to the possession of the executor or administrator of his or her estate for purposes of administration, the estate is an eligible shareholder even if under state law legal title to the stock passes directly to the legatees under the decedent's will or to his or her legal heirs.

(c) Trusts as S Corporation Shareholders: Generally

Only five types of trusts are eligible S corporation shareholders: (1) a voting trust; (2) a "grantor" trust (3) a qualified subchapter S trust ("QSST"); (4) a testamentary trust with respect to stock transferred to it pursuant to the terms of a will (a "will recipient trust") or (5) an electing small business trust ("ESBT").

(1) Voting Trust – The Regulations define a qualified voting trust that is a permitted S corporation shareholder as a trust that (a) delegates to one or more trustees the right to vote; (b) requires that all distributions with respect to the stock owned by the trust be paid to or on behalf of the beneficial owners; (c) requires title and possession of the stock to be transferred to the beneficial owners on the trust's termination; and (d) terminates on or before a specific date or event.

(2) Grantor Trust - A trust that is treated as wholly owned by one individual who is a U.S. citizen or resident, for purposes of taxing the person on the income of the trust, may be a shareholder of an S corporation. Therefore, the trust may be a shareholder if the person includes all the trust's items in determining his or her taxable income and credits. The deemed owner does not have to be the grantor. To be eligible, the trust must meet the above requirements only during the period it holds S corporation stock.

(3) QSST –

(a) A Qualified Subchapter S Trust is a trust: (a) that distributes (or is required to distribute) all of its income currently to one individual who is a U.S. citizen or resident, (b) that requires that: (i) during the life of the current income beneficiary there will be only one income beneficiary of the trust, (ii) any corpus distributed during the term of the trust must be distributed to the current income beneficiary, (iii) the current income beneficiary’s income interest terminates on the earlier of termination of the trust or the death of that income beneficiary, and (iv) upon trust termination during the life of the current income beneficiary all corpus and income must be distributed to that beneficiary.

(b) Trusts that Qualify as a QSST

(i) General Power of Appointment Marital Deduction Trust —

A marital trust employing a general power of appointment under §2056(b)(5) typically qualifies as a QSST, if, during the term of the trust, all the income is distributed at least annually to the spouse and the spouse's interest will terminate at death or on the trust’s termination resulting from depletion of its assets, if earlier.

(ii) QTIP Trust —
A testamentary qualified terminable interest property (QTIP) marital trust satisfies the QSST requirements. By definition, a QTIP trust requires that the surviving spouse (the only current income beneficiary) receive all the income at least annually for life and that no person have a power to appoint any part of the trust property to any person other than the spouse during the spouse's life. Furthermore, the spouse's income interest terminates on the spouse's death (or the termination of the trust in the event of depletion of the trust property). However, an inter vivos QTIP trust will generally be a permitted S corporation shareholder because it is a grantor trust, not because it is a QSST; the grantor will usually be treated as the owner of the trust under §677.

Two elections must be made for a QTIP trust to qualify as a QSST: one by the executor to qualify the trust for the marital deduction and another by the spouse beneficiary to qualify the trust as a QSST.\(^{18}\)

(iii) **Section 2503(c) Trust**

A §2503(c) trust for the benefit of a minor is designed to satisfy the present-interest requirement for the annual gift tax exclusion and, by definition, has only one income beneficiary. Only the income beneficiary qualifies for corpus distributions during his or her lifetime and, upon termination of the trust during the life of the beneficiary, the trust assets are to be distributed to the beneficiary. A §2503(c) trust permits, but does not necessarily require, accumulation of income. Thus, a §2503(c) trust qualifies as a QSST, provided the trustee distributes, or is required to distribute, the income at least annually to the beneficiary. The beneficiary could be given the right annually to elect to have the trustee retain all or a portion of the trust income without disqualifying the trust as a QSST.

(iv) **Charitable Remainder Trust**

In Rev. Rul. 92-48,\(^{723}\) the IRS concluded that a charitable remainder annuity trust or unitrust cannot qualify as a QSST and vice-versa. Consequently, assets other than S corporation stock must be used to fund charitable remainder trusts. The IRS based its ruling on the mutual exclusivity of the two systems of income taxation applicable to charitable remainder trusts and QSSTs. The QSST election causes the beneficiary of the trust to be treated as the owner of the portion of the trust consisting of S corporation stock under §678(a) and guarantees that the beneficiary is taxed on all the income earned by the trust relating to the stock. In contrast, the beneficiary of an income interest in a charitable remainder trust can be taxed only on the unitrust or annuity amount. A charitable

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\(^{18}\) The §2056 marital deduction may be disallowed with respect to any part of a marital trust that is funded with stock in a closely held business if the terms of the trust or any buy-sell agreement governing the stock either require the consent of an individual other than the surviving spouse for the transfer of the stock or give individuals other than the surviving spouse the right to purchase the stock for a price significantly below its fair market value. \(^{37}\) See Estate of Rinaldi v. United States, 38 Fed. Cl. 341 (Fed. Cl. 1997), aff'd, 178 F.3d 1308 (Fed. Cir. 1998) (unpublished decision; discussed in detail above at II.A.6.b(3)); TAM 9147065.
remainder trust treated as a QSST would, therefore, have two owners of S corporation stock: the income beneficiary and the trust.\textsuperscript{724}

Although §1361(b)(1)(B) permits certain exempt organizations to be S corporation shareholders, it only includes organizations described in §401(a) or §501(c)(3). Split-interest trusts are not included.

\textit{(v) Unified Credit “Sprinkle” Trust —}

A unified credit trust may qualify as a QSST if it has only one beneficiary and the trust satisfies all the other QSST requirements. The typical unified credit sprinkle trust permitting the trustee to distribute income to the surviving spouse and issue does not qualify as a QSST. However, the terms of such a trust can be modified by an agreement or disclaimers.

(4) \textit{A Will Recipient Trust} - A testamentary trust, i.e., a trust which receives stock under a will, is allowed to own S corporation stock during the two-year period beginning on the day the S corporation stock is transferred to it. In addition, a trust that receives stock under the terms of an "electing Code Sec. 645 qualified revocable trust" during the election period or is deemed to receive stock at the close of the election period is allowed to own S corporation stock during the two-year period beginning on the day the S corporation stock is transferred or deemed to be distributed. If the trust continues to hold the stock after the two-year period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(5) \textit{ESBT} - (1) The trust must not have any beneficiaries other than individuals, estates, or charitable organizations described in Code Sec. 170(c)(2), (2) no interest in the trust may have been acquired by purchase; (3) an election to be an ESBT must apply to the trust., (4) A qualified Subchapter S trust (QSST) election must not have been made with respect to any stock held by the trust.(5) The trust must not be a tax-exempt trust,

(d) \textit{Trust Provisions}

"XII. Special Provisions for S Stock.

A. The Trustee may at any time hold stock of an S Corporation as defined in the Internal Revenue Code (hereinafter "S Stock"), make an election to have any corporation treated as an S Corporation, enter into agreements with other shareholders relating to transfers of S Stock or the management of the S Corporation, and allocate amounts received and the tax on undistributed income between income and principal.

B. The Trustee may allocate the tax deductions and credits arising from ownership of S Stock between income and principal. In making any such allocations, the Trustee shall consider that the income beneficiary is to have enjoyment of the property at least equal to that ordinarily associated with an income interest and in all events shall provide the required beneficial enjoyment to the income beneficiary.
C. The Trustee may make an election to have the Trust, or any trust share provided hereunder that is eligible to make an affirmative election to be treated as Electing Small Business Trust as defined in Sec. 1361(e)(1) of the Code.

D. Notwithstanding anything herein to the contrary, as an alternative to subparagraph C, above, the Trustee may at any time divide any trust hereunder which has a single income beneficiary into two separate trusts, one trust consisting of all S Stock and the other trust consisting of the remaining assets.

   (1) Each such trust shall be held under the terms hereunder applicable to the trust so divided, except that (i) there shall be no power in the trust consisting of S Stock to make payments of principal during the lifetime of the income beneficiary to any person other than the person then entitled to receive the income, (ii) all income of the trust consisting of S Stock shall be paid to the income beneficiary at least annually and (iii) all income of such trust accrued or undistributed at the death of the income beneficiary shall be payable to his or her estate.

   (2) The trust consisting of S Stock shall at all times have only one current beneficiary and shall not be recombined with the other trust upon the exchange of any S Stock for other assets, but shall at all times after its creation permit payments of principal only to the then-current income beneficiary.

E. Any provision of this Agreement which may appear to conflict with my intention that any trust containing S Stock qualify as a Qualified Subchapter S Trust as defined in Sec. 1361(d) of the Internal Revenue Code shall be construed so as to accomplish that intention.

F. If the Trustee, in the Trustee’s sole discretion, determines that such intention might not be accomplished, the Trustee shall have the power to amend the trust to accomplish said intention, subject to the following conditions and limitations:

   (1) No such amendment shall be made except to accomplish the intentions set forth in this subparagraph F.

   (2) All such amendments shall be in the form of a decree of the court having jurisdiction over the trust, upon petition by the Trustee and after such notice to the parties in interest as such court may direct.

   (3) The Trustee shall have the power to request that any such amendment take effect as of the effective date of this trust, or any subsequent date, in the Trustee’s sole discretion.”

3. Sale and Liquidation
   a. Business Corporations

      (1) Approval of a Sale of Assets

         (a) The sale, lease, exchange or other disposition of all, or substantially all, the property and assets of a business corporation, when made in the usual and regular course of the business of the corporation, or for the purpose
of relocating all, or substantially all, of the business of the corporation, may be
made upon such terms and conditions, and for such consideration, as shall be
authorized by its board of directors.\(^{19}\)

(b) Except as otherwise restricted by the bylaws, authorization or
consent of the shareholders shall not be required for such a transaction.\(^{20}\)

(c) In sales of assets, dissenters’ rights are not provided for in
transactions that (i) are on terms requiring that the net proceeds of the sale be
distributed to the shareholders within one year, or (ii) are made in connection with
a dissolution or liquidation of the corporation.\(^{21}\)

(2) **Dissolution**

The shareholders or incorporators of a business corporation that has not
commenced business may affect the dissolution of the corporation by filing articles
of dissolution in the Department of State.\(^{22}\)

b. **Partnerships**

(1) **General Partnership**

(a) **Approval of a Sale of Assets**

(i) In general, every partner is an agent of the partnership for
the purpose of its business, and any act of a partner, including execution
of any instrument in the partnership name, that is apparently for the
transaction of partnership business in the usual manner generally binds
the partnership.\(^{23}\)

(ii) However, an act by a partner does not bind the
partnership if the partner has in fact no authority to act for the partnership
in the particular matter and if the person with whom the partner is dealing
knows that the partner has no authority to act.\(^{24}\)

(iii) Similarly, a partner’s act that is contrary to a restriction on
the partner’s authority does not bind the partnership to persons who have
knowledge of the restriction.\(^{25}\)

(iv) Title to real property acquired in the partnership name
can be conveyed only in the partnership name.\(^{26}\) If title to real property is

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\(^{20}\) Id.


properly recorded in the partnership name, that property may be conveyed by deed or another instrument of conveyance in the partnership name signed by any one authorized partner. 27

(v) Moreover, a partner’s act that is not apparently for transacting partnership business in the usual way does not bind the partnership unless the act is authorized by the other partners. 28

(b) **Dissolution**

Dissolution of a general partnership is caused:

(i) Without violation of the agreement between the partners: (i) by the termination of the definite term or particular undertaking specified in the agreement; (ii) by the express will of any partner when no definite term or particular undertaking is specified; (iii) by the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking; (iv) by the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners. 29

(ii) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time. 30

(2) **Limited Partnership**

(a) **Approval of a Sale of Assets**

Except as otherwise provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners. 31

(b) **Dissolution**

A limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following: (1) At the time or upon the happening of events specified in the certificate of limited partnership; (2) At the

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27 15 Pa. Cons. Stat. § 8322(a)
28 15 Pa. Cons. Stat. § 8321(b)
29 15 Pa. Cons. Stat. § 8353(1)
30 15 Pa. Cons. Stat. § 8353(1)
time or upon the happening of events specified in writing in the partnership agreement; (3) Written consent of all partners; (4) an event of withdrawal of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so. The limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal if, within 180 days after the withdrawal, a majority in interest, or such greater number as shall be provided in writing in the partnership agreement, of the partners agree in writing to continue the business of the limited partnership or to the appointment of one or more replacement general partners.\(^{32}\)

c. **Limited Liability Companies**

(1) **Approval of a Sale of Assets**

(a) *General rule.* — Except as provided in subsection (ii), management of the business and affairs of a limited liability company shall be vested in its members.\(^ {33}\)

(b) *Managers.* — The certificate of organization may provide that management of a company shall be vested, subject to limitations provided in the operating agreement, to the extent provided in the certificate of organization, in one or more managers.\(^ {34}\)

(2) **Dissolution** — See Sec.I.D.4. above.

II. **Post-Mortem Recapitalizations**

The management of a corporation may consider a recapitalization in order to shift control from a surviving spouse or other inactive beneficiaries of the estate of a deceased shareholder to shareholders operating the business. A recapitalization may also be a suitable solution when the decedent's surviving spouse, a primary beneficiary of the decedent's estate, needs a source of fixed income, but the corporation is unable or unwilling to purchase the spouse's stock outright. In both situations, the corporation could create a second class of stock, either nonvoting common or nonvoting preferred stock, paying fixed annual dividends, which would be distributed to the spouse in exchange for the spouse's voting common stock. Such a recapitalization would provide the spouse with a fixed income and assure the surviving shareholders that they would be able to operate the corporation without interference from the spouse. If the corporation wished to be in a position to eliminate the spouse's interest when it was financially able to do so, the corporation could make the new stock callable

III. **Dealing with Liquidity Issues**

A. **The Irrevocable Insurance Trust**

\(^{32}\) 15 Pa. Cons. Stat. § 8571

\(^{33}\) 15 Pa. Cons. Stat. § 8941(a)

\(^{34}\) 15 Pa. Cons. Stat. § 8941(a)
The irrevocable insurance trust or “ILIT” can prove a valuable estate planning tool and a source of funding for estate taxes and other costs of dying. If properly structured, the ILIT can effectively remove life insurance form an insured’s taxable estate with very little or no gift tax consequence.

If an individual dies owning the incidents of ownership on a life insurance policy, the face value of the policy is fully includable in their federal gross estate. As an alternative to naming one or more individuals or the insured's estate as the beneficiary of the life insurance policy, consideration should be given to having the policy owned by an irrevocable life insurance trust. An individual who already owns a life insurance policy may transfer that policy to an inter vivos trust or, if an individual has not already acquired a policy, he or she could create a trust and have the trustee acquire one or more policies on his or her life.

Under either scenario, the life insurance policy will be the property of the trust. The trust will be both the owner of the life insurance policy and the beneficiary of the proceeds, and therefore it will not be taxed as part of the insured estate. In the case of an existing policy, this does require that the transferor survives for three years after the transfer. From a gift tax point of view, the transfer of the policy is generally a taxable gift, but its value is based on the cash surrender value of the policy and not its face value. The trust instrument then designates the intended beneficiaries of the policy and the nature and extent of their interests in the proceeds. This allows the insured to control the use and enjoyment of the funds through the trust.

B. Estate Tax Deferral – Sec 6166

1. Overview.

Section 6166 provides for an extension of time for the payment of estate tax where an estate consists of a specified percentage of one or more interests in a closely held business. The payment of estate tax can be deferred for as long as 14 years from the date the estate tax return is due to be filed if the benefits of Section 6166 are elected in a timely manner by the taxpayer and the IRS approves the election.

2. Requirements of Section 6166.

If the gross estate of a U.S. citizen or resident includes an interest in a closely held business valued at more than 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not more than 10) equal installments. 26 U.S.C. §6166(a)(1). The "adjusted gross estate" is the value of the decedent's gross estate reduced by deductions allowable under §2053 and §2054 of the Internal Revenue Code. Interests in two or more "closely held business" may be combined and treated as a single business interest for the purposes of the 35% test if at least 20% of the total value of each business is included in the decedent's gross estate. Section 6166(c).

In general, such an estate may defer that portion of the estate tax, as reduced by the credits against the estate tax, in proportion that the amount of the interest in the closely held business bears to the adjusted gross estate. The first installment payment of estate tax may be made on or before a date selected by the executor; however, the date selected cannot be more
than 5 years after the due date for the payment of estate tax. Each succeeding installment payment must be made on or before the next anniversary of the initial payment date selected by the executor. The deferred estate tax can always be prepaid without penalty at any time before it is due. However, if an election is made for a period that is less than the maximum allowable deferral period, a longer period cannot be elected after the election has passed. The estate's payment of the first required installment five years after the decedent's death is allocated proportionately in the following order: (1) first to the required installments of deferred tax; (2) next to the interest on the deferred tax; and (3) finally to any unpaid balance of deferred tax. An election under Section 6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions.

If an election was made under Section 6166(a) to pay estate tax in installments and a deficiency is later assessed, under Section 6166(e) that part of the deficiency attributable to the closely held business interest qualifying for Section 6166 deferral is payable pro rata with the installments of the estate tax that has not then been paid on the respective due dates of such installments. Section 6166(e) only applies if the deficiency is not due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.

Section 6166(g) sets forth the rules for determining when an estate forfeits the right to continue to defer the payment of estate tax under Section 6166. There are four situations that can accelerate the deferred obligation of an estate to pay estate taxes. These situations are: (1) a disposition of the business interest or a withdrawal of funds from the business; (2) a distribution of insufficient income by the estate; (3) a default in the payment of installment amounts or interest; and (4) a violation of a lien condition under Section 6324A. Section 6166(g).

If an executor did not previously make an election under Section 6166, but the estate qualifies under Section 6166 after a deficiency in the estate tax is assessed, the executor may elect to pay the deficiency in installments under Section 6166(h)(1). Section 6166(h) only applies if the deficiency is not due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. This election must be made no later than sixty days (60) after a notice and demand for payment of the deficiency has been issued.

3. **The "Closely Held Business" Requirement Under Section 6166(b)(1)**

Under Section 6166(b)(1), "closely held business" is defined as (i) an interest in a trade or business carried on as a sole proprietorship; (ii) an interest in a partnership carrying on a trade or business if either the partnership has 45 or fewer partners or 20% or more of the total capital interest in the partnership is included in the decedent's gross estate; or (iii) an interest in a corporation carrying on a trade or business if either the corporation has 45 or fewer shareholders or 20% or more in value is included in the decedent's gross estate. Section 6166(b)(1). The business interest does not have to be included in the probate assets to qualify for Section 6166.

4. **The "Trade or Business" Requirement Under Section 6166(b)(1)**
As stated above, the definition of "closely held business" includes a requirement that the partnership, corporation or sole proprietorship carry on a "trade or business." Section 6166(b)(1). There is no definition of "trade or business" in Section 6166. However, "passive investments”, as defined under Section 6166(b)(9)(B), will not qualify as a business. Here, Section 6166 is interpreted to mean that for an interest in a business to qualify as interest in a closely held business, the decedent must conduct an active trade or business, or must hold an interest in a partnership, limited liability company, or corporation that itself carries on an active trade or business. To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the IRS will consider all the facts and circumstances, including the activities of agents and employees, the activities of the management companies or other third parties, and the decedent's ownership interest in any management company or other third party.

In Revenue Ruling 2006-34 ("Rev. Rul. 2006-34"), the IRS stated that it will consider the following non-exclusive factors in determining whether the decedent's interest in real estate was an active trade or business immediately before his death: (1) the amount of time devoted to the trade or business; (2) whether an office was maintained during regular business hours; (3) involvement in finding new tenants and negotiating leases; (4) the provision of landscaping, grounds care, and other services; (5) involvement in repairs and maintenance; and (6) handling tenant repair requests and complaints. The IRS indicated that, in evaluating these factors, it would look to the involvement of the decedent, as well as that of the employees and agents of the decedent and any management company. Rev. Rul. 2006-34. No single factor is dispositive of whether a decedent’s activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166. Rev. Rul. 2006-34.

Rev. Rul. 2006-34 also contains five hypothetical situations that are used to illustrate the use of the guidelines. In Situation 2, the IRS determined that the decedent was not carrying on an active trade or business with respect to a small office park, because all services to the tenants were provided by a management company in which the decedent had no ownership interest. In the other four situations, the IRS concluded that the decedent had been carrying on an active trade or business, because the services to tenants were provided by the decedent or by the employees and agents of entities in which he or she had a 20% or greater ownership interest. Rev. Rul. 2006-34.

No single factor is dispositive of whether a decedent’s activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166.

5. Making the Section 6166 Election

In order to make a Section 6166 election, the individual preparing the estate tax return may check "Yes" on line 3 of Part 3 of IRS Form 706. Attached to the timely filed Form 706 must be a notice of election containing the following information: (1) the decedent's name and taxpayer identification number as each appears on the Estate Tax Return; (2) the amount of the estate tax to be paid in installments; (3) the date selected for the payment of the first installment; (4) the number
of annual installments, including the first installment, in which tax is to be paid; (5) the property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and (6) the facts that serve as the basis for executor's conclusion that the estate qualifies for payment of the estate tax in installments.

An election under Section 6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions. In many estates consisting of closely held business interests, an executor will not know if the IRS will accept the valuations originally set forth in an estate tax return. These returns typically have a high probability of audit because such estates consist of substantial interests in one or more closely held businesses. Any adjustment by the IRS in the value originally reported on an estate tax return could affect the ability of an estate to qualify for Section 6166 deferral. Thus, if the IRS increases the value of a closely held business interest it will increase the likelihood that the interest will qualify under the 35% of adjusted gross estate limitation previously discussed. On the other hand, if the IRS includes assets in an estate not included by the executor, such as a transfer with certain retained interests (under Sections 2036-2038), it could decrease the likelihood that the closely held business interest will meet the threshold 35% limitation. Similarly, an adjustment in the value of another asset in an estate, such as an interest in a limited partnership consisting of marketable securities and cash, could also decrease the likelihood that a closely held business interest will meet the threshold 35% limitation. Therefore, an executor may make a protective election to defer estate tax payments under Section 6166 if the values originally reported on an estate tax return do not qualify under the threshold 35% limitation or the estate tax return as originally filed shows that no tax is due.

The IRS decides in examination whether an election meets the requirements of Section 6166. An executor will be notified of a determination only if an election is not accepted by the IRS. If the election is rejected, the executor may request consideration by the Appeals Office. The appellate determination will be regarded as the IRS's final decision.

While the election is under consideration in examination of Appeals, an executor may request that the case be referred to the National Office for technical advice, either because a lack of uniformity exists as to the disposition of the issue or the issue is so unusual or complex as to warrant review by the National Office.

C. Other Means of Deferral

1. IRC. Sec. 6161

The IRS can exercise discretion in permitting the deferral of estate tax liabilities in circumstances that do not qualify for postponement under the elective provisions described above. The IRS can extend the time for paying the tax for a "reasonable period" not to exceed 12 months. The effect of a 12-month extension is to make the tax due 21 months after death. Upon the expiration of the extension period, the estate may apply for another extension. The IRS can grant an extension of the time to pay estate taxes for up to 10 years if “reasonable cause” exists.
Reasonable cause might exist, for example, because estate assets cannot produce sufficient present cash to pay estate tax liabilities and a significant economic loss would be inflicted on the estate if these assets were required to be sold at distress prices. The assets might be located in several different jurisdictions and not be otherwise immediately subject to the control of the executor. Alternatively, a claim to substantial assets might not be collectible without litigation, thereby postponing liquidity in the estate and the availability of cash for estate tax payments. The Service will want to examine all the relevant facts and circumstances to verify that reasonable cause does exist for a payment extension.

2. **Reversions and Remainders**

An extension of the time for the payment of estate tax attributable to inclusion of the value of a reversionary or remainder interest in property is available. The right to elect this tax payment extension is limited to reversionary and remainder interests. It does not apply, for example, to any post-mortem installment payments of deferred compensation (although the same policy considerations would seem to be pertinent).

At the election of the executor, the estate tax payment can be postponed until six months after the precedent interest in property is terminated. The postponement is limited to the estate tax attributable to the interest in the property. A further deferral is permitted for no more than three years when the IRS finds "reasonable cause."
Estate Planning for S Corporations
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