Planning for Business Succession and Transition

Langdon T. Owen, Jr.
Cohne Kinghorn, pc
(801) 363-4300
lowen@cohnekinghorn.com

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Langdon T. Owen, Jr.
Cohne Kinghorn , pc
(801) 363-4300
lowen@cohnekinghorn.com

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In this outline, we will touch on the broad scope of the planning problem presented where a family member holds an interest in a family-dominated business or in a closely held business with nonfamily owners where the family is not dominant. Since we are all mortal, the business interest must eventually be transferred to a successor either within or outside the family. Also, at some time an owner, whether in a family dominated firm or in a firm involving substantial interests held by unrelated persons, may want to leave the business to pursue other opportunities or because there has been a substantial business disagreement. Each situation will present numerous problems and choices, and there will be many possible ways to deal with them.

As will become apparent, the area is so broad that we will necessarily need to limit the scope of the issues to be discussed in any detail. Thus, we will deal primarily with the issues which most commonly arise in this particular planning context where transactions are likely to be among business insiders, whether or not related, with some particular attention to buy-sell agreements executed among related and unrelated owners before anyone dies or leaves the business and also to arrangements which can be used at the time an owner dies or otherwise leaves or desires to leave the business. We will assume we all have a basic familiarity with general tax and estate planning concepts and techniques and with the various forms of business organization. Of necessity given the above focus, we will only lightly discuss third-party stock or partnership-taxed company interest sales, asset sales, and acquisitive mergers or reorganizations, and will ignore some important but less commonly-encountered issues and techniques.

A. **Overview**. In addition to tax savings, business succession and transition planning in a small family or closely held business context has two major focuses: liquidity and control. However, there may be numerous other problem areas which proper planning can help to solve. These areas may become problems either during the life of the owner of a business interest or at death, but at death the issues can become very stark. As we will see, a buy-sell agreement is extremely helpful, but it cannot, alone, accomplish everything; before putting together the agreement the planner should start with an analysis of the business' organizational documents and restructure them to the extent necessary, and to the extent possible or practical given the interests of third persons (owners, lenders, franchisors, etc.). Also, the planner should consider what other steps may be appropriate to solve the variety of problems which may be encountered. Let's review some of the typical problems and then look at some planning goals and methods and some issues relating to the planner.

(1) **Liquidity Problems**. The issue is how best to extract presently-usable value from the business for the benefit of the business interest owner and the owner's family, in order to pursue other uses of the funds during life or for use in paying taxes and administrative

expenses, and meeting other needs after death, and how quickly this can or should be accomplished and whether the business can survive the transition and prosper after it. There is generally no outside market for the business interest, particularly if it is a minority interest. An outside buyer may be interested only if it can buy the entire business. The owner may be unable to sell during lifetime and may also be unable to sell on death, when estate taxes could be payable. A minority owner may be locked into a situation where significant distributions may be impossible to force. To make matters worse, if a partnership, limited liability company, or corporation with an S-election is involved, the tax pass through feature of the organization may cause income taxation for the interest owner without the right to obtain the funds necessary to pay the taxes.

(2) **Control Problems**. There are also problems related to control. Can or should control be maintained in the family or with an inside group of unrelated owners? It may be important to include or exclude certain persons or classes of persons. The majority owner may be distracted on day-to-day matters or stymied on major matters, by disgruntled shareholders new to the business. The other owners may be forced to deal with the transferring or deceased person's family or with an outsider if the business interest is transferred outside the management group. A minority interest holder may lack an effective say in management and may be at the mercy of the other owners.

(3) **Family Problems**. Some of the most difficult problems of planning for business succession or transition arise from the dynamics of family relationships.

(a) Lack of Faith in Younger Generation. Members of the older generation may believe that the members of the younger generation, whether their own descendants or those of their business partners, are idiots or worse. They are sometimes right in this assessment; but right or wrong, where this belief exists, there will be a tendency for the older generation not to plan at all, or in planning, to resist ceding any significant control to the younger generation during the life of the older generation business interest owner. This tendency can prevent tax savings, for example, from gift programs or from structuring for valuation discounts (even if gifts are made) where the older generation retains excessive business controls. Further, this tendency can cause all the most significant changes to occur after death when the strong hand or wise counsel of the older generation owner will be missing, when family emotions will be running at peak intensity, and when family members inexperienced in the business suddenly need to make key decisions about the future. Moreover, where planning is undertaken, lack of faith in the younger generation will require serious consideration of an eventual sale or other transaction with nonfamily members, and will require the judicious selection of high quality fiduciaries to deal with the family situation and the business interest.

(b) Lack of Interest by Younger Generation. The members of the younger generation may have no desire to actively participate in the business. It may be too difficult for them to work with older generation members, or they may move away or embark on careers totally unrelated to the business. Planning in this situation is more likely to involve structuring for an eventual transaction with nonfamily members.

(c) Unequal Participation. Some family members may be very involved in the business while others are not. Where the older generation has sufficient assets not dedicated to the business, those involved in the business can receive the business interest while those not involved can receive something else of equal value. The bigger problem comes in the rather common situation where almost all the family assets are tied up in the business. Here the planning approach may include some combination of tactics such as obtaining life insurance to increase the available nonbusiness assets, using a buy-sell agreement to generate value for the nonparticipating family members while freeing the participating family members to pursue their business ideas unhindered by co-owners who may not share those ideas, or building into the business organization protections to balance the interests of the participating owners and of the nonparticipating owners, perhaps including, among other things, alternative dispute resolution mechanisms to help manage disputes and keep them private.

(d) Active Hostility. Where a family suffers from actual or potential active hostility among its members, planning, of course, becomes more difficult. The planner needs to be sensitive to potential hostilities because during the life of the business owner, such owner's personality or economic power may keep a tight lid on hostilities, but when that owner dies, the lid may come off with explosive force. This situation can arise in blended families on second marriages (children of first marriage against new spouse or new spouse's children) or in nonblended families (sibling against sibling, nephews and nieces against co-owner uncle or aunt, and so on). It may be disastrous to leave the business in such a way that the contending parties will need to deal with each other on a continuing basis. Thus, finding ways to divide assets to keep the parties away from each other can be important, and in order to do this the assets not tied up in the business may need to be increased (*e.g.*, with life insurance), premarital or post-marital agreements may be advisable, a buy-sell arrangement may be critical, and a business division or a sale or other transaction with a nonfamily member may need to be seriously considered. The choice of fiduciaries can make an enormous difference.

(e) Divorce. Divorce or the potential for divorce will frequently be of concern to the business owner, and just about always will be of concern to the business owner's fellow owners. Divorce can be extraordinarily disruptive. It can also be very hard to predict; today's happy couple may be tomorrow's bitter litigants. Premarital or postmarital agreements and buy-sell agreements are often used to help solve divorce related problems. Unrealistic pricing arrangements need not be given effect by a court in a divorce proceeding, so overly aggressive planning with these sorts of agreements can backfire on a business interest owner. Also, the business interest itself may be structured to become nonvoting in the event some of it falls into the hands of a disaffected spouse; limited liability company interests which on transfer become nonvoting assignee interests in future distributions only can be particularly helpful. Such agreements and structures can be critical and generally provide a broad solution but are not, and usually cannot be, very specific. Spouses can become quite offended at the thought of early divorce planning and the particular problems to be dealt with won't be known with any specificity. Thus, detailed planning for divorce almost always takes place at the time of the divorce. At the time of divorce there are things that can be done to reduce tax cost and enable some family goals to be met if the spouses can maintain their rationality. For example, transfers exempt from income tax under IRC § 1041 can be structured. (See Regs. § 1.1041-2 relating to redemptions of stock not resulting in a constructive distribution to the original stock owning spouse, and relating to those that do result in a constructive distribution. The original stock owning spouse may want to avoid a primary obligation to buy the interest of the other spouse. Spousal agreements meeting the requirements of the Regulations will be given effect.) Also, holding a business interest in an alimony trust under IRC § 682(a) may be useful (see PLR 92-35032).

(4) **Third-Party Problems**. There may be third persons to be considered as well.

(a) Business Associates. The business partners of the owner may not want to be in business with that owner's spouse or children. They may be very concerned with what may happen in the event of a divorce. Lenders, landlords, franchisors, or key suppliers or distributors for the business may be very happy with doing business with the current owners but be very concerned with the possibility of a shift in control to someone they do not know. Thus, there may be preexisting restrictive agreements among the business owners (such as forbidding transfers without the consent of, or without options in favor of, the other owners) or restrictive provisions in loan documents, franchise contracts, or other agreements (such as a right to call the loan or terminate the transaction) with which the planner will need to deal. Also, key employees may become uncomfortable and although they may not have restrictive contract provisions to help them, they can almost always vote with their feet and simply quit. Sometimes bonus or compensation vesting structures are needed to give key employees incentive to stick it out through a transition. Some businesses require governmental or regulatory licenses tied to individuals in order to operate; it may be necessary to obtain or retain another person with such a license where a business owner holding the license ceases to participate in the business. Clients and patients of professional practices may be concerned with the continuity of their matter or the confidentiality of their records and documents, and professional ethical rules will need to be met.

(b) Owner's Creditors. Also, if one business owner has or may come to have significant creditor problems, the other business owners will be greatly concerned with the effect on the business of a seizure of that owner's interest by a creditor or trustee in bankruptcy. They will, for example, be concerned whether the creditor or bankruptcy trustee can force a liquidation or otherwise get at the underlying business assets, or can exercise voting or management rights, or can force dividends or other distributions, or can force a redemption of the business interest, or can sell the business interest to someone with whom they would not want to do business, or can challenge a transfer as a fraudulent conveyance.

(5) **Typical Planning Goals**. Some of the key goals a business owner may want to achieve through planning can include: maintaining family control of the business, or keeping control in the hands of a management group (such as other owners) and away from the family of an owner; preventing outsiders from becoming owners, or positioning the business for a takeover or public offering without other owners being able to prevent it; maximizing value to a leaving or deceased owner, or preventing cash demands by a leaving or deceased owner which could damage the business; produce liquidity for a business interest internally by requiring a

buy-out by other owners on certain events, or avoiding the need to buy out the interest of other owners; retaining all the value of the business for family, or allowing key nonfamily managers to participate as owners in the business in order to retain them; minimize transfer tax value, or maximize flexibility for the owner or for the beneficiaries of the business interest; retain maximum control during life, or decentralize ownership or control for tax or business reasons; let family members or other owners work matters out themselves, or prevent internal disputes; fix a value for the interest which is easily determinable, or fix a value which will withstand transfer tax scrutiny; assure distributions and other benefits or protections for owners, or maximize flexibility for management or by majority owners; get family members involved and trained in the business, or keep them out of the business owner's way; maintain some income flow for a former owner, or remove them from further consideration.

Not all these goals will be involved in any given situation. Some are simply incompatible with others, and some will just be out of the question. In any event, choices will need to be made, and some of them will not be easy.

(6) **Transfer Options**. When planning for business succession, one thing at least is certain – a transfer will need to be made, at death if not before. As with any transfer, the concerns of third parties who are not directly involved may need to be considered, such as employees, lenders, franchisors, landlords, licensing and regulatory officials, and others important to the success of the enterprise. The transfers can be internal, to family members, or external, outside the family, or in some combination of internal or external.

(a) Internal. Transfers for family members can take the form of lifetime gifts of business interests, subject to greater or lesser levels of restriction, made directly or through various forms of trust with life interests, remainder interests, spendthrift restrictions, and so on. They can also be made at death by will or through trust. They may include redemptions by the business organization. They can include sales to other family members or to trusts (such as "defective" grantor trusts) or organizations for the benefit of or under the control of family members; the consideration may take such forms as cash, other property, installment notes, self-cancelling installment notes, or private annuities. All the tools in the estate planner's tool box may be available to be considered in appropriate circumstances.

(b) External. Similarly, transfers outside the family can take a variety of forms such as sales of interests or of assets to others in the industry, merger with, or acquisition of the business by, a public company, public offerings of securities, stock bonus or option plans for key managers with vested or nonvested, voting or nonvoting interests, Employee Stock Option Plans for employees (ESOPs are qualified defined contribution profit sharing retirement plans which are authorized to invest in employer securities), gifts to charity, directly or through lead or remainder trusts, and so on. Again, all the tools in the business lawyer's tool box may be available where appropriate.

(7) **Restructure Options**. In addition to transfers, internal restructuring of the business interests may be appropriate. Some common restructure methods include: classifying the stock or interests and the governing board to assure minority interests a seat on

the board, establishing voting trusts, creating a nonvoting class of stock or interests, creating a preferred class of stock or interests to be held, for example, by the older generation to freeze the value of its interests and allowing future appreciation to accrued to the younger generation (see IRC § 2701), changing the form of organization, separating into different organizations certain assets (for example, real estate or intellectual property) or certain lines of business (to facilitate a split-up, for example as a tax deferred reorganization under IRC §§ 355 and 368 (discussed in more detail below), or to limit risk), or adding to the organizational instruments provisions useful to, or eliminating from those instruments provisions detrimental to, the overall plan.

(8) **Company Issues**. On the death of an equity owner of a business organization, special issues can arise as to control exercised by the holder of the interest of the deceased or as to rights of the estate to have the interest bought out. Particularly for an estate struggling with insolvency and holding significant interests in closely held organizations, these issues can be critical. These matters are often dealt with in buy-sell agreements, partnership agreements, or operating agreements. Otherwise they are dealt with under applicable statutes. The following is a summary of what happens under Utah statutes absent an agreement. (Citations to the UCA below as to partnerships and LLCs are to the provisions effective January 1, 2014. Those provisions apply to these types of organizations formed on or after that date or formed earlier and electing to be governed by these provisions, and apply to all organizations of the affected type after 2015 regardless of when formed. Before those dates the rules for these types of organization were somewhat different.)

(a) Corporation. The stock of the corporation passes to the personal representative who can vote it.

(i) S-corp. If the corporation is an S-corporation (*i.e.*, with the small corporation election under IRC ' 1361), the decedent's estate can hold the S-corp stock for a reasonable period of administration without destroying the S-corp election. IRC ' 1361(b)(1)(B). A bankruptcy estate can also be a qualified stockholder. IRC ' 1361(c)(3). A will recipient trust (a testamentary trust) only qualifies as a shareholder for two years beginning on the day the stock is transferred to it from the estate. If longer term holding by a trust of the stock with the S-election continuing an election as a qualified subchapter S trust or QSST (IRC § 1361(d)) or as an electing small business trust or ESBT (IRC § 1361(e)), will be required.

(ii) Dissolution or Buy-out. There is generally no mandatory dissolution of the corporation or required buy-out of the deceased owner's stock. If however, the corporation is a professional corporation, a buyout of disqualified (non-licensed) shareholders is required at reasonable fair value. UCA ' 16-11-13.

(b) Partnership. Death of a partner dissociates that partner as a partner of a general partnership, including a limited liability partnership. UCA ' 48-1d-701(6)(a). This may under the partnership agreement lead to a dissolution and winding up, or the business may continue with a buy out of the deceased partner's interest and indemnity against all partnership liability under UCA ' 48-1d-801.

(i) Winding up. Death is generally not an event for a mandatory winding up under the statute (UCA ' 48-1d-901) except for a partnership for a definite term or particular undertaking, in which cases the express will of at least half the remaining partners will cause a winding up to occur. UCA ' 48-1d-901(2)(a). If there will be a winding up of the business, the remaining general partners may wind up the business or if there are none remaining, the legal representative of the last surviving partner may wind it up (UCA ' 48-1d-902).

(ii) Management. Other than where the representative of the last survivor is authorized to wind up the business, the deceased partner and the estate of the deceased partner (unless the estate is admitted as a partner) have no right to participate in management, whether winding-up occurs or not. UCA ' 48-1d-703(2)(a).

(iii) Buy out. Absent a winding up, the buyout of the deceased partner is at a price in the amount that would have been distributable if the partnership had been wound-up with its assets sold as of death (the date of disassociation) at the greater of liquidation or going concern value, with interest accruing from disassociation until payment. UCA ' 48-1d-801(2).

(c) Limited Partnership. There are significant differences in the effect of death which turn on whether the deceased was a general partner or was a limited partner.

(i) General Partner. Death dissociates a general partner. UCA ' 48-2e-603(6)(a).

(A) Effect on Partner's Interest. The interest of the deceased general partner no longer carries management rights. UCA ' 48-2e-605(1)(a). It is not a discharge of any obligation. UCA ' 48-2e-605(2). The interest becomes that of a mere transferee (UCA ' 48-2e-605(1)(d)), except that for the purposes of settling the estate it will have the rights of a limited partner to receive information. UCA ' 48-2e-704.

(B) Effect on Partnership. If there is at least one other general partner, the consent within 90 days of a majority of the partners (general or limited) with rights to receive distributions as partners will cause dissolution and winding-up. UCA ' 48-2e-801(1)(c)(i). If there are no other general partners, dissolution and winding up will occur unless within 90 days a majority of the rights to receive distributions as limited interests consent to continue and admit a general partner who consents to act effective as of the date the last general partner ceased to be a general partner. UCA ' 48-2e-801(1)(c) (ii).

(ii) Limited Partner. Death dissociates a limited partner. UCA ' 48-2e-601(2)(f).

(A) Effect on Partner's Interest. The interest of the deceased limited partner no longer carries a limited partner's rights. UCA ' 48-2e-602(1)(a). Of course, limited partners have no management rights to discontinue. UCA ' 48-2e-302. Dissociation is not a discharge of any obligation. UCA ' 48-2e-602(2). The interest becomes that of a mere transferee (UCA ' 48-2e-602(1)(c)), except that for the purposes of settling the estate it will have the rights of a limited partner to receive information (there may also be rights under the merger, conversion, or domestication provisions). UCA ' 48-2e-704.

(B) Effect on Partnership. On the death of the last limited partner, the partnership dissolves and winds up unless within 90 days the partnership admits a limited partner. UCA ' 48-2d-801(1)(d). This generally requires the consent of all partners, in this case general partners since there are no limited partners. UCA ' 48-2e-301. A contribution by the limited partner may not be required. See UCA ' 48-2e-102(2) and UCA ' 48-2e-301(3).

(iii) Winding Up. If there is a general partner, general partners control winding up. See UCA ' 48-2e-406(1). If there are none, a majority of the rights to receive distributions as limited interests may appoint a person to wind up the partnership. UCA ' 48-2e-802(3). If no one is appointed in a reasonable time any partner may request a court to make the appointment. UCA ' 48-2e-802(4)(a).

(iv) Buy out. There is no statutorily required buyout of a partner in a limited partnership.

(d) Limited Liability Company. Death dissociates a member. UCA ' 48-3a-602(7)(a).

(i) Winding Up. Dissociation, including by reason of death, does not require dissolution and winding up of the company unless it results in there being no members for a period of 90 consecutive days. UCA ' 48-3a-701(3). If the deceased was the last member, the legal representative can designate a person to become a member if such new member consents effective as of the date the last member ceased to be a member. UCA ' 48-3a-401(3)(d). No contribution or transferable interest as to distributions is required to be a member. UCA ' 48-3a-401(4). Any dissolution is controlled by the remaining members with management authority or the remaining managers of a manager managed company, but subject to consents of members as to dispositions outside the ordinary course. See UCA ' 48-3a-703; UCA ' 48-3a-407(5); UCA § 48-3a-407(2)(d); UCA ' 48-3a-407(3)(c) and (d). However, if there are no members, the legal representative of the last member may do the winding up. UCA ' 48-3a-703(3).

(ii) Management. Dissociation of a member by death terminates management rights both if the company is member managed (UCA ' 48-3a-603(1)) and if the member is also a manager of a manager managed company (UCA ' 48-3a-407(3)(e)). Termination of management rights does not in either event terminate any liability. UCA ' 48-3a-407(3)(f); UCA ' 48-3a-603(2). The member's interest becomes that of a mere transferee (UCA ' 48-3a-603(1)(c)) except for the right of the legal representative to information of a current

member for purposes of settling the estate (UCA ' 48-3a-504; UCA ' 48-3a-410). The information available to members is different for a company that is member managed and one that is manager managed.
UCA § 48-3a-410.

(iii) Buy-out. There is no general requirement to buy out a member's interest on death or other event. If however, the company is a professional services company under UCA ' 48-3a-1101, a buyout of a deceased member is required at reasonable fair market value at the time of death within 90 days of the company being notified of the death. UCA ' 48-3a-1111(2) and (3). If court action is needed, attorney's fees and costs can be awarded, and the court has authority to require liquidation of the company. UCA ' 48-3a-1111(4), (5), and (6).

(9) **The Planner**. Those who help the owners of closely held business interests plan for business succession need to have a wide range of knowledge and experience with respect to business, legal, and family matters and need to have access to others with expertise.

(a) Knowledge. They need to understand: how business is done by a number of industries in a competitive environment and how businesses are successfully managed, the likely interests and concerns of employees, lenders, landlords, franchisors, suppliers, distributors, government regulatory agencies, and other constituencies related to the business, the different forms of business organization and the choices available in structuring such organizations, when and how to use the great many estate planning techniques available, the different ways to value a business interest and the factors involved, the features of different kinds of real and personal property whether tangible or intangible, the types of transactions available to transfer businesses and business interests and why one type may be used instead of another, creditor rights and remedies, federal and state income, transfer, and other taxes, family dynamics and conflicts, how litigation and other dispute resolution processes work, and so on.

(b) Expertise of Others. The planner also needs to value the contributions of other knowledgeable professionals to the planning process and be able to work with them as a team. Such professionals may include the general counsel for the business or specialist counsel in particular areas, accountants, appraisers of tangible assets and of business interests, insurance professionals, trust officers, investment bankers and business brokers, business consultants, and, in some cases, psychologists and similar advisors. This sort of planning, even more than general estate planning, is multidisciplinary.

(c) Avoidance of Conflicts of Interest. Planners must be very careful to avoid improper conflicts of interest.

(i) Who Is the Client? The planning may involve a number of persons in the family, co-owners or key employees of the business outside the family, and the business organization itself. It is imperative that the planner's client be clearly identified. Furthermore, it will often be important, to clearly define who is not a client by means of some document which makes the point clear to those who are not represented. See, *e.g.*, *Margulies v. Upchurch*, 696 P.2d 1195 (Ut. 1985), and *Kilpatrick v. Wiley, Rein & Fielding*, 37 P.3d 1130 (Ut. 2001) (if a person has a reasonable expectation that he or she is represented as well, the attorney will owe duties to that person). The engagement letter is addressed to the client, so an exclusion in it as to a nonclient will not provide any notice to the nonclient. On the other hand, if the buy-sell agreement or some other instrument is signed by the nonclient and contains a disclosure about nonrepresentation, presumably the nonclient will have such notice that it should not be heard to later claim it was a represented party.

(ii) Conflict Rules . Although in some situations more than one person may be represented, it is often the case that present or potential conflicts will simply preclude multiple party representation under the ethical rules or as a matter of prudence on the part of the planner. If more than one person is represented, the appropriate disclosures need to be provided and consents obtained pursuant to applicable ethical rules.

(iii) Confidentiality. Also, when there is more than one client, confidentiality between them becomes an issue. This is an issue best dealt with up front because the rule generally is to maintain the confidence of each client, although the clients may well expect to share information. At the time a dispute arises, the attorney could well be caught in the middle unless there is a clear understanding. The easiest understanding to implement is probably one of complete disclosure among co-clients. This is generally workable with clients, such as a husband and wife in a long and stable marriage, with broad areas of common interest. This, however, may not work if the area of commonality between the clients is narrow and where the clients may want to maintain general confidentiality against each other. This may be the case between the owner of a business interest and the company or between that owner and the other owners, even those who are related.

(iv) Privilege. An attorney will also want to take into account appropriate ways in which the attorney-client privilege and the attorney work product doctrine may be preserved. At one extreme, the crime or fraud exception to the privilege must be avoided; however, in all situations, how the planning team participates in client meetings or communications must be considered.

B. **Buy-Sell Agreements**. After a careful review, and if appropriate, after or as a part of a restructure of the business's governing instruments, a buy-sell agreement should be considered for inclusion in those governing instruments or for execution as a separate instrument. A properly drafted buy-sell agreement can help solve illiquidity and generation or other control transition problems and related issues. The agreement can also provide for assurance of distributions, management control, and related goals. It may be important for the health of the business that the proper persons wind up with effective control, whether inside the family or inside the group of key nonfamily owners or managers. The issue of who among contending family members should end up in charge can create some awe-inspiring battles. A lack of adequate checks and balances to protect minority owners could destroy the best intentions of a business owner who seeks to benefit some family members with minority interests. Minority younger generation owners may have a short-term perspective and desire maximum amounts of immediate cash while the other owners or managers may have a longer term growth perspective requiring conserving and reinvesting cash. Some business owners may simply want a clear exit strategy. A buy-sell agreement can be a major part of an overall plan to help with all these issues.

The buy-sell agreement may be a cross-purchase agreement where the shareholders (or partners or members, if a partnership or limited liability company is involved) agree to buy each other out, or it may be a redemption agreement where the corporation or company agrees to purchase the shares or interests, or it may contain features of each. A number of approaches to buy-sell arrangements described below can apply, with or without some level of modification, to corporations or to companies taxable as partnerships (*e.g.*, general and limited partnerships and limited liability companies). Some important provisions to consider using include:

(1) **Transfer Restrictions**. The parties will probably want to restrict transfers except under certain agreed options, subject perhaps to exceptions for family gifts, family revocable trusts, or for pledges to banks. These exceptions for family transfers would not be made for a business where it is not desirable to have an owner's family involved in the business. Even where family transfers are allowed, the new interest holders should take their interests subject to the agreed restrictions. Transfer restrictions cannot be so onerous as to violate legal prohibitions against unreasonable restrictions on alienation. See general discussion of restrictions in *Redd v. W. Sav. & Loan Co*., 646 P.2d 761,(Utah 1982) (due on sale clause an indirect and reasonable restraint justified by legitimate interests of the parties); Restatement (Third) of Property (Servitudes) § 3.5 (2000) (a servitude that lacks a rational justification is an invalid indirect restraint);

(2) **Options**. Options of various sorts, or combinations of them, are often used.

(a) Call Options. The parties may want to provide a series of call options for flexibility. (A call option is the option to require the other party to sell.) For example, the first option might be in favor of the corporation or company, followed by an option in the other shareholders or members for the shares or interests not purchased by the corporation or company. Such a series of options would create a hybrid redemption and cross-purchase agreement. The order of the options can make a difference in a corporate context; the option to the corporation should generally come first. Were the owner's options to come first and the corporation's second, and if an owner were to exercise its option and then there was a later modification allowing the corporation to purchase the stock, there would be a strong implication that the corporation picked up the primary obligation of the owner and thus made a disguised dividend to that owner. *Jacobs v. Com'r*, T.C. Memo 1981-1; Rev. Rul. 69-608, 1969-2 C.B. 42.

(b) Put Options. Another possibility would be for the owner of the shares or interests in the business to have a put option exercisable on death or forced termination of employment or expulsion from the business, or some other event. (A put option is the option to require the other party to buy.)

(c) First Refusal Option. A further possibility would be to grant the business organization or its other owners a right of first refusal option. (A right of first refusal is the option to be able to buy on the same or similar terms as is offered by a third party.)

(3) **Ultimate Sale or Release of Restrictions**. The parties may want to consider an ultimate mutual requirement on the owner of the shares or interests and on the corporation or company or on the other shareholders or members, to simply sell and purchase all shares or interests of the owner, or to purchase those remaining after the exercise of any prior options. Or, they may want to then release all restrictions on the unpurchased interests or limit the restriction to a right of first refusal. They may, alternatively, want to then release all restrictions on all offered interests (not just on those remaining unpurchased after the exercise of the options) so that the offering shareholder or interest owner may sell a larger interest to a third party (if one can be found).

(4) **Trigger Events**. The agreement should clearly specify which events trigger which options or trigger a mutual obligation to sell and buy. Some possible trigger events include: death, disability, desire to sell or transfer, attempt to sell or transfer, selling or transferring a specified interest in an owner which is, itself, an organization (such as a controlling interest, or an aggregate of interests which amount to some important percentage of ownership or control over a specified period of time) or a significant change in board or management control over the owning organization, bankruptcy or insolvency or creditor seizures as to an owner, divorce, loss of license, termination of employment, expulsion from the business.

(5) **S-Corporation Provisions**. An S-corporation election maintenance provision may be desirable where the corporation has made such an election. Such a provision would typically require the owners to act if necessary to maintain the election, unless all stockholders agree to terminate it, not to make transfers to nonresident aliens, corporations, or others who are not qualified to hold S-corporation stock, only to use the limited sorts of trusts which are qualified to hold S-corporation stock, and otherwise refrain from doing anything to jeopardize the election. It may also provide for other matters, such as a book closing to determine shares of income on a transfer of stock.

Generally, the existence of a buy-sell agreement triggered by contingent events does not create of the stock to which a trigger applies a second class of stock with differing distribution and termination rights which would disqualify the S-corp election. Regs. § 1.1361-1(i)(2)(iii)(3). There may be such an issue, however, if pricing is significantly more or less than fair market value.

(6) **Minimum Distributions**. Also, a provision to require at least enough distributions to enable tax obligations to be met will be an important protection to minority shareholders of an S-corporation. Members of a limited liability company or partnership will similarly find that such a distribution provision could be just as useful in the partnership and limited liability company context as well.

(7) **Price**. Price terms are always important. Price may be established by various means such as:

(a) Agreement Value Provisions. Sometimes pure agreement pricing is used where the parties simply agree on a price to be effective, typically for a period of time, such as a year or 18 months. Such an agreement usually has a fallback mechanism in case the price is not re-agreed but goes stale at the end of the time period. The fallback mechanism is usually an appraisal of one of the sorts described below or a formula of one of the sorts described below.

(b) Formula Provisions. Formula provisions are sometimes used to value businesses as a whole. Some formulas are based on earnings and will capitalize an earnings-related amount such as EBITDA (earnings before interest, taxes, depreciation, and amortization). Other formulas are based on any number of factors, sometimes including net book value, assets, cash flow, marketable securities in the same industry, numbers of customers, and so on. In a family-dominated business, formula provisions may be quite dangerous for tax purposes. See IRC § 2703. Even in a business not dominated by a family, these sorts of provisions need to be carefully scrutinized to assure they do not unfairly prejudice some owners to the benefit of others.

(c) Revaluation Provision. In order to protect against the dangers of formula provisions or other pricing methods which may not equal fair market value, some agreements have contained revaluation clauses designed to make the price come out the same as the tax value. These are controversial. They may possibly work where the clause simply requires additional payments. See *Estate of Dickenson, Jr. v. Com'r*, 63 T.C. 771 (1975); *King v. U.S.*, 545 F.2d 700 (10th Cir. 1976); *McCord v. Com'r*, 461 F.3d 614 (5th Cir. 2006) *rev'g and remanding* 120 T.C. 358 (2003) (involving a defined value clause where the transferor gets nothing back). But if the clause revokes or rescinds the transaction (for example, by reducing the size of the interest transferred to fit the price paid after the tax value is established), this will violate public policy and will not be effective to prevent taxation. *Com'r v. Proctor*, 142 F.2d 824 (1944); Rev. Rul. 86-41, 1986-1 C.B. 300; *Ward v. Com'r*, 87 T.C. 78 (1987); *Est. of McLendon v. Com'r*, TCM 1993-459 *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995); PLR 9309001; Field Service Advice 200122011.

An example of a possibly permissible formula provision would be: I give to child X a fractional portion of my company interest in A, LLC, the numerator of which is $1 Million and the denominator of which is the fair market value of my company interests in A, LLC, as finally determined for federal gift tax purposes, and I give the balance to Y charity. See *Hendrix v. Com'r*, TC Memo 2011-133 (upholding such a provision as being at arm's length and not against public policy).

In *Estate of Christiansen v. Com'r*, 130 T.C. 1 (2008); *aff'd*,586 F.3d 1061 (8th Cir. 2009), *Estate of Petter, v. Com'r*, T.C. Memo. 2009-280; *aff'd*, 653 F.3d 1012 (9th Cir. 2011), and *Estate of McCord v. Com'r*, 461 F.3d 614 (5th Cir. 2006), formula gift clauses were upheld in situations where any additional value would pass to charity. Where the documents clearly indicated that the gift was of a fixed dollar amount and not of a percentage interest in the LLC, the Tax Court has upheld a formula gift valuation clause against a Service challenge on the basis of a supposed violation of public policy, and, for the first time, did so even without a charitable component. The Court said, "... In *Estate of Petter* we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern." *Wandry v. Commissioner*, T.C. Memo. 2012-88.

(d) Appraisal Provisions. Some appraisal mechanisms are based on appraisals of the company interest involved or of the company as a whole. These business appraisals are different types of appraisal from appraisals of the underlying assets of the company (real estate, equipment, software, etc.), which are also sometimes used separately or as an adjunct to a business appraisal.

(i) Owner's Interest. An appraisal of the company interest of a specific owner will generally look to the fair market value of the interest to a buyer and thus generally will take into account discounts for lack of control, lack of marketability, and other matters. This type of appraisal takes into account the reality that, for example, a buyer will not pay as much per unit of interest for a 40% interest in a company as it would for a 60% interest, because the 60% interest will have greater control over the course of the business in such important areas as monetary distributions, compensation for services, strategic business developments, and so on.

(ii) Company. An appraisal of the company as a whole will value the company as if it were to be sold as an entire business, as a going concern held in a company form, 100% to the buyer. Thus, it will generally not contain discounts for minority or other interests lacking control. It will, however, take into account the lack of marketability of the business as a whole. Some buy-sell arrangements will use an appraisal of the company as a whole and then proportionately allocate the value to the various interests. Thus, the value of a unit will be the same whether the holder of the unit holds 60% or 40% of the aggregate of units.

(iii) Assets. Other appraisal provisions look to the value of the underlying assets of the business. This is essentially a liquidation analysis. It analyzes what a prospective buyer would pay for a particular asset or group of assets in isolation from other assets and without consideration of whether the assets are held in a company. This may produce a value higher than the value of the asset held in a company form, because the asset may be worth something less if held in a business entity with rules and restrictions and with potential liabilities from a history which will likely not be completely transparent. Sometimes asset appraisals are used as a base with an appraisal of the company interest or of the company as a whole to follow. Other times such an appraisal is made and the result allocated among the interest holders proportionately to the number of units held.

(e) Slice of Pie Provision. In two person lifetime situations where both parties have approximately equal economic power, the one desiring a change may select the price and the other be given right to choose to buy or sell at that price. This tends to give an incentive to the owner proposing a change to select a reasonable value.

(f) Situational Differences. It is possible to price an interest differently under different situations, for example, it may be that full price is payable at death but some reasonable lesser amount is payable on voluntary resignation or termination for cause. Where an S-corporation is involved, differences should be analyzed to assure that no second class of stock is deemed to be created thus killing the S-election. Also, in every case care should be used to prevent an excessive and unenforceable penalty or forfeiture.

(8) **Insurance Funding**. The agreement can be funded with life insurance to provide funds for a death-time buy-out and the parties can agree to deferred payments on lifetime buy-outs or on the uninsured part of a death-time transfer. Disability insurance is also sometimes acquired to enable a buy-out in case a shareholder or member becomes permanently disabled (premiums are not deductible, but proceeds are excluded from policyholder's income under IRC § 104; see Rev. Rul. 66-262, 1966-2 C.B. 105; see also IRC § 265(a)). Also, the cash value buildup in a life policy can provide some level of liquidity for a lifetime buy-out.

(a) Insurable Interest. Under insurance law a beneficiary of life insurance must have an insurable interest in the life of the deceased. *Warnock v. Davis*, 104 U.S. 775 (1881); UCA § 31A-21-104; *Comm'l Travelers' Ins. Co. v. Carlson*, 137 P.2d 656 (Ut. 1946). Buy-sell agreements should be adequate in Utah to provide an insurable interest for acquiring a policy or rights in a policy in a reasonable amount in either a cross-purchase or entity purchase arrangement. See UCA § 31A-21-104(3)(b).

(i) Subsequent Events. Due to the troublesome holdings of the Utah Supreme Court in the two *Parduhn* cases, *Parduhn v. Bennett*, 61 P3d 982 (Ut. 2002) and *Parduhn v. Bennett*, 112 P.3d 495 (Ut. 2005), in Utah prior to 2007, contrary to the law of many other states, an insurable interest would likely terminate and not continue if the buy-sell agreement terminated, and a buy-sell agreement may have been the only way an unrelated co-owner obtained an insurable interest. However, the insurable interest provisions of the insurance code were amended in 2007, with presumptive retroactive effect, to change these results and to provide much needed clarification on a number of issues. In other states, an insurable interest continues if the insurable interest existed at the time the policy was issued even if matters have changed at the insured's death. See *Mckee v. Penrick* (*In re Al Zuni Trading, Inc.*), 947 F.2d 1403 (9th Cir. 1991) and *Herman v. Provident Mutual Life Ins. Co.*, 886 F. 2d 529 (2d Cir. 1989). This will now generally be the rule in Utah–if there was an insurable interest when the policy was acquired, whether at its effective date or on later procurement of an interest in the proceeds, there does not need to be an insurable interest at the time the proceeds are payable. UCA § 31A-21-104(2)(c).

(A) However, where rights with respect to a policy are transferred, the Viatical Settlement provisions of UCA § 31A-36-101 *et seq.* must not be violated. See UCA § 31A-21-104(8).

(B) Also, the Utah Department of Insurance will apply a step-transaction, substance over form analysis to determine if the required insurable interest existed when the rights to the policy were obtained (for example, in a secondary market by a nonrecourse loan, etc.). Bulletin 2006-3, dated July 10, 2006, of the Utah Insurance Commissioner.

(C) Does it make a difference if the ultimate transferee is not known at the time the policy is obtained? It has in some trial court proceedings. Compare *Sun Life Assurance Co. v. Paulson*, No. 07-3877 (D.C. Minn., Feb. 15, 2008) (the most important factor in determining the parties' intent is whether the transfer was pursuant to a preconceived agreement; intent to sell irrelevant without party lacking insurable interest intending to buy), with *Life Product Clearing LLC v. Angel*, 7 Civ. 475 (So. Dist. NY) (policy is not lawful where insured purchases with intent to resell to stranger at earliest moment).

(ii) Employer's Interest. An employer will have an insurable interest in employees, officers, directors, managers, and retired employees (UCA § 31A-21-104(3)(d)(i), but that interest as to nonmanagement employees or retired employees is "limited to an amount commensurate with the employer's unfounded liabilities," presumably those owing to the employee or retired employee (perhaps deferred compensation or possibly a buy-sell obligation), at the time the insurance was procured. UCA § 31A-21-104(3)(d)(iv). On an acquisition of the business of the employer, the insurable interest of the employer or benefit trustee transfers automatically to the subsequent employer or trustee. UCA § 31A-21-104(3)(d)(iv).

(iii) Trust's Interest. Trusts are often used to hold policies or to receive policy proceeds in connection with buy-sell agreements. The insurable interest for policies or rights to policy proceeds held in trust is determined at the beneficiary level. UCA § 31A-21-104(3)(c) provides that the trust will have an insurable interest "to the extent that a beneficiary of the trust has the insurable interest." The phrase "to the extent that" appears to limit the insurable interest so that it may only benefit the beneficiary with that interest and may limit the extent of that interest.

(iv) Creditor's Interest. Creditors may, without the consent of the debtor, obtain insurance on the debtor in an amount reasonably related to the amount of the debt. UCA § 31A-21-104(5)(a)(ii). A buy-sell arrangement will create a creditor-debtor relationship on the death of a party (or some other event). Although this rule relates to an insurer's requiring consent of the insured, it also can be expected to limit the insurance under a buy-sell agreement so that there will be no unreasonable windfall.

(v) Standing for Challenges. The challenge to insurable interest is in a number of states only for the insurer. See *Ryan v. Tickle*, 316 N.W. 2d 580 (Neb. 1982). However, under the *Parduhn* cases, it appears that standing to raise the insurable interest issue may extend beyond the insurer; in those cases, the proceeds were reallocated to family, and it was not clear whether the insurer was involved at all and the cases did not address the issue. See *Stillwagoner v. Travelers' Ins. Co.*, 979 SW 2d 354 (Tx App.-Tyler 1998) (estate of deceased may challenge employer named as beneficiary; although the lives of important employees, officers, directors, and shareholders may be insured by a corporation, the corporation does not have an insurable interest in a mere employee). Given the remedies available in Utah discussed below, it seems likely that where the insurable interest requirement is violated, any person who can make an equitable claim may be able to challenge payment of the proceeds, or may be able to collect the proceeds from the payee after payment, under a constructive trust theory.

(vi) Remedies. The revisions to the Utah Insurance Code reiterated and strengthened the statutory remedy used by the court in the *Parduhn* cases, to require that proceeds of a policy issued (or in that case, received) without an insurable interest be paid to a person "who is equitably entitled to the proceeds," other than the person designated as the payee. The court may impose a constructive trust for this purpose. UCA § 31A-21-104(6)(b). The policy itself is not invalidated under UCA § 31A-21-104(6)(a). The Viatical Settlement Act, UCA § 31A-36-101 *et seq.* has its own remedies. See UCA § 31A-21-104(8). Given the limitations on the extent of an insurable interest of an employer, trust, or creditor, the remedy appears to be available on something other than an all-or-none basis and could apply even where some insurable interest exists in order to prevent an unjustifiable windfall to unrelated parties.

(vii) Some Estate Tax Questions. If an insurable interest is lacking, or to the extent it is lacking, would an equitable claim of the insured's estate cause estate tax inclusion of the proceeds under IRC § 2042(1) ("amount receivable by executor as insurance"), even if the personal representative did not pursue it? Is this an estate claim at all, or a direct claim by family members as to which the insured held no includible incidents of ownership under IRC § 2042(2) or other includible rights? In the second *Parduhn* case, the equitable distribution by the District Court was described as being to the deceased partner's "surviving heirs" or the "Buchi survivors." The deceased partner's spouse joined the action both individually and as personal representative, but the distribution was routed past the estate and was not an invalid nontestamentary transfer under UCA § 75-6-201. The trial court could use the buy-sell agreement, even though invalid to provide an insurable interest, as an indication of intent, and the insurance itself was not invalidated but was a sufficient writing for a nontestamentary transfer. The trial court will have broad discretion to decide on an equitable distribution. The state law rights do not seem sufficient to create inclusion under IRC § 2042(1) as "receivable by the executor," at least where the estate does not have a contractual right and does not assert the equitable right to receive the proceeds but the individual family members do, and the proceeds do not become available for, and are not used for, the payment of estate creditors. If the insured did not hold the policy or incidents of ownership, the proceeds would not be includible under IRC § 2042(2), either.

(viii) Some Income Tax Questions. Is the payment of proceeds without an insurable interest actually insurance exempt from income tax under IRC § 104, or is it something else? Is it insurance if paid on an equitable claim to the estate or family of the insured? This appears to be the likely result under the *Parduhn* cases, if state law controls what is treated as insurance for this purpose. Is it something else, potentially taxable as income, if paid to the payee without an insurable interest? This is not clear. If otherwise taxable, the potential equitable claim of the family of the deceased would not prevent taxation, under the claim of right doctrine. *North American Oil Consolidated v. Burnett*, 286 U.S. 417 (1932); *U. S. v. Lewis*, 340 U. S. 590 (1951). Subsequent relief under IRC § 1314(a)(1) might be available on repayment of the proceeds in excess of $3,000 (there is, however, a substantial division among courts as to the interpretation of this section).

(b) No Premium Deduction. The life insurance premiums will not be tax deductible whether a redemption or cross purchase agreement is used. IRC § 264(a)(1); Rev. Rul. 70-117, 1970-1 C.B. 30. Premiums for certain annuities purchased by a corporation or partnership-taxed company may be deductible by the company (IRC § 72(s)(5) retirement plans and retirement annuities, IRC § 72(u) annuity held by organization, the income on which is currently taxable; see IRC § 264(b)). Also, interest (but not principal) on indebtedness not exceeding $50,000 with respect to policies covering a "key person" may be deductible by the corporation or company. IRC § 264(e). A key person is an officer or 20% owner, but there are limits on the number of key persons. IRC § 264(e)(1), (3).

(c) Alternative Minimum Tax. A corporation holding life insurance on its stockholders as part of a redemption agreement may become taxable on the buildup of cash value in the policies for Alternative Minimum Tax (AMT) purposes. IRC §§ 55, 56(c)(1), 56(g)(4)(B)(ii). This occurs when there is "income" in the policy (determined under IRC § 7702(g)). Such income is the amount by which that year's increase in surrender value plus the cost of that year's life insurance protection exceeds the premiums paid for that year. IRC § 7702(g)(1)(B). A similar rule applies to disability insurance, as well. IRC § 53 allows a credit against regular tax in future years for AMT paid; this may make the issue more of a timing matter where the corporation has income.

(d) Dividend and Distribution Issue. If paid by the corporation that is the policy beneficiary under a redemption agreement, the life insurance premiums are not likely to be treated as disguised dividends. Rev. Rul. 59-184, 1959-1 C.B. 65; *Sanders v. Fox*, 253 F.2d 855 (10th Cir. 1958). However, if the corporation pays the premiums under a cross purchase agreement, the premiums will be treated as dividends. See *Doran v. Com'r.*, 246 F.2d 934 (9th Cir. 1957), rev'g 15 T.C.M. 629 (1956).

Premiums paid by a partnership-taxed organization should be treated as distributions in a cross-purchase arrangement. In a redemption (*i.e.*, liquidation of a partner's interest) arrangement, the premiums paid by the company will be treated as nondeductible expenditures not properly changeable to capital account. IRC § 705(a)(2)(B). The result will be to reduce the basis of the partners' partnership interests; thus, the nondeductible item will not later create a tax loss (a basis reduction generally creates more potential gain and less potential loss).

(e) Tax Effect of Proceeds to Corporation or Company or to Stock or Interest Holders. The receipt of the life insurance proceeds generally will not be income to the beneficiary corporation or company under a redemption agreement or to the beneficiary shareholder or interest owner under a cross purchase agreement unless the corporation, company, shareholder, or interest owner acquired an existing policy for value. IRC § 101(a)(1) and (2).

Death benefits on a policy held by an employer on the life of an employee which are excluded from gross income generally can't exceed the sum of the premiums and other amounts paid by the employer-policyholder for the policy. Any excess is income. IRC '' 101(j)(1) and 101(j)(3). There are important exceptions which may lead to up to full exclusion, however. If certain notice and consent requirements are met, proceeds will be excluded if: the insured was an employee at any time within 12 months before the insured's death; the insured was a director or highly compensated employee or individual (under IRC ' 105(h)(5), but using a highest paid 35% instead of 25% test) at the time the policy was issued; or to the extent the proceeds are paid to a family member of the insured (as family is defined under IRC ' 267(c)(4)) or a designated beneficiary (other than the employer-policyholder), a trust established for a family member or beneficiary, or the insured's estate, or the proceeds are used to buy an equity (or capital or profits) interest in the employer from such a family member, beneficiary, trust, or estate. IRC ' 101(j)(2). The notice and consent requirements are set forth in IRC ' 101(j)(4) which requires that before the contract is issued, the employee is notified in writing that the employer-policyholder intends to insure the employee's life and of the maximum face amount for which the employee could be insured at the time the contract was issued, the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and the employee is informed in writing that the employer-policyholder will be a beneficiary of any proceeds payable upon the death of the employee. In some cases a buy-sell agreement between the employer and its shareholder employees along with the life insurance application may be sufficient to meet the notice requirements. PLR 201217017.

(i) <u>Other Corporate Effects</u>. The difference between the premiums paid and proceeds received will, however, increase the corporation's earnings and profits account for purposes of determining dividends. Rev. Rul. 54-230, 1954-1 C.B. 114. The proceeds of the insurance may increase the corporation's "adjusted current earnings" used in calculating the corporation's alternative minimum tax under IRC § 55; this could result in a minimum tax liability even where the proceeds are generally not taxable for ordinary federal income tax purposes. IRC § 56(g)(4)(B).

(ii) <u>Transfer for Value</u>. If the policy was transferred for value, only the value of the consideration for the policy and any later premiums paid or interest paid on debt with respect to the policy (to the extent not deductible under IRC § 264(a)(4)), will be excluded from income. The transfer for value rule will not apply where (a) the transferee's basis in the policy is determined in whole or in part by reference to the transferor's basis (*e.g.*, an IRC § 351 transfer of policy for stock will not trigger the rule) or (b) the transfer is to the insured, to a corporation in which the insured is a stockholder or officer, or to a partnership or limited liability company in which the insured is a partner or member, or to a person who is a partner or member with the insured. IRC § 101(a)(2)(A) and (B). Notice the significant difference in treatment between corporations and partnership-taxed companies.

(A) If a corporation transferred in liquidation a policy on one stockholder to a different stockholder, the transferee would recognize gain or loss and would take a new fair market value basis (eliminating exception (a) above) and the transferee is not a listed person (eliminating exception (b) above), so the transfer for value rule would apply. Similarly, if a shareholder buys a policy from the corporation on the life of another shareholder (*e.g.*, in changing from a redemption agreement to a cross purchase agreement), the transfer for value rule would apply. If the shareholder buys the policy on his or her own life from the corporation (*e.g.*, on the termination of the buy-sell agreement or on leaving the corporation), this would not normally trigger the transfer for value rule, but if that shareholder directs the policy be transferred as a gift directly to the shareholder's spouse, the rule may be triggered. See *Estate of Rath v. U.S.*, 608 F.2d 254 (6th Cir. 1979).

(B) Transfers by anyone (not just by an officer or shareholder) to a corporation of a policy on the life of an officer or shareholder will not trigger the rule. A similar result holds true in the partnership-taxed company context, as well: a sale by anyone to the company of a policy on the life of a member or partner will not trigger the rule. However, if the policy is on the life of a nonmember manager of an LLC, the rule would be triggered.

(C) Sales of policies between partners or members or between partners or members and the company, whether the policy is on the partner's or member's own life or that of any other partner or member, will not trigger the rule. This is much more flexible and favorable treatment than is available for corporations.

(D) A partnership (*e.g.*, one holding modest other investments) holding policies on the lives of corporate shareholders may be used to take advantage of the flexibility of the partnership exceptions to the transfer for value rule, even where there is no other connection between the partnership and the corporation. See PLR 9042023 and PLR 9239033.

(iii) Other Partners. A partnership-taxed company may want to have insurance proceeds specially allocated to the surviving partners or members in order that they will receive a full basis step-up on buying out the deceased interest owner (see IRC § 705(a)(1)(B)) and in order that the deceased will not have a share of the proceeds included in his or her gross estate when there are otherwise no incidents of ownership under IRC § 2042(2).

(f) Tax Effect of Proceeds on Insured. The life insurance proceeds will not be included in the estate of the deceased insured unless the insured retains a right to excess proceeds from a transferred policy (IRC § 2038(a)) or the insured held incidents of ownership (as is typical in a cross purchase arrangement, but may exist in a redemption agreement situation, too) (IRC § 2042).

(i) Proceeds of Business Held Policy Payable to Company. Normally where the insurance is both owned by and payable to the corporation or company, the incidents of ownership will be held by the corporation or company. Regs. § 20.2042-1(c)(6).

The proceeds, however, will be taken into account in valuing the stock or company interest (Regs. § 20.2031-2(f)), unless the buy-sell agreement effectively sets the value otherwise under IRC § 2703. This is true in the partnership context as well, where the courts have applied an entity rather than an aggregate theory where the insurance is payable to the company. *Knipp v. Com'r*, 25 TC 153 (1955) *aff'd on other issues* 244 F.2d 436 (4th Cir. 1956); *acquiesced* in by the Service in Rev. Rul. 83-147, 1983-2 C.B. 158. Thus, the policy should be payable to the company, not to the estate of the deceased partner or member. Compare *Mushro v. Com'r*, 50 T.C. 43 (1968) (*nonacq*.) with *Legallet* 41 BTA 294 (1940). Even if the shareholder or member has incidents of ownership or the proceeds are otherwise includible in his or her estate, the proceeds should not be counted twice by including them separately and by also including them in the value of the corporation or company. <u>See</u> *Cockrill v. O'Hara*, 302 F. Supp. 1365 (M.D. Tenn. 1969); *Kearns v. U.S.*, 399 F.2d 226 (Ct. Cl. 1968).

However, a different take on this issue is set forth in *Blount v. Com'r*, 428 F.3d 1338 (11th Cir. 2005). In that case the Court found that the value of insurance acquired to purchase shares under a corporate redemption buy-sell agreement should not increase the value of the company to the extent offset by an obligation to pay the proceeds to the insured's estate. <u>See</u> also *Est. of Cartwright v. Com'r*, 183 F.3d 1034 (9th Cir. 1999). The proceeds were not treated as a nonoperating asset not otherwise taken into account in the determination of net worth under Regs. § 20.2031-2(f)(2). This was the case even though the buy-sell agreement failed to set the value under IRC § 2703, because there was still an enforceable state law purchase obligation, and was so even though the shareholder under the regulation does not have incidents of ownership in the policy. This result by which proceeds might escape estate tax altogether seems too good to be true and may be dangerous to rely on.

(ii) <u>Excess Proceeds</u>. Where the insurance proceeds exceed the amount payable for the decedent's stock or company interest, and where the excess is payable to the decedent's beneficiary, spouse, or estate but the decedent has not made an irrevocable beneficiary designation, a power to alter or revoke may be retained causing estate inclusion under IRC § 2038(a). <u>See</u> PLR 8943092 (involving a redemption agreement). Thus, excess proceeds should remain with the corporation or company or the stockholder or interest holder should make an irrevocable beneficiary designation.

(iii) <u>Business Held Policy Payable to Third Party</u>. As mentioned above, where insurance on the life of an owner of stock or partnership-taxed company interest is owned by the corporation or company and is payable to it, the incidents of ownership reside in the corporation or company and not in the stockholder or owner of a company interest. However, if the insurance is payable to a third party (*e.g.*, another owner) rather than the corporation or company, the proceeds will be includible in the partner or member insured's estate, regardless of the proportionate interest held in the company (Rev. Rul. 83-147, 1983-2 C.B. 158 (partnership)) and, with respect to a corporation, will be included in the shareholder insured's estate if the shareholder is the sole or controlling (*i.e.*, over 50% voting power) shareholder. (A minority shareholder does not have this problem.) In testing for control, the decedent shareholder will be deemed to own the stock of certain others: agent, nominee (*e.g.*, through IRA), joint ownership in proportion to consideration supplied by the decedent (<u>see</u> IRC

§ 2040), voting trust to extent of decedent's interest, and grantor trust (Regs. § 20.2042-1(c)(6) which purports to be exclusive by use of the word "only"); and (despite the word "only" in the regulation) may be deemed to own the stock of a trust of which the shareholder is a beneficiary with a distribution right (*e.g.*, bequest of cash or property of a certain value) where such beneficiary as trustee has the right to choose assets or where the stockholder-beneficiary has a withdrawal right (*e.g.*, 5% or $5,000 power) or where the stockholder relinquishes such distribution or withdrawal right within three years of death under IRC § 2035(d)(2) (PLR 9037012).

(iv) Option to Purchase Policy. A right of an insured shareholder to purchase the corporate-owned policy for its cash surrender value on certain events (*e.g.*, termination of employment, sale or gift of stock, proposed surrender of policy) where the corporation is the beneficiary, does not appear to create incidents of ownership at least where the insured did not assign the policy to the corporation. Presumably, the same result would apply to insurance held by a partnership-taxed company. PLR 9233006, PLR 8049002. A similar rule applies to employees. *Smith Est. v. Com'r*, 73 T.C. 307 (1979) *acq'd in result* by Service 1981-1 C.B. 2; Cf. Rev. Rul. 79-46, 1979-1 C.B. 303 (includible to extent of proceeds less cash surrender value option price where payable to employee's spouse). See also TAM 9128008 (option to reacquire assigned policy caused policy proceeds to be includible in insured's estate) and TAM 9349002 (poorly reasoned; option to purchase policy on payoff of installment obligation treated as a reversionary interest under IRC § 2042(2) based on "constructive transfer" by shareholders when corporation used assets to obtain the policy).

(g) Trustee for Cross Purchase Policies. In a cross purchase arrangement where there are a number of business owners, several practical problems will be encountered. First, the number of insurance policies needed may be quite large. For example, if there are 10 company owners, each one will need to buy policies on each of the others; this is a total of 90 policies. Second, it will be difficult to verify that each owner is in fact buying and paying the premiums on the required policies. One solution to these problems is to use an entity redemption agreement where the company itself holds but one policy on each owner and each owner can verify through the company records that the policy exists and the premiums are being paid. However, where a cross purchase arrangement is strongly desired, some other solutions must be found. The most common solution is to have a trustee acquire one policy on each shareholder's life and verify to all that premiums are being paid to the trustee by the company owners as required under the agreement.

(i) Allocation of Authority. The trust should provide for an independent trustee. However, if business owners are also trustees, the trust should provide that no such owner will have any authority over policies on his or her own life. This is to avoid holding incidents of ownership which would include the policy proceeds in the owner's gross estate under IRC § 2042.

(ii) Grantor Trust. The trust will be subject to the grantor trust rules of IRC § 671 ff. See IRC § 677(a)(3). Thus, any trust income will be taxed to the owners who are treated as if they own the trust assets. Particularly in a corporate cross purchase arrangement, the owners will want to be careful with respect to the transfer for value rules. It may be best to have the trustee acquire new policies (if possible) rather than transfer existing policies.

(9) **Payment**. Payment terms should establish the time within which to pay the price. It could provide for the use of any insurance proceeds first, then set a number of years over which to amortize the remainder. The time element will need to balance the cash flow needs of the business with the desire of the leaving owner for a quick payout. An interest rate should be provided. The rate must meet the standards of IRC § 1274 or § 483 in order to avoid imputed interest for tax purposes. Applicable Federal Rates are published by the Service monthly, and provide minimum rates for long term (over 9 years), medium term (less than 10 but more than 3 years), and short term instruments (3 years or less). The Applicable Federal Rate for a demand loan is the short term rate but it fluctuates monthly as long as any of the note remains unpaid. Regs. § 1.482-2(a)(2)(iii)(C).

(a) Original Issue Discount. Also, if the payments are back-end loaded, the more than usually complex original issue discount rules could apply. IRC §§ 1271 to 1275. For example, if some of the interest accruing is or is deemed to be, deferred, this might create original issue discount income to the lender (*i.e.*, the seller), and a corresponding current interest deduction to the borrower (*i.e.*, the buyer) (determined under the "constant yield method" of IRC § 1272(a)(1)).

(i) What is OID? Original issue discount is the excess, if any, of the stated redemption price at maturity of a debt instrument over its issue price. The stated redemption price at maturity is the sum of all payments other than qualified stated interest. The qualified stated interest is the stated interest that is unqualifiedly due at least annually at a single fixed rate. The issue price for nonpublicly traded debt bearing adequate interest is its face amount; for publicly traded debt it is the market price at issue, or at deemed issue on a material modification.

Example: If the entire obligation is $100X payable at maturity and it is issued for $90X, the OID is $10X:

$100X redemption price at maturity
- 90X issue price
$ 10X OID

Example: If property worth $70X is bought with an obligation payable in installments over time where the total of all installments payable is $100X, and where of this $100X a $20X part is qualified stated interest, the OID will be $10X:

$100X total of all payments to maturity
- 20X payments which are qualified stated interest
$ 80X the redemption price

80X the redemption price
\- 70X the price for the property (issue price)
$ 10X OID

(ii) Adequate Stated Interest. For OID purposes, adequate stated interest exists if the stated principal amount of the debt is less than or equal to the imputed principal amount. IRC §§ 1274(c)(2) and 1274(b). The imputed principal amount is the sum of the present values of all payments due under the instrument using a discount rate equal to the applicable federal rate compounded semiannually with respect to the period (*i.e.*, short-term (3 years or less), midterm (9 years or less, but over 3 years), or long-term (over 9 years)) determined by the weighted average maturity of the installment obligation. The weighted average maturity is the sum of the following amounts determined for each payment other than a payment of qualified stated interest: (1) the number of complete years from the issue date until the payment is made multiplied by (2) a fraction the numerator of which is the amount of the payment and the denominator which is the stated redemption price at maturity.

(iii) Possible Exceptions. Even if there were to otherwise be original issue discount, three possible exceptions may apply.

(A) All qualified stated interest. The first exception arises under Regs. § 1.1274-1(b)(1) which makes the OID issue price rules inapplicable (resulting instead in the application of IRC § 1273(b)(4)) so that the issue price will, by legislative fiat, equal the stated redemption price at maturity. This exception applies if all interest is qualified stated interest, the rate at least equals the test rate that applies, the debt is not issued in a potentially abusive situation, and the borrower does not pay lender points or interest at the time of the issuance of the debt. Thus, this exception essentially puts the debt outside the OID rules.

(B) De minimis Rule. Secondly, there is a de minimis rule under IRC § 1273(a)(3) that ignores OID if the excess of the stated redemption price at maturity over its issue price is less than 0.25% (or alternatively, 0.167% may be used where payments of principal are no more rapid than under a self-amortizing installment obligation) of the stated redemption price at maturity, multiplied in the usual case by the number of complete years to maturity, but in the case of an installment obligation multiplied by the weighted average maturity.

(C) Cash Method Election. The third exception would be to elect cash method treatment for the obligation under IRC § 1274A. The election would be available for a deemed debt for debt exchange (such as in the case of a significant modification) unless the principal purpose of the modification is to defer interest income or deductions. To qualify for the election the stated principal must (in 2016) be less than $ 4,046,300, the lender must not use the accrual method of accounting or be a dealer with respect to the property sold or exchanged (here debt instruments), the issue price rules of IRC § 1274 would otherwise have applied (this apparently makes the election an alternative exception, not an additional exception, to the first exception), and the borrower and lender, together elect to have the debt treated on the cash basis by means of a joint statement signed not later than the due date including extensions) for filing the return of the borrower or the lender for the tax year of the issuance (*i.e.*, the date of the deemed exchange on the significant modification). A copy should be the timely filed returns of the borrower and the lender.

(D) Specialized Exceptions. The more specialized exceptions to the OID rules may apply where nonpublicly-traded debt is issued for nonpublicly-traded property. However, the imputed interest rules of IRC § 483 would apply. Subject to various conditions and requirements, these exceptions involve: total payments of $250,000 or less (IRC § 1274(c)(3)(C)), principal residence of an individual (IRC § 1274(c)(3)(B)), farms with a sales price not exceeding $1,000,000 (IRC § 1274(c)(3)(A)), sales of patents (IRC § 1274(c)(3)(E)), transfers of land between family members where all land sales aggregate not more than $500,000 (IRC § 1274(c)(3)(F)), property that is personal use property to the debt issuer that evidence a below-market loan or transactions involving a demand below-market loan (Regs. § 1.1274-1(b)(3)(i) and (ii), IRC § 7872), or transfers between spouses incident to divorce (Regs. § 1.1274-1(b)(3)(iii)).

(b) Related Terms. The obligation could be evidenced by a negotiable promissory note or be nonnegotiable. Security interests and guarantees may be provided. Negative covenants, such as loan, net worth, or dividend restrictions could be included. There may be an escrow to hold a portion of the price for a period of time to protect the buyer against claims or warranty violations. See the discussion of the tax effects of installment obligations at E below.

(c) Accumulating Earnings to Make Payments. If a C-corp accumulates earnings to make the payments under a buy-sell agreement, the accumulated earnings tax under IRC § 531 needs to be considered. This is a punitive tax designed to force the corporation to issue a taxable dividend to the stockholders where the accumulated amounts exceed the needs of the business. After (not before) the death of a shareholder, a corporation may accumulate earnings without concern for the accumulated earnings tax in order to fund a redemption under IRC § 303 to pay estate taxes and administrative expenses. Otherwise, the accumulation needs to meet the reasonable needs of the business. This test is not likely to be met where the accumulation is to purchase a majority interest. *Pelton Steel Casting Co. v. Com'r,* 251 F.2d 278 (7th Cir. 1958), *Lamark Shipping Agency Inc. v. Com'r,* 42 TCM 28 (1981). On the other hand, the test may well be met where the buy-out will be of a minority interest. *Shaw-Walker Co. v. Com'r,* 24 TCM 1709 (1965), *rev'd on other grounds* 390 F.2d 205 (6th Cir. 1968), *Wilcox Mfg. Co v. Com'r,* 38 TCM 378 (1979). Once the redemption has occurred and there is an installment obligation payable, the corporation can accumulate income to make the payments. *Mountain State Steel Foundries, Inc. v. Com'r,* 284 F.2d 737 (4th Cir. 1958).

(10) **Consulting Agreements**. Employment or consulting agreements may be helpful in providing a stream of income for the former owner of a closely held business. Where reasonable, the payments may be a deductible business expense to the corporation or company and will be ordinary income to the recipient. However, in the case of a corporate redemption they cause problems because the payments may be treated as essentially equivalent to a dividend

where family members continue as stockholders. IRC §§ 301, 302(b)(3) and (c). Also, they may be treated as plans of deferred compensation under IRC § 409A and thus be subject to complying with the restrictions under that section or to the harsh tax results for failure to comply (including a 20% addition to tax and other severe measures).

(11) **Sale of Business Provisions**. In some circumstances it may be appropriate to include provisions to facilitate the sale of the business as a whole to a third party. The goals could be to protect the minority interest holders from being subjected to business control by someone they don't know or trust, or to allow a favorable transaction to proceed without the ability of a disgruntled minority to stop it or without the cost and hassle of dealing with dissenter's rights. For example, the majority owner may agree to make available to minority owners the benefit of any transaction to purchase the majority owner's interest by a private buyer or as part of a public offering (a "tag-along right" in the minority), or (along with the foregoing or separately) minority owners may agree to sell their interests to anyone offering to buy the majority owner's interests or all the interests in the business organization (including by merger or other reorganization or through a public offering) if certain terms or procedures are met (a "drag-along" right in the majority). Also, the owners could agree to consent to the sale by the organization of substantially all of its assets if certain terms or procedures are met. Similar provisions could be included with respect to registering securities if going public is a realistic future option for a business.

(12) **Noncompetition**. Noncompetition provisions are often contained in the buy-sell agreement; the consideration for these provisions will not be deductible by the organization but may be amortizable by it over a 15-year period where acquired in connection with the acquisition of a business (see IRC § 197; *Recovery Group, Inc. v. Com'r*, 652 F.3d 122 (1st Cir. 2011)). Payments under noncompete agreements may well be treated as a deferred compensation plan subject to the provisions and restrictions of IRC § 409A, and to the very harsh tax result if the terms of that section are not complied with.

Such provisions raise public policy concerns because economic competition is generally favored, and such provisions must be structured to comply with applicable state law. At a minimum they must be reasonable in time, geographic application, and scope of activities in order not to exceed the restriction necessary to protect a legitimate need of the business.

(a) Purposes. Some purposes have been found to legitimately allow certain covenants against competition.

(i) Protection of Goodwill. A business may depend on its reputation and goodwill with its customers to obtain a return on its investment greater than a passive investment such as a bank account. This may take many years of development and many dollars of investment to create, and may be a very important, or even the single most important, asset of the enterprise. This is particularly true of professionals providing services. It may not be fair to allow a professional or employee or active owner to build a personal reputation in the industry using this important asset, only to take the benefit of it away from the business when the person leaves the business. Most of the other purposes for covenants against competition are variations on this theme.

(ii) Protecting Confidential Information. It may be unfair to allow an employee or professional or owner to use certain information against the business that produced it. There may also be trade secret act protection available.

(iii) Protecting Investment in Employees. In order to encourage investment in employees or active owners, such as through training beyond a base level, it may be important to prevent an employee or owner from using that training to the competitive disadvantage of the business.

(iv) Protecting Customer Relationships. If an employee or owner develops a relationship with a customer on behalf of the business, it may be unfair to allow that employee or owner to deprive the business of the benefit of that relationship.

(b) Limitations on Use. Although there are circumstances where covenants against competition can legitimately be used, they should be restricted to protect the valid interests involved and not to go beyond this to restrict general competition of the sort a stranger could provide. The courts thus generally require such covenants to be reasonably limited. The limitations are as to:

(i) Span of Time. The restriction should not last longer than reasonably necessary.

(ii) Space of Application. The geographical area to which the restriction applies should be reasonable.

(iii) Scope of Activities. The restriction should be limited as to the activities involved to those reasonably necessary to protect a legitimate interest of the person benefitting from the restriction.

(iv) Special Restrictions. Some states impose special restrictions on covenants affecting competition by statute or by case law. Some of these are to deny enforceability except in specific circumstances (*e.g.*, business sales), to require the covenants be in writing, to require separate consideration, or to require no unconscionability or unfair bargaining power in their creation. See T. Leigh Anenson, the "Role of Equity in Employment Noncompetition Cases," 42 Am. Bus. L. J. 1 (Spring 2005) (possible unclean hands defense where employer enforces its own covenants while challenging other's covenants, at least in context of competitor's suit for tortious interference with contract). Beginning in 2016 Utah generally imposes a one year restriction on post-employment covenants not tied to the sale of a business. UCA § 34-51-201.

(c) Factors in Determining Reasonableness. These limitations (to the extent not imposed by a statute) are generally applied by use of a balancing process taking into account the relevant facts and circumstances. No particular easily definable weight can be given to any particular circumstance. How various factors are applied and weighted varies from jurisdiction to jurisdiction, and appears to vary over time, with the trend of the cases being to restrict such covenants more than they were restricted, say, 30 years ago. See Covenants Not to Compete, a State By State Survey, Tenth Ed., ABA 2015, as Supplemented. Some factors that may be important in a set of circumstances include:

(i) Level of Responsibility. A harsher covenant (*e.g.*, longer term, broader geographical coverage) may be enforceable against an employee or owner who is also the chief executive of the business than may be reasonable for a manager in the first year of employment without broader responsibilities.

(ii) Time and Space Relativity. Generally, the more space covered, the shorter the time element will need to be, and the longer the time, the narrower the space factor will need to be, but in either event there are certain (not very clear) outside limits beyond which neither element can go. A key element to a geographic limitation is the market area in which the business competes - where do the customers really come from. A key element to a time limitation is how long it will take the business to consolidate its position with its customers.

(iii) Scope Effects. If the covenant covers a narrower range of activities, such as being limited to not soliciting the particular customers with which the employee or owner had personal contact, a somewhat longer time element may be found enforceable.

(iv) Community Need. The perceived reasonableness of a covenant may be influenced by the effect its enforcement may have on the community as a whole, for example, eliminating needed medical skills or resources in an area of scarcity may be a factor in the health care industry. See S. Elizabeth Wilborn Malloy, "Physician Restrictive Covenants: The Neglect of Incumbent Patient Interests," 41 Wake Forest L. Rev. 189 (Spring 2006).

(v) Consideration Paid. Some states require adequate consideration or some particular type of consideration for such covenants. In other states, the amount paid for the covenant is one factor (among others) that relate to the reasonableness of the covenant.

(vi) Freedom of Contract. Freedom of contract considerations also are factors, and courts tend to try to enforce agreements freely entered into. This tendency may be of more influence in some states than in others, and can be overcome by indications of unfairness or overreaching in the bargaining process. Take it or leave it contracts of adhesion may be more carefully scrutinized for reasonableness than openly negotiated agreements between equals.

(vii) Type of Agreement. The reasonableness of a covenant may also be influenced by the type of agreement containing it. Sales of a business with the goodwill of the business may support a more restrictive covenant than an at-will employment agreement, because it may be unfair to allow a person to sell goodwill and then reduce its value by competing against the buyer.

(viii) Hardship. Some courts take into account the hardship on the individual restricted by the covenant. Others do not.

(13) **Other Provisions**. Provisions in corporate articles and bylaws or in partnership agreements or limited liability company operating agreements establishing or limiting control are also helpful. A restrictive legend should be placed on the stock certificates or any certificates for other sorts of organizational interests. See Uniform Commercial Code § 8-204. Mediation and arbitration provisions may be desirable. For partnership-taxed organizations, a provision forbidding transfers which may cause a deemed termination for partnership tax purposes can be useful. See IRC § 708. A provision acknowledging which party to the agreement was represented by which attorney, can be useful to prevent any misunderstanding that an attorney represented persons not actually represented.

C. **Tax Aspects of Corporate Transactions**. The most significant tax effects of consummating a corporate buy-sell arrangement include:

(1) **Effect on Parties to Corporate Cross Purchase**. A cross purchase sale of stock or the sale of stock to a third party receives the same treatment. Generally, the purchase price of a cross purchase agreement will be treated as proceeds from a sale of a capital asset subject to tax on the capital gain. In the event of death, because the basis of the stock will usually have been stepped up on death under IRC § 1014, if the sale occurs soon after the death there will generally not be any actual gain to recognize. The corporation recognizes no gain or loss. The buyer receives a cost basis for the shares purchased. However, the underlying assets of the corporation (either with or without an S-corporation election) will not be stepped up on death or any other transfer of stock; thus, the taxable gain inherent in those assets may well be an economic detriment to the corporation and its shareholders on disposition of the assets in the future. There will be one level of tax (at the shareholder level) on such a disposition by an S-corporation, but there will be two layers of tax (at the corporate level, and on distribution of proceeds by dividend or liquidating distribution, at the shareholder level) with respect to such a disposition by a C-corporation.

(2) **Effect on Parties to Corporate Redemptions**. A similar result will usually occur as well with respect to a redemption agreement, if the redemption is not treated as a dividend. In either event the redemption price is not deductible by the corporation, but its earnings and profits account will be reduced by the amount of the deemed dividend on the distribution if the redemption is treated as a disguised dividend, or by the amount of earnings and profits attributable to the shares redeemed if treated as a sale or exchange (IRC § 317(n)(7)). The remaining shareholders generally do not recognize income on the redemption, absent a disguised sale to other shareholders paid for by the corporation. The corporation recognizes no

gain or loss on a cash redemption, but if property is distributed, it will be deemed sold by the corporation whether the corporation is a C-corporation or an S-corporation. If the redemption is treated as a dividend, the whole amount (not just the gain portion) is taxed to the redeemed shareholder at ordinary income rates. Dividend treatment is avoided if:

(a) Substantially Disproportionate. The redemption is substantially disproportionate under IRC § 302(b)(2) because it reduces the shareholder's percentage interest below 80% of the shareholder's percentage interest before the redemption, and the shareholder ends up with less than 50% of the voting power. Stock ownership attribution rules apply under IRC § 318(a) in determining these percentages.

(b) Complete Termination. The redemption completely terminates the shareholder's interest in the corporation. IRC § 302(b)(3). Ownership attribution under IRC § 318 applies, but with a modification that prevents attribution to the shareholder of other family member's stock if the shareholder has no continuing interest of any kind as an officer, director, or employee or otherwise, except as a creditor, and if the shareholder does not acquire any interest (except by bequest or inheritance) for 10 years, and agrees to notify the Service of any disqualifying acquisition. IRC § 302(c)(2)(A).

(c) Not Substantially Equivalent. The redemption is not substantially equivalent to a dividend under IRC § 302(b)(1). This is a very difficult provision to use for planning purposes because it turns on a "meaningful reduction" of the stockholders proportionate interest. *U. S. v. Davis*, 397 U.S. 301 (1970). It is generally best to use this provision as a back-up only.

(d) Partial Liquidation. A partial liquidation under IRC § 302(b)(4) will avoid dividend treatment if: the redemption is from a noncorporate shareholder, the distribution is not essentially equivalent to a dividend (but determined at the corporate rather than the shareholder level), there is a plan of partial liquidation, the distribution is made in the year in which the plan was adopted or in the next year, and the corporation either ceases a trade or business conducted for 5 years (this active business requirement is analogous to the similar requirements under IRC § 355) which was not acquired in those 5 years in a taxable transaction (note: the purchase of stock of a corporation conducting such a business might work for a partial liquidation where it clearly will not work under the 5-year business requirements of IRC § 355 described below in the discussion D-Reorgs and split-ups under IRC § 355), or it distributes the assets of such a trade or business, but, in either event, afterwards continues in some other such 5-year trade or business. IRC § 302(e)(1).

(i) Uses. A partial liquidation is a useful way to obtain capital gain treatment on a distribution in a corporate contraction. However, the sale or distribution of the separate business leading to the distribution is generally taxable at the corporate level; if, on the other hand, IRC § 355 applies to the distribution of the stock of a controlled subsidiary, no tax at the corporate level occurs, thus IRC § 355 is generally better where it applies.

(ii) Non-pro rata. The distribution may be pro rata but does not need to be. Stock is deemed to have been given up where the liquidation distribution is pro rata. Rev. Rul. 90-13, 1990-1 C.B. 65. Otherwise, stock actually should be given up in a non-pro rata, partial liquidation distribution. A typical example is described in the cited Revenue Ruling: a sale by a corporation to a third party of one of two or more divisions for cash is followed by a pro rata distribution of the proceeds to the individual shareholders.

(iii) Pass-through organizations. Stock is attributed to the partners or beneficiaries of partnerships, trusts, and estates in order to determine whether the redemption is from noncorporate shareholders who are beneficially receiving the partially liquidating distribution. IRC § 302(e)(5). For a corporate shareholder, IRC § 1059 (basis reduction for extraordinary dividend) might apply.

(e) Estate Stock Redemption. A stock redemption to pay estate taxes and administrative expenses under IRC § 303 will also avoid dividend treatment. Hybrid agreements are possible where there is a corporate redemption for the amounts that qualify for IRC § 303 treatment, with the balance bought by the remaining stockholders, like a cross purchase agreement. This sort of redemption is discussed further below at N.

(3) **Special Concerns for S-Corporations**. S-corporations are domestic corporations with a valid S-election in place under IRC § 1361. In order to have a valid election, certain conditions must be met, including (but not limited to) (i) no more than 100 shareholders (after 2004), (ii) all shareholders are individuals (other than nonresident aliens or, in most cases, their spouses), decedents' estates, bankruptcy estates, certain limited kinds of trusts, or charities, or the corporation's stock may be 100% owned by another S-corporation, and (iii) there is only one class of stock. As long as the economics are the same (such as rights to dividends or liquidating distributions), there may be different classes varying only as to voting rights without violating the one class of stock requirement. IRC § 1361(b). If the corporation has a valid S-corp election in place, then with some exceptions, income is not taxed at the corporate level, but income, loss, deductions, and credits pass through to its shareholders. The pass-through feature of S-corporations makes them different from other corporations (called "C-corps") without the S-corp election.

(a) Sale of Stock for Cash. The gain of S-corp stockholders on the sale of their stock for cash will be the difference between the amount realized for their stock and their adjusted basis in their stock. IRC § 1001(a). This is generally true of a cross purchase, a redemption, or a sale to a third party.

(i) Redemption. Sales through redemptions can create some issues for an S-corp shareholder.

(A) Gain is figured in the usual way. However, a loss on the stock might not be deductible immediately on a stock redemption but the deduction would need to wait until an "inclusion date" when the seller's constructive ownership of stock is reduced (to treat the redemption as an exchange rather than a dividend under the substantially disproportionate rules) or all of the corporation's stock becomes worthless. IRC § 1368(b); Prop. Reg. §§ 1.302-5(a)(3), 1.302-5(e); see Eustice, Kunz, and Bogdanski, Federal Income Taxation of S Corporations, Fifth Ed. (2015) at ¶ 13.02[3][c].

(B) Also, the distributions from the corporation in redemption are treated differently from normal distributions, and, thus, who gets which type of distribution could be a matter for agreement. The seller may want to avoid regular distributions, which could carry out with them earnings and profits for dividend treatment. But where the corporation has no earnings and profits, this won't make a difference. Or the seller may want distribution treatment to offset basis first rather than prorata under an installment sale.

(ii) Basis of Stock. The basis of the stock will have been adjusted up and down over the years reflecting income and loss passing through the corporation and certain tax-free distributions. IRC § 1367. Also, the income or loss of the corporation in the year of sale will likely affect the basis of the stock sold so that the shareholders as sellers generally would not know the exact basis for their stock until after the end of the corporation's taxable year. If a party takes a position inconsistent with prior tax reporting, the adjusted basis element would allow the Service (or the seller) to adjust certain errors that may have been made in prior S-corporation years. The seller may want to consider asking the buyer for an agreement that the buyer and the corporation will maintain consistency with prior tax reporting. This should last for a minimum of three years after the seller files the tax return with respect to gain on the sale; perhaps the chance that a return extension will be needed should be taken into account in establishing the time period.

(iii) Book Closing. Income and loss generally pass through to shareholders on a per-share, per-day basis. IRC § 1377(a)(1). Where there is a 50% change of ownership during the year and the S-election terminates, then the normal per-share, per-day at-the- end-of-the-year rule does not apply. IRC § 1362(e)(6)(D). Also, however, where a stockholder's stock interest terminates during the year or the sale terminates the S-election, the corporation may close its books with appropriate consents or (in the case of a terminated S-election) the books may be closed automatically. IRC §§ 1362(e), 1377(a)(2). There are three book closing events which are applied in priority order so there is no overlap:

(A) the S-election is terminated (for example, by a sale to a nonqualifying person); this creates a new tax year;

(B) a complete termination of a shareholder's interest; the book closing is elective (IRC § 1377(a)(2)) with the consent of all affected shareholders (*i.e.*, the terminating shareholder and all to whom such shareholder transferred shares during the taxable year) and will be hypothetical as to the affected shareholders rather than actually creating a new return filing period, etc.; and

(C) a shareholder disposes of 20% or more of the outstanding stock during any 30-day period of the corporation's tax year, the corporation redeems 20% of its stock, or corporation issues to new shareholders shares equal to 25% of the prior shares outstanding; the book closing is elective, and this election allows separate treatment for the selling shareholders regarding income and other attribute allocations but does not create a new filing period. Regs. §1.1368-1(g)(2)(i).

(iv) Planning for Book Closing . The book closing rules may provide a planning opportunity for the buyer and seller who can calculate the effect of closing the books and compare this to the expected effects of not closing the books. For example, if the books were not closed in a situation where no income would pass to the seller and, say, $40 would pass to the buyer, but where if the books were closed $20 would pass to the seller and $20 to the buyer, then it may be better overall to close the books and for the seller to receive an allocation of income. Such a situation may arise when there is a sale at midyear where the business results for the first part of the year were to break even or incur a loss, and where the business results in the last part of the year more than make up for the poor first part of the year. The reason for this is that since the seller will be recognizing capital gain anyhow, the cost of the additional ordinary income to the seller is only the difference between the rates for capital gain and ordinary income, but the seller will have a $20 basis increase (the allocated income is not distributed) in his stock, reducing his gain on the sale. The buyer will save current ordinary income tax on the amount of income allocated to the seller. If these were the economics, it may be possible to structure a transaction better for both the buyer and the seller and not so good for the U.S. Treasury.

(v) Capital Gain. The gain of the shareholders would be taxed in the normal way at capital gain rates, assuming a long-term investment in the stock.

(vi) Matters for Agreement. Buyer and seller will want to agree on some tax related points in the sale transaction. See J. Eustice, J. Kuntz, J. Bogdanski Federal Income Taxation of S Corporations, Fifth Edition, Warren Gorham and Lamont, 2015 at ¶13.06[5][c][iv]:

(A) Whether the S-election will continue through the end of the corporation's tax year. A retroactive revocation could lead to a nasty surprise. The S-corp revocation would only be an issue if it occurred on or before the 15th day of the third month of the corporation's taxable year and, thus, depending on the corporation's tax year, may or may not create a risk.

(B) The effective date of the sale.

(C) Whether the corporation will attempt to change its accounting methods, which it could do retroactively with the consent of the Service even to the detriment of the selling shareholder.

(D) Whether an election to close the corporation's books will be made. If income were to flow through to the seller, the seller's stock basis will increase and its favorably taxed capital gain will consequently decrease.

(E) If the S-election will end (*e.g.*, too many or wrong kind of shareholders will exist) whether an election under IRC §1362(e)(3) to allocate income and deductions between a short S-election year and a short C-corp year will be made.

(vii) Tax Indemnity. Sometimes a buyer will agree to a tax indemnity provision and not close the corporate books. This may help with solving the foregoing problems. However, it may be a good idea for the tax indemnity from the buyer to cover not only the income tax on the corporate income itself, but also the additional tax from reduction of capital gain treatment on the stock, and the tax on receipt of the indemnity payment itself.

(b) Dividend. If the corporation has accumulated earnings and profits from an earlier time when it was a C-corp, then it is possible for a shareholder to receive a dividend taxed at ordinary income rates on a redemption (and on certain other events, as well, such as current distributions sufficiently large to go through the other available accounts for distributable income and reach into the earnings and profits account, or on a liquidating distribution). Exceptions to dividend treatment are described in the general discussion of corporate redemptions above.

(c) Basis at Death. Partnership-taxed organizations allow tax-free, in-kind liquidating distribution and allow (with the proper IRC § 754 election) the underlying assets of the partnership to be stepped up on the death of a member or partner; these important benefits are unavailable to corporations with or without the S election. The best that can be achieved in the corporate context would be for an S corporation, after the death of a shareholder, to sell everything to a third party and liquidate in one year so that gain from the sale creates a basis increase resulting from that gain, which can be added to the step-up basis in the stock at death, producing a loss on liquidation, which offsets the gain on sale. This is often impractical and to the extent depreciable assets are held, recapture (see IRC § 1239) will reduce its effectiveness as a tax strategy.

(4) **Divisive Reorganizations and Split-ups**. Corporations, whether a C-corp or an S-corp, may use the reorganization provisions of the corporate tax law in order to restructure on a tax-deferred basis in some circumstances. See IRC § 368(a)(1)(A) through (G); the types of reorganizations are labeled with the designation of the subsection, A through G, of IRC § 368(a)(1), which describes the transaction. Some of the reorganization provisions are designed for acquisitions (*e.g.*, type A mergers, type B stock for stock transactions, type C stock for asset transactions), and some have other special purposes (*e.g.*, type E recapitalizations, type F mere change in form, type G bankruptcy reorganizations). Here, however, we will deal with divisive reorganizations and stock distributions in split-ups or split-offs designed to allow corporations with two or more active businesses to divide those businesses among shareholders without incurring an immediate tax to the corporation or its shareholders. Transactions known as type D reorganizations may be quite useful in dividing corporations and even have some limited use in acquisitions where the requirements of IRC § 354 are met. The divisive reorganizations under IRC § 368(a)(1)(D) also need to meet the requirements of IRC § 355 relating to tax-free stock distributions. If business assets are not already divided into separate corporations so that

creating a new subsidiary or contributing additional assets to an existing subsidiary will be part of the transaction, qualifying as a D Reorg may be necessary; but where subsidiaries for distribution already exist, IRC § 355 can operate on its own to protect the distribution. Thus, the key to a tax-free division is IRC § 355, which is also subject to the judicially created doctrines applicable to reorganizations (*i.e.*, whether or not a D-Reorg is involved).

Each form of reorganization has its own technical requirements under the Code, and, in addition to the technical requirements, there are the judicially created requirements of continuity of proprietary interest, business purpose, and continuity of business enterprise. Let's review these and then return to the technical requirements of corporate divisions subject to IRC ' 355.

(a) Judicially Created Requirements. Courts have developed tests to distinguish real reorganizations deserving of tax-deferred treatment from sales or exchanges which should be taxable. These tests apply in addition to statutory requirements. To some extent, these doctrines have been codified in some provisions of the Code and Regulations but the judicial doctrines retain independent vitality where not superseded by a specific statutory provision.

(i) Continuity of Interest. The single biggest difference between a sale or other taxable transaction (*e.g.*, a liquidation or redemption) and a reorganization is that some substantial part of the proprietary interest in the target (or in a division, the affected corporations) continues after the transaction. The continuity must be provided through stock of the acquirer (or in a division, of the affected corporations), whether voting or nonvoting, common or preferred; long-term debt, warrants, convertible debt, etc., are not sufficient. The issue is how large a proportion of the shareholder's equity must remain. It must at least be a "substantial portion" of the total consideration. *Helvering v. Minnesota Tea Co*., 296 U.S. 378 (1935). For purposes of the divisive D Reorg, there is a statutory 80 % control requirement, as described below.

(ii) Business Purpose. The reorganization must be "undertaken for reasons germane to the continuance of the business of a corporation." Regs. § 1.368-2(g); see also Regs. § 1.368-1(c). The business purpose doctrine is a variation on the general substance over form concerns throughout tax law. If there is no purpose other than tax avoidance, the transaction may be recharacterized. However, in the reorganization area in particular, the Service wants more than this, it wants an affirmative statement of a valid nontax business purpose for any private letter ruling. If there is such a purpose, the transaction may be structured to increase its after-tax value. For purposes of a divisive distribution under IRC § 355, the business purpose must relate both to the division of the business assets and to the distribution of the stock, where the purpose can't otherwise be achieved by some other tax-free transaction. Regs. § 1.355-2(b)(3). See Regs. § 1.355-2(b)(5) Ex. (3) (separate corporation enough to meet risk protection purpose; distribution not required). Non-pro rata distributions to solve a bona-fide business dispute among shareholders should generally be a sufficient business purpose.

(iii) Continuity of Business Enterprise. For a reorganization generally, the corporation's shareholders should retain an interest in what is fundamentally the same business enterprise. The transferee corporation needs to continue a line of the corporation's historic business or use a significant portion of the corporation's historic business assets, even if in a different line of business. See Regs. § 1.368-1(d)(2); Cf. Rev. Proc. 99-3, 1999-1 IRB 103. Special rules apply in D Reorgs because they require a distribution qualifying under IRC '' 354, 355, or 356. Among other things, there are specific 5-year active business requirements under IRC ' 355.

(b) Types of Divisive Transactions. There are three main types of divisive tax-deferred transaction under IRC ' 355, each of which has its particular uses.

(i) Spin-off. A spin-off is the pro rata distribution by a corporation to its shareholders of the stock of a subsidiary, whether newly created or already existing. If the distribution qualifies under IRC ' 355, a taxable dividend is avoided.

(ii) Split-off. In a split-off, a corporation distributed stock of a subsidiary to some of its shareholders in exchange for those shareholders' shares in the distributing corporation. If the distribution qualifies under IRC ' 355, a taxable redemption is avoided. This form of transaction is very useful in dividing a corporation between feuding factions of shareholders.

(iii) Split-up. A split-up involves a corporation distributing to its shareholders stock in two or more subsidiaries and then dissolving. If the distribution qualifies under IRC ' 355, a taxable liquidation is avoided. This form of transaction is also quite useful for divisions between feuding factions, particularly where the shareholders desire that the corporate history of the parent corporation be eliminated.

(c) Requirements of IRC ' 355. In order to obtain the tax-deferral benefit for shareholders, the provisions of IRC ' 355 must be met as part of the spin-off, split-off, or split-up distribution transaction. There must, of course, be a distribution, but the distribution need not be pro rata among shareholders. IRC ' 355(a)(2)(A). This is what allows a distribution to one feuding faction so that the factions can go their separate ways. In somewhat simplified form, the main requirements of IRC ' 355 are:

(i) No Device. The transaction must not be a device for distributing earnings and profits (*i.e.*, it cannot be used as a disguised dividend). A quick later sale of stock received in a distribution, for example, can create an issue under this requirement. IRC ' 355(a)(1)(B).

(ii) Control. The distributing corporation must before the distribution have control over the corporation, the stock of which will be distributed. Control means owing voting stock with at least 80% of the total combined voting power and owning 80% of the total number of shares of all other classes. IRC ' 368(c) defines control for this purpose.

The distribution must be of stock carrying such 80% control. Any retention of some stock in the corporation (the other stock of which is distributed) must be established, to the satisfaction of the Treasury Department, not to have a principal purpose of avoiding federal income tax. IRC ' 355(a)(1)(D). Where it is necessary to create a new subsidiary to allow a split-off or split-up, the D-Reorg provisions of IRC ' 368(a)(1)(D) are helpful, because they allow as a tax-deferred reorganization the transfer of corporate assets to another corporation where after the transfer control of the transferee resides in the transferor corporation, one or more of its shareholders, including persons who were shareholders immediately before the transfer, or any combination of these.

(iii) <u>5-year Active Business</u>. After the distribution, either both the distributing corporation and the controlled corporation, the stock of which was distributed are in an active 5-year trade or business, or else the distributing corporation had nothing else but the stock of the subsidiaries which was distributed, and those subsidiaries are each in a 5-year active trade or business. IRC ' 355(b)(1)(A) and (B).

(A) The 5-year active business requirement means that there must be two (or more) active trades or businesses conducted for 5 years ending on the date of the distribution, the business was not acquired within that period in a taxable transaction (typically a purchase), and was not conducted by another corporation control over which was acquired in that period by the distributing corporation in a taxable transaction. IRC ' 355(b)(2).

(B) The active business needs to be a substantial portion of the corporation's assets. If the active business is too low a portion and liquid financial assets are too great a portion, there may well be a "device" to distribute earnings and profits. <u>See</u> Regs. § 1.355-2(d)(2)(iv)(A) (takes into account "the nature, kind, and amount of the assets of both corporations (and corporations controlled by them) immediately after the transaction").

(C) Each business must have its own 5-year history. An expansion in the same line of business may be able to tack on the history of the earlier existing operation if closely enough connected, but if the expansion is viable on its own, then it may not be able to tack on the earlier history. <u>See</u> Regs. §§ 1.355-3(b)(3)(ii) and 1.355-3(c), Exs. (7) (new store expansion to suburbs) and (8) (purchase of store in another state). Vertical or all-function divisions, such as those described in examples (7) and (8) of the above cited regulations, may be easier to qualify as separate active businesses on their division than horizontal divisions of particular functions of an integrated business. If the post-distribution activities of the divided-out function are mostly with the distributing corporation or affiliates, rather than with third parties, the distribution may be a "device" (under IRC ' 355(a)(1)(B)) to distribute earnings and profits. Regs. §§ 1.355-2(d)(2)(iv)(C) and 1.355-3(c), Exs. (9) through (11).

(d) <u>Effect of the Distribution on the Distributing Corporation</u>. The effect to the distributing corporation will be very similar whether or not a D-Reorg is involved (a D-Reorg will be involved where a new subsidiary is created or assets are transferred to an existing subsidiary as part of the transaction involving the distribution). The effects where the

D-Reorg applies are governed by IRC ' 361(a); where no such reorganization is necessary but IRC ' 355 operates on its own, the effects are governed by IRC ' 355(c)-(e).

(i) Gain or Loss. In either event, the distributing corporation normally does not recognize gain or loss or the distribution of stock or securities of the controlled corporation. IRC '§ 355(c); 361(c). However, if some other nonqualifying property is distributed, as well, gain is recognized as if that property had been sold; no loss is recognized unless there is a liquidation of the distributing corporation (*i.e.*, a split-up). IRC ' 311(a). If there is a liquidation, loss may be recognized if not otherwise prevented by IRC ' 336(d). Unless any assumed liabilities in the D-Reorg transaction exceed the basis of the assets contributed to the subsidiary, the assumption by the transferee subsidiary of liabilities of the transferor makes no difference. However, where such liabilities exceed such basis, the transferor corporation recognizes gain to the extent the amount of the assumed liabilities exceeds that basis. IRC ' 357(c).

(ii) Earnings and Profits. The earnings and profits of the distributing corporation must be allocated or adjusted between the distributing corporation and the distributed corporation.

(A) Where the transaction involves a D-Reorg (newly created subsidiary or assets contributed to existing subsidiary), the earnings and profits must be allocated where the transferred asset includes an active trade or business. IRC ' 312(h); Regs. § 1,312-10(a). Deficits in the earnings and profits of the contributing corporation are not reallocated. Regs. § 1.312-10(c). Allocation is typically by fair market value of the businesses or property interests immediately after the transaction, but may, in proper cases, be by the proportion of the "net basis" of assets (aggregate basis less liabilities) or other method appropriate under the facts and circumstances. Regs. § 1.312-10(a).

(B) Where IRC ' 355 applies without a D-Reorg, the earnings and profits are not allocated but are adjusted under Regs. § 1.312-10(b). The distributing corporation's earnings and profits are reduced by the lesser of either the earnings and profits that would have been allocated if the stock being distributed had instead been contributed to a new corporation in a D-Reorg as described above (and the new corporation's stock had been distributed), or else the amount by which the basis of the controlled corporation's assets plus cash exceeds its liabilities. Regs. §1.312-10(b). The controlled corporation picks up the earnings and profits so reduced, but only if the amount of the reduction is greater than the earnings and profits the controlled corporation already has. Thus, the result is that the controlled corporation (the stock of which is distributed under IRC ' 355) ends up with earnings and profits immediately after the transaction which are the greater of that reduction in the distributing corporation's earnings and profits, or the earnings and profits the controlled corporation had just before the transaction. The controlled corporation just keeps its own earnings and profits where the reduction in the earnings and profits of the distributing corporation is less. Regs. § 1.312-10(h) (last paragraph).

(C) It is not clear that the accumulated adjustment account of an S-corp is similarly allocated as a general matter in a D-Reorg. The regulation on point only deals with situations in which the distributing S-corp has its own earnings and profits, a trade or business is contributed to another corporation in a D-Reorg, and an immediate distribution of the controlled corporation's stock or securities occurs immediately. In such a particular case, which by no means covers all possibilities, the allocation of the accumulated adjustments account is allocated in a manner similar to earnings and profits. Regs. § 1.368-2(d)(3). Beyond this, it is not clear what happens, but as a policy matter, the general treatment of accumulated adjustments in the same way as earnings profits makes sense.

(iii) Tax History. IRC § 381 is the only way a tax history can survive in another organization in a Reorg, and that section does not apply to a D-Reorg. The distributing corporation keeps its tax history, except that in a split-up, the tax history disappears on the liquidation of the distributing corporation. It is possible that IRC § 382 could limit the use of the loss carryovers of either the distributing or controlled corporations where there is a non-pro rata split-off because this could result in an ownership shift in a 5% stockholder or an equity structure shift.

(iv) Basis; Holding Period. In a D-Reorg, the corporation receiving assets also receives a carryover basis and holding period in those assets. IRC §§ 362(b), 1223(2).

(e) Effect on Stockholders. The tax effect on the stockholders (or security holders, if applicable) receiving the distributed stock is that they do not recognize income, gain, or loss, as to this distribution in the transaction. IRC § 355(a)(1).

(i) Boot. If the stockholders (or security holders) also receive anything other than the distributed stock (the other property is called "boot" in tax jargon) then income and gain will generally be recognized.

(A) Exchange. Where the stockholder gives up stock in the distributing corporation (*e.g.*, a split-off) this is an exchange and gain but not loss will be recognized on the receipt of the boot, up to the amount of the boot. Thus, if the gain (calculated by adding the boot to the value of the stock received, then reducing this by the basis of the stock given up) is more than boot, all the gain up to (but not over) the amount of boot is recognized. IRC § 356(a)(1) and (c). If the gain recognized is equivalent to a dividend, it is taxed as such. If the boot received in exchange for stock does not qualify for an exception to dividend equivalence, it will be treated as a dividend. These exceptions are described above in the discussion of redemptions. See, *e.g.*, IRC § 302(b)(2) (providing a substantially disproportionate test for not being essentially equivalent to a dividend; this can be a key test to meet in a disproportionate split-off); IRC § 302(b)(3) (complete termination test). If dividend treatment does not apply, the gain will receive capital gain treatment.

(B) No Exchange. Where the stockholder does not give up stock in the distributing corporation on receiving the distribution of the distributed stock (*e.g.*, in a spinoff), then boot is a dividend under IRC § 301 to the extent of the distributing corporation's earnings and profits.

(C) Special Boot. Some stock distributed could itself be boot if the stock was recently purchased (within 5 years) by the distributing corporation (IRC § 355(a)(3)(B)) or if the stock is a type of preferred stock deemed too much like debt (See IRC §§ 355(a)(3)(D), 351(g)(2)). Excess principal amounts received in an exchange of securities, or securities surrendered which have accrued but unpaid interest, can create boot. IRC §§ 355(a)(3)(H) and (a)(3)(C).

(ii) Basis. The basis of the stock received by the stockholder in the distribution is treated as received in an exchange, whether or not there really is an exchange. Where no actual exchange occurs, the retained stock is treated as if given up and then received back in an exchange. Thus, whether or not a real exchange occurs, the basis in the property received (or deemed received) is the basis of the property given up (or deemed given up), less the fair market value of any boot received, but increased by any recognized gain or dividend income. IRC § 358(a)(1). The boot received takes a fair market value basis. IRC § 358(a)(2). The basis of a shareholder in various blocks of the given up (or deemed given up) stock of the distributing corporation must be allocated between the stock received (or deemed received) and in various classes based on principles relating to market values. See Regs. §§ 1.358-2(a)(2)(iv) and 1.358-2(c) Ex. 12; 1.358-2(a)(2)(vii) and 1.358-2(c) Ex. 13; 1.358-2(a)(2)(v).

(iii) Holding Period. The holding period of stock received without gain or loss on the distribution includes the holding period of the stock given up by the stockholder in a split-off or split-up, or retained by the stockholder in a spin-off. IRC § 1223(1). For boot, the holding period starts at the distribution.

D. **Partnership Transactions**. Rather different rules than those applicable to corporations apply to transactions involving partnership-taxed organizations. Although partnership-taxed organizations, such as most limited liability companies, are extremely popular, many planners are not as familiar with these rules as they are with the rules for corporations; thus, we will look at these rules in some detail. It is important to analyze the effects of the transaction from an "aggregate" perspective on each remaining partner or member as well as on the company and the deceased or leaving partner or member. The planner will want to keep a close eye on shifts in what are called "hot assets" and in shares of company liabilities. Let's refer to the organization as simply the "partnership," even though it may be a limited liability company, and let's refer to partners or members as simply "partners." When pursuant to a buy-sell agreement, a partner reduces his or her investment in the partnership, in whole or in part, during life or at death, but the partnership is not totally dissolved and liquidated, the choices available are: distributions (for a partial reduction), liquidation of the partner's interest (like a redemption of the entire interest), and sales of all or part of the partnership interests.

(1) **Distributions**. Distributions can be made during the life of the partnership or upon liquidation of a partner's interest. There are some differences between these two situations, although the general thrust of the rules is similar.

(a) General Rules of Partner Gain or Loss. Partners usually recognize gain on distributions only to the extent the cash distributed exceeds the basis of the partner's partnership interest. IRC § 731(a)(1). Subject to special rules relating to hot assets, there is generally no gain recognized on the distribution of assets other than cash. Thus, if it is desired to postpone the gain, assets other than cash should be the only assets distributed. The gain is treated as relating to the sale or exchange of the partnership interest. No loss is recognized, except in some cases of liquidating distributions, because the transaction will not be deemed to be closed. (If a loss is desired to be recognized, some or all of the partnership interest should be sold.)

(b) Partner Basis Effects. The partner's basis in his or her partnership interest is adjusted by decreasing it in the amount of cash and the basis of partnership property distributed to the partner. IRC § 733. If a partner receives partnership property in a nonliquidating distribution, his or her basis in that property is the same as was the partnership's, but not above the partner's own basis in his or her partnership interest just prior to the distribution. IRC § 732(a). The basis of property other than cash distributed in liquidation will be the partner's basis in his or her partnership interest immediately before the distribution, reduced by any cash received as part of the liquidating distribution. IRC § 732(b).

(c) Hot Assets. Items known as "hot assets" get some special treatment designed to prevent transforming what should be ordinary income into capital gain. Hot assets include inventory (meaning any inventory for some purposes such as a sale of partner's interest, but substantially-appreciated inventory for other purposes, such as a distribution) and unrealized accounts receivable. Unrealized receivables include typical trade receivables for goods or services but, as defined in IRC § 751(c), also include a laundry list of items with special tax treatment, such as depreciation recapture and market discount. These recapture-type items are thus treated as if they were a form of property.

(i) Special rules apply to distributions of hot assets, which may make the gain on resale of these items ordinary. IRC §§ 735(a) and (b), 751. Unrealized accounts will create ordinary gain or loss without a time limit on disposition, and inventory items (whether or not substantially appreciated) disposed of within 5 years of the distribution will create ordinary gain or loss, even though the property may have ceased to be inventory in the hands of the distributee partner.

(ii) Further, if an uneven distribution of hot assets diminishes the partner's interest in nonhot assets, or vice versa, if such a distribution of nonhot assets diminishes the partner's interest in hot assets, there will be, in essence, a deemed sale or exchange of the one class of assets for the other, and the partner or the partnership (or both) may recognize gain or loss, which will be ordinary with respect to the hot assets, and capital with respect to the nonhot assets. IRC § 751(b). Substantially appreciated inventory is a hot asset for this purpose. Cash is a nonhot asset, and a cash distribution could trigger IRC § 751(b) "sale" treatment where, for example, it diminishes the interest of the partner in unrealized receivables.

(A) There is an exception for the return to a partner of a particular property contributed. IRC § 751(b)(2)(A).

(B) We will deal further below with liquidations of a partner's interest and IRC § 736, but it should be noted now that hot assets will have an effect in a great many situations there, as well as in the case of nonliquidating distributions. Payments to liquidate the interest of a retiring or deceased partner fit into one of two categories under IRC § 736. Payments under IRC § 736(a) (as a distributive share of income or as a guaranteed payment) are not subject to the IRC § 751(b) deemed sale treatment. IRC § 751(b)(2)(B). On the other hand, payments under IRC § 736(b) (relating to the interest of the partner in partnership property) are generally subject to the IRC § 751(b) treatment where unrealized receivables or substantially appreciated inventory is involved. However, there is a further exception for the share of normal trade unrealized receivables of a retiring or deceased general partner of a service partnership (*i.e.*, where capital is not a material income producing factor); payments with respect to such receivables are excluded from IRC § 736(b) and thus are covered by IRC § 736(a) and the exception to IRC § 751(b) deemed sale treatment. But there is an exception to the exception such that recapture-type items treated as unrealized receivables under IRC § 751(c) remain subject to IRC § 751(b) treatment, even where the normal receivables of a service general partner do not.

(C) Certain reorganizations or realignments with a business purpose and without tax avoidance motive may be able to avoid IRC § 751(b) treatment. See PLR 8619015, PLR 8514035, and PLR 8838063 as supplemented by PLR 8851005.

(D) Also, IRC § 751(b) treatment "does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital." Regs. § 1.751-1(b)(1)(ii).

(E) Inventory will be substantially appreciated inventory, decided on an all or none basis, if its value exceeds 120% of its adjusted basis. IRC § 751(b)(3). In order to avoid manipulations from the acquisition of additional, nonappreciated inventory, inventory is excluded from use in applying this rule if the principal purpose for acquiring the inventory was to avoid the special rules on substantially appreciated inventory. IRC § 751(d)(1)(B).

(F) Remember that, as described above, unrealized receivables include numerous recapture-type items. IRC § 751(c).

(d) Liquidating Losses. Liquidating distributions may result in loss. If only cash or hot assets are distributed in liquidation of a partner's interest loss will be recognized if the amount of cash received and the partnership's basis in the hot assets is less than the basis of the partner's partnership interest. Loss recognition will be postponed if any other asset, even with little value, is distributed. Regs. § 1.731-1(a)(2).

(e) Reduction of Liabilities. A reduction in the partner's share of partnership liabilities will be treated as a deemed distribution of cash (IRC § 752(b)) which may cause a gain to be recognized if the deemed distribution exceeds the partner's basis in his or her partnership interest. IRC § 731(a).

(f) Partnership Gain or Loss. The partnership itself does not generally recognize gain or loss on a distribution of cash or property to a partner. IRC § 731(b). There are exceptions (i) for payments by a continuing partnership to retiring or deceased partners for their interest in partnership assets in liquidation of their partnership interests (IRC § 736(b)) where the payments involve an exchange of unrealized receivables or substantially appreciated inventory (*i.e.*, "hot assets") (IRC § 751(b)), and (ii) for other nonliquidating uneven distributions of hot assets or of nonhot assets (IRC § 751(b)(ii)). In such cases, the partnership may be treated as having, in essence, sold an interest in either the hot assets or in the nonhot assets and thus may recognize gain or loss.

(g) Seven-year Taint. Built-in gains or losses may be recognized if property has been contributed to the partnership within seven years.

(i) If appreciated or depreciated property has been so contributed, then as of the distribution of it to any other partner, the contributing partner will recognize gain (or loss) in the amount of the built-in gain (or loss) which existed at the time of contribution determined as if the property had been sold at the date of distribution. IRC § 704(c)(1)(B). (There may be an exception where like kind exchange property is distributed to the contributing partner (see IRC § 704(c)(2)).)

(ii) Further, in the case of a distribution of some other property to a partner who contributed appreciated property in the previous seven years, the contributing partner will recognize gain equal to (i) the net built-in gain at the time of contribution, or (ii) if less, the excess of the value of the distributed property over the basis of the partner's partnership interest, reduced, but not below zero, by money received in the distribution. IRC § 737(a).

(iii) There is an exception, however, for the return to the distributee partner of the property earlier contributed. IRC § § 737(d) and 704(c)(1)(B).

(2) **Liquidation of a Partnership Interest on Death or Retirement**. A partnership interest may be completely disposed of on death or retirement by liquidating the entire partnership (treated as distributions; see IRC §§ 731, 732, and 751 and the discussion above), by selling the partnership interest to another person (an existing partner or a third party) (see IRC §§ 741 and 751 and the discussion below), or by liquidating the interest of the deceased or retiring partner by the continuing partnership (this form of transaction is analogous to a corporate redemption, except for tax consequences) (see IRC § 736). Let's look at such liquidations of partnership interests.

Payments in liquidation of a partner's interest under IRC § 736 come in two varieties, those made in exchange for the partner's interest in partnership property which are thus capital in nature (IRC § 736(b)), and those for something else, which are treated as ordinary in nature (IRC § 736(a)). The payments in exchange for partnership property generally result in capital gain or loss to the receiving partner and provide no deduction to the partnership. Other payments (IRC § 736(a)) are either a share of income or are guaranteed payments under IRC § 707, depending on whether the amount of the payment is determined by reference to partnership income or not; these payments result in ordinary income to the receiving partner and reduce the income of the remaining partners. To the extent a payment under IRC § 736(a) is treated as a guaranteed payment (rather than a distributive share of income), it is deductible by the partnership. (IRC § 707(c) capitalization does not apply to IRC § 736(a)(2) payments. Regs. §§ 1.736-1(a)(4) and 1.717-1(c).) Guaranteed payments do not affect capital accounts. Regs. § 1.704-1(b)(2)(iv)(o). In allocating payments between those covered by IRC § 736(b) (capital in nature) and those covered by IRC § 736(a) (ordinary in nature), two types of partnership get two different treatments with respect to unrealized receivables and goodwill.

(a) General Partners in Service Partnerships. Partnerships where capital is not a material income producing factor, generally service partnerships such as law and accounting firms, physicians, architects, etc., do not treat payments to a general partner with respect to unrealized normal trade receivables as being in exchange for the partner's interest in partnership property, and the same holds true for goodwill unless the partnership agreement provides for a payment for goodwill. IRC § 736(b) and (c). Thus, these items will generally result in ordinary income to the retiring or deceased partner and reduce income for the remaining partners. Although not clear, it may be that limited liability company member managers, or all members where none are managers, should be treated as general partners for this purpose. See Rev. Proc. 95-10, 1995-1 C.B. 501 (treating member managers as general partners for other purpose).

(b) Other Partnerships. Other partnerships and partners who are not general partners, on the other hand, will treat payments in exchange for unrealized receivables and goodwill as being in exchange for partnership property. This results in ordinary gain or loss as to the receivables and capital gain or loss as to the goodwill. If the partnership makes a basis step-up election under IRC § 754, the basis of the retiring partner's share of goodwill, will be stepped up in the hands of the partnership and the partnership will obtain an amortization deduction for the intangible asset under IRC § 197 (see House Ways and Means Committee Rept. p. 775, on Act § 13261).

(c) Hot Assets. As discussed above, a distribution which results in the reduction of a share of hot assets or of nonhot assets can trigger gain or loss to the partner, the partnership, or both under IRC § 751(b). For a number of purposes, other than IRC § 736 liquidation payments, "unrealized receivables" includes a variety of recapture and other ordinary income-generating items. IRC § 751(c). However, since such recapture items are not unrealized receivables for purposes of IRC § 736 pursuant to the IRC § 751(c) definition, the exception in IRC § 736(b)(2) for the unrealized receivables of general partners in a service partnership (where capital is not a material income-producing factor) will not apply, and thus IRC § 751(b) deemed sale treatment will apply to distributions in exchange for potential recapture-type items, such as

IRC § 1245 depreciation recapture or market discount, even if IRC § 751(b) does not apply to the ordinary service trade receivables of the service general partnership.

(d) Typical Results. The result of a cash payment with respect to the share of receivables of a retiring or deceased partner who is not a general partner or of any partner in a capital intensive partnership is often (i) ordinary income to the partner, thus accelerating income to the partner (who is treated as having sold his share of the receivables), (ii) no timing benefit for the partnership which will, however, obtain an increase in basis for its receivables (it just paid for an additional share of them), and (iii) no gain or loss to the partnership with respect to the exchange of cash for the receivables (although cash is a nonhot asset, it can't be sold to trigger gain or loss). If, however, the interest of the partnership in some other asset decreases, that other asset could be deemed sold to that extent, triggering gain or loss to the partnership. Thus, it is important to review what happens with respect to each class of asset as to each side of the transaction.

(e) Installment Liquidations. Even if no longer a state law partner or member, until all liquidation payments are made, the withdrawing member remains a tax partner. Regs. § 1.736-1(b)(5) and (6). Where installment liquidation payments are made, each installment is allocated between IRC § 736(a) and IRC § 736(b) amounts. Losses are not recognized until the end. Generally, fixed payments are allocated ratably and contingent payments are allocated first to IRC § 736(b). Regs. § 1.736-1(b)(5)(i). The partners may agree to a different timing and allocation so long as the amounts allocated to the IRC § 736(b) portion equal the value of the partner's share of partnership property. Regs. § 1.736-1(b)(6). This could accelerate the leaving partner's ordinary income and the partnership's deduction for IRC § 736(a) amounts, and could delay an IRC § 754 basis adjustment for partnership property since it won't apply until gain is recognized by the leaving partner. Rev. Rul. 93-13, 1993-1 C.B. 126.

(i) If payments for goodwill are specified in the partnership agreement pursuant to IRC § 736(b)(2)(B), then each installment payment creates a new goodwill asset amortizable by the partnership over 15 years. Regs. § 1.734-1(e)(1), Rev. Rul. 93-13. The time value of such a serial amortization sequence will generally be less than an up-front payment with immediate amortization.

(ii) Payments to a retired partner under IRC § 736(a) (ordinary income) are taxed on the return for the year for which the payments are made, rather than the year of receipt (possibly accelerating the tax). Regs. § 1.736-1(a)(5). Installment reporting rules generally do not apply to IRC § 736 redemption payments since they are taxed under IRC § 731 (except, of course, hot assets under IRC § 751(b)). See Regs. § 1.736-1(b)(6). Thus, basis is recovered first, often producing a tax deferral greater than that available under the installment reporting rules, a deferral benefit not available for corporations, whether a C or S corporation.

(iii)An installment liquidation of a member's interest also appears to eliminate interest on deferred taxes under IRC § 453A if it would apply (generally, all installment obligations held by the taxpayer exceed $5 Million), and arguably may also prevent the deemed interest rules (IRC §§ 483, 1272, and 7872) from applying because any interest-like component of the payment is a guaranteed payment for the use of capital under IRC § 707(c) and should not be treated like real interest. See IRC § 736(a)(2), which treats payments not determined by profits as guaranteed payments.

(3) **Sale of Partnership Interest**. The sale or exchange of a partnership interest results in capital gain except that the amounts attributable to the hot assets of accounts receivable and inventory, even if not substantially appreciated, will be treated as ordinary income, and investment tax credit may be recaptured. IRC §§ 741, 751(a); on credit recapture, see IRC § 50(a)(1) and Regulations under prior IRC § 47(a)(1). Gain or loss is measured by a hypothetical sale at fair market value (but not less than any nonrecourse debt to which the property is subject) and includes remedial allocations under Regs. § 1.704-3(d). Regs. § 1.751-1(a)(2).

(a) Later Income from Hot Assets. The buyer may be able to exclude income later received from the hot assets if an election under IRC § 754 is made to adjust the basis of partnership property.

(b) Tax Year Closure for Seller. The selling partner must take into account all profits and losses to the time of sale and, as to the selling partner only, the partnership tax year ends.

(c) Receivables. Again, recall that unrealized receivables include a number of recapture-type items under IRC § 751(c).

(d) Look-through Gain. Also, some of the capital gain on sale of a partnership interest will be treated as look-through gain for applying the different applicable capital gain rates to the portion attributable to unrealized appreciation of collectibles ("collectibles gain") and unrecaptured Section 1250 gain. IRC § 1(h)(5), (6), and (9) and Regs. § 1.1(h)-1.

(4) **Comparison of Sale of Interest and Liquidation of Interest**. The two major forms of transaction used in buy-sell arrangements, sales of membership interests to remaining members or the liquidation of a member's interest by the company (similar to a corporate redemption), have similar economic results in that the deceased or withdrawing member receives a price and the remaining members' shares increase proportionately. However, the tax results between the two forms of transaction can be significantly different. The following chart may help summarize the usual key tax differences between the forms of transaction.

Issue	Sale of Membership Interest	Liquidation of Membership Interest
General Character of Gain (Loss) and Deductibility of Payments	Generally, capital in nature to seller; no flexibility to obtain partnership deductions. Amounts for the "hot assets"	Divided into § 736(a) share of income or guaranteed payment, (even if for goodwill of a

	of accounts receivable and inventory will be ordinary, and investment credit may be recaptured. Later income to buyer from the hot assets may be excluded, however, if § 754 election is made. Seller takes into account income of company to time of sale.	service company) (likely ordinary income in nature with effect of deduction to company benefitting remaining members) and into § 736(b) payment for property (likely capital in nature without company deduction, except for any amortization of payments for goodwill) (if the company does not have capital as material income-producing factor but provides for payment of goodwill, this payment for property amount for a general partner may include goodwill).
Goodwill Treatment	Goodwill may or may not be amortizable by purchaser, but otherwise not deductible.	Goodwill payments (for property § 736(b)) may be amortized if a § 754 election is made. The parties also have flexibility to treat goodwill amounts as § 736(a) deductible payments.
Availability of § 754 Election to Step Up Inside Basis	Available.	Available.
Treatment of Installment Payments	Gain is recognized partly as return of basis and partly as gain on each payment made on the installment basis.	Deceased or withdrawing member is treated as continuing member for tax purposes until paid out, so that basis in interest is recovered first, then any gain (or loss); amounts are allocated between § 736(a) and § 736(b) treatment, generally with set amounts treated as § 736(a) or (b) ratably, and

		contingent amounts treated as § 736(b) first.
Tax Year of Company	Tax year of company terminates as to selling member only, who takes into account income to time of sale.	Tax year of company for withdrawing member generally does not terminate until final payment.
Accounts Receivable	Income to seller; later potential income exclusion for buyer depends on § 754 election and any allocation of the basis increase to receivables.	§ 736(a) treatment moves income to deceased or withdrawing member.
Termination	Prior to 2018, 50% or more interest transfer makes partnership terminate for tax purposes (may affect tax elections; usually will not trigger taxation).	No termination of partnership for tax purposes.

(5) **Sale or Distribution Elective Basis Adjustment**. Unless the partnership makes an election under IRC § 754 the basis of partnership property is not adjusted due to a sale of a partnership interest, the death of a partner resulting in a step-up of the partner's basis in his or her partnership interest, or the (non-pro rata) distribution of partnership property, even though the basis of the partner's partnership interest will be adjusted in such events. With the IRC § 754 election, however, the differences that arise between the partner's basis in his or her partnership interest (outside basis) on the one hand, and the partner's share of the partnership's basis in its properties (inside basis) on the other hand, can be mitigated.

(a) Distributions. In cases of distributions, the IRC § 754 election is designed to allow the partnership to adjust under IRC § 734 the basis of its property distributed to a partner to the basis of the partner's interest in his or her partnership interest and to reflect in the basis of assets retained by the partnership any gain or loss recognized by the distributee partner. This helps alleviate the differences that may develop over time between the partnership's basis in its assets and the basis of the partner's interest in the partnership. Basis can be lost in a current distribution to a partner because the basis of the property received by the partner will generally be the partnership's basis but it cannot be greater than the partner's basis in the partnership interest affected (less any money distributed). Generally, if on distribution a distributed asset can be said to lose basis, the other assets that remain with the partnership will gain basis, and if a distributed asset can be said to gain basis, the basis of the other assets of the partnership will be reduced.

(i) Adjustments. The adjustments to the remaining property of the partnership work this way:

(A) Basis goes up by the gain recognized by the partner receiving the distribution and by the amount of any basis decrease (lost basis) on the distributed asset.

(B) Basis goes down by the loss recognized by the partner receiving the distribution, and by the amount of any basis increase (gained basis) on the distributed asset.

(ii) Adjustments–Another Perspective. Another way to look at this situation is that the remaining partners are in effect using the distributed asset to buy the share of the distributee partner in the remaining assets and thus the basis of the remaining assets should be adjusted accordingly to reflect this cost.

(A) In a cash distribution the partnership will generally increase its basis in remaining assets because the other partners essentially paid cash for an additional share of them.

(B) In an asset distribution where the distributee takes a basis in the distributed assets higher than the partnership's basis in them (*e.g.*, distribution of loss asset in liquidation of a partner's interest), the partnership will decrease its basis in its remaining assets because the other partners have essentially exchanged an interest in low basis assets for the distributee's share of high-basis assets.

(C) In an asset distribution where the distributee takes a basis in the distributed assets lower than the partnership's basis in them, the partnership will increase its basis in its remaining assets because the other partners have essentially exchanged an interest in high-basis assets for the distributee's share of low-basis assets.

(b) Transfer of Partnership Interest. Where a partner sells a partnership interest, or where the partner dies and his or her estate receives a step-up in basis with respect to his or her interest, the IRC § 754 election allows the partnership to adjust under IRC § 743 the basis of the partnership's property and to adjust the income allocated to the new partners to reflect the price paid on the stepped-up basis. The adjustment will affect the basis in the partnership property with respect to the new partner or the deceased partner's estate or heirs, but not the other partners. Thus, with the IRC § 754 election, a new partner who pays full value to a selling partner for a partnership interest where the partnership assets have increased in value over the inside basis, should not have to bear a share of the tax on a later sale of the asset of the partnership at the value used in setting the price for the new partner's partnership interest where the selling partner has paid the tax on the inherent gain. Also, on the death of a partner where the basis of the partner's interest is stepped up to fair market value, the inherent gain should disappear and not be borne by the partner's heirs on later sale of the assets by the partnership.

(c) Allocation of the Adjustment. There are complex rules for allocating the basis adjustment among the partnership's remaining assets. IRC § 755. Generally, the adjustment is allocated first among several classes of assets (accounts receivable, inventory, capital and depreciable assets) proportionate to the appreciation in the class compared to other classes, and then among the assets of the classes being adjusted proportionate to the appreciation in the asset compared to the other assets in the class. This may cause some surprising results, for example if some assets have appreciated in a class that as a class has not appreciated overall, the appreciated asset in that class receives no basis increase.

(d) Making the IRC § 754 Election. Generally, the IRC § 754 election is made with the partnership tax return for the year in which a transaction that could benefit by the election occurs, unless the election is already in place. Once made, the election continues until revoked with the consent of the Service. Regs. § 1.754-1(c).

(i) The election under IRC § 754 is to be made with a timely-filed return for the taxable year during which a distribution or transfer (including by death) occurs. Regs. § 1.754-1(b)(1). This can well be before the estate tax return of a decedent is due. In such a situation, the election might not have been timely made. However, in any situation of a late filing of the election (at death or otherwise), there are two possible sources of relief, a 12-month automatic extension of time within which to make the election, or a discretionary allowance of an extension of time to do so.

(ii) The 12-month automatic extension is provided by Regs. § 301.9100-2. It requires corrective action consisting of filing, at the address where the original election should have been filed if made timely, an amended or original return for the appropriate period with the election attached (including having the election signed by any authorized partner under Regs. § 1.754-1(b)), stating at the top of the return or the election "Filed Pursuant to § 301.9100-2," and acting consistently by the taxpayers affected by the election in the filing of their returns (or amendments) and in otherwise acting consistently with the requirements for making the election.

(iii) The discretionary extension may apply where the automatic extension does not and will generally be granted if the requirements of Regs. § 301-9100-2 are met, the taxpayer acts reasonably and in good faith (*e.g.*, the action is before the failure is noticed by the Service, and the action is not taken with 20/20 hindsight to retroactively obtain a benefit after events have transpired), and granting the extension is not prejudicial to the interests of the government. See Regs. § 301.9100-3.

(e) Not Making the Election. What is the difference if an election is not made? There will be some difference in the timing and character of income. If an increase adjustment would otherwise be made, the remaining partners will recognize more current income, and with a higher basis in their partnership interests, will recognize less capital gain at the liquidation of the partnership. If a decrease adjustment would otherwise be made, the remaining partners will recognize less current income (due to smaller gains and greater depreciation deductions) and, with a lower basis in their partnership interests, will recognize more capital gain on liquidation of the partnership. Distortions between inside and outside basis become permanent on the death of a partner where his or her partnership interest gets the step up basis at death.

(f) Transferee Partner Election. A special basis election may be possible for a partner to make where the partner buys or inherits the partnership interest from another partner when no IRC § 754 election was in place, and within two years receives a property (not money) distribution. In this case the partner can elect to have the property's basis treated as if it had been adjusted under IRC § 743(b) and IRC § 754 at the time the partnership interest was obtained. IRC § 732(d).

(g) Substantial Built-in Losses. There is a forced basis adjustment even without an election under IRC § 754 where there are substantial built in losses. It applies on the sale of a partnership interest or on the death of a partner. IRC § 743(a). Prior to 2018 this loss adjustment rule, under IRC § 743(d), applied on the transfer of a partnership interest where the overall loss at the partnership level exceeded $250,000 (i.e., basis exceeds value by $250,000). After 2017, there is a second, partner level, test which if met will cause a basis adjustment. Under IRC § 743(d)(1)(B), the adjustment will also apply if the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market values immediately after the transfer. For example, assume a three member partnership has an overall gain in its assets. The gain in one asset (say $1 Million) is allocated entirely to one partner under IRC § 704(c) because that partner recently contributed the asset with the built-in gain. The other asset of the partnership has a loss allocated equally among all partners, and if that asset were to be sold the loss would be $900,000. If one of the partners other than the one with the built-in gain allocation, sells its interest, the transferee immediately after transfer would be allocated a loss of $300,000 which is in excess of $250,000 were the assets of the partnership to be sold immediately after the transfer; this will trigger a basis adjustment in the share of the basis of the assets of the partnership for the transferee new partner.

(6) **Termination**. The termination of a partnership for tax purposes may occur without a state law termination.

(a) Requirements to Termination. All that is required is that:

(i) partnership operations cease to be carried on by any partners,

(ii) Prior to 2018, 50% or more of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, (IRC § 708(b)), or

(iii) in some circumstances, the merger or consolidation of two or more partnerships (the resulting partnership is deemed a continuation of the prior partnership whose partners own 50% or more of the capital and profits interest in the resulting partnership) or the division of one partnership into two or more (the resulting partnerships in which partners continue to hold 50% or more in the capital or profits will be deemed to be continuations of the prior partnership) (IRC § 708(b)(2)).

(b) Inadvertent Terminations (prior to 2018). Prior to 2018, these rules could lead to inadvertent partnership terminations, and in some such circumstances to adverse tax results to the partners. For example, if the holder of a 50% capital and profits interest incorporates a wholly owned corporation and contributes the partnership interest to the corporation, this will cause a termination of the partnership for tax purposes.

(i) Some transactions changing 50% of the partnership's interests will not create a termination of the partnership: a contribution for a more than 50% interest (assuming no disguised sale), a redemption of a more than 50% partner, or a gift bequest or charitable contribution of more than a 50% interest. See Regs. §§ 1.708-1(b)(1)(ii), 1.708-1(b)(2).

(ii) Some transactions which will trigger a termination under the 50% interest rule include: contribution of a partnership interest to a corporation or partnership (Regs. § 1.708-1(b)(2)), distribution of a partnership interest by a corporation or partnership (IRC § 761(e), FSA 2002 19008), or a transfer of economic rights where the transferee does not become a partner (see *Evans v. Com'r*, 54 T.C. 40 (1970) *aff'd*, 447 F.2d 547 (7th Cir. 1971) (transfer to corporation without required consent of other partner). (Query: could a charging order cause a termination under the *Evans* case?) There are no ownership attribution rules under IRC § 708 to prevent such termination results (see FSA 200132009).

(c) Effects of Termination. Upon a termination the partnership's tax year closes (requiring a separate final tax return) and, if the partnership continues under state law (e.g., an organization without actual operations) (or prior to 2018, as a result of an inadvertent termination), a deemed contribution of partnership property to the "new" partnership will occur for interests in the "new" partnership, followed by a deemed distribution of the interests in the "new" partnership to the partners in liquidation of the "old" partnership. IRC § 706(c); Regs. § 1.708-1(b)(1)(iv). See TD 8717, 1997-1CB 125.

(i) Favorable tax elections may be lost.

(ii) No gain or loss should be recognized on the termination. See Regs. § 1.731-2(g)(2) (distribution of partnership interests not treated as money or securities) and IRC § 731.

(iii) The rules on property contributions (IRC § 704(c)) will apply to the deemed contribution, including as to holding period and character of the assets. Regs. § 1.708-1(b)(1)(iv).

(iv) For depreciation, property deemed contributed to the "new" partnership will continue to be subject to the antichurning rules of IRC § 168(f)(5); also the rules of IRC § 168(e)(4)(e) and § 381(c)(6) ("step-in-the-shoes" rule) should apply for the new partnership to inherit the depreciation position of the "old" partnership.

(v) The basis of partnership property will not automatically increase or decrease. IRC § 723 carryover basis applies.

(vi) Investment credit will not be recaptured.

(vii) Suspended losses under IRC § 704(d) should carry over.

(viii) The capital accounts of the partners will not be affected. Regs. § 1.704-1(b)(2)(iv)(1).

(ix) No new built-in gain property is created; rather, property is treated as IRC § 704(c) property only to the extent that it was so treated in the hands of the terminated ("old") partnership immediately prior to termination. Section 737 (gain to a contributing partner on distribution within seven years of other property to that partner) will not apply to the deemed distribution of interests in the "new" partnership, and a distribution of property will be subject to the IRC § 737 recognition of seven-year taint precontribution gain only to the same extent that a distribution from the "old" partnership would have been subject to IRC § 737.

(x) The distribution of the "new" partnership interest is generally not a sale or exchange, but for basis adjustment under IRC § 743 it will be, so an IRC § 754 election can be filed with the "new" partnership's first return. Regs. § 1.708-1(b)(1)(v).

E. **Installment Sale**. The redemption or cross purchase may be made by means of an installment obligation, particularly if the sale is during the shareholder's life or if at death there are insufficient insurance proceeds to allow a fully cash sale. If installment reporting applies, basis and gain are treated as being received proportionately, and gain is postponed, and so is the tax on that gain.

(1) **Redemption**. The use of a note that is not a disguised equity interest (there may be a problem if payments are contingent on future performance, if the payments are subordinated to general creditors, or if the corporation does not have the ability to meet its obligation when the note is issued) should not disqualify an IRC § 303 redemption to pay estate tax and administrative costs (Rev. Rul. 65-289, 1965-2 C.B. 86) or a complete redemption under IRC § 302(b)(3) which otherwise avoids (under IRC § 302(c)(2)(A)) the family attribution rules of IRC § 318(a)(1).

(2) **Installment Reporting**. The note may qualify for installment reporting under IRC § 453 if at least one payment is due after the end of the tax year of the sale. Sales of real or personal property by dealers, sales of publicly traded property, or sales of depreciable property to related parties, generally do not qualify for installment reporting. IRC § 453(b)(2)(A), (k)(2), and (g)(1)(A). The obligation must be that of the actual purchaser, not its

parent or another (except for certain liquidations) (Regs. § 15A.453-1(b)(3)(i)), must not be a demand obligation or one which is readily tradeable (IRC § 453(f)(4)), and must not be secured by cash or a cash equivalent (Regs. § 15A.453-1(b)(3)(i)). Installment reporting may be available, however, to target shareholders who receive the debt of the acquirer after liquidation of the target in an asset sale transaction if the sale and liquidation all occur within 12 months of adoption of a plan of complete liquidation. It is possible to elect out of installment reporting. IRC ' 453(d).

(a) Disposition of Note by Seller. However, a sale, exchange, or gift of the note will trigger acceleration of the gain. IRC § 453B(a). Borrowing against the obligation will also accelerate the recognition of gain because the loan proceeds are treated as payments on the obligation. IRC § 453A(d). Calling the note and foreclosing on security interests will also accelerate gain, even where there is a deficiency. Transfer to a grantor trust will generally not trigger gain acceleration but other transfers in trust generally will be a taxable disposition. Rev. Rul. 67-167, 1967-1 C.B. 107; Rev. Rul. 74-613, 1974-2 C.B. 153. A transfer resulting from the death of the note's obligee will generally not be a taxable disposition unless transferred to the obligor. IRC §§ 453B(c), 691(a)(5). The gain will, however, be income in respect of a decedent under IRC § 691. There is an exception to the recognition of gain on obligation disposition in the case of transfers incident to divorce. IRC § 453B(g).

(i) Where the disposition is a sale, exchange, or satisfaction for less than face, all unrecognized gain from the sale is recognized by the seller.

(ii) Where the disposition is a gift or other disposition (other than a borrowing subject to IRC § 453A(d)), the seller recognizes the difference between the basis of the note and the note's fair market value at the time of the gift or disposition. IRC § 453B(a)(1) and (a)(2). The basis in the note is the amount by which the fair value of the note exceeds the gain portion of the principal of the note. IRC § 453B(b).

(b) Disposition of Interest by Related Buyer. If the buyer and seller are related (see IRC § 453(f)(1)) and the buyer sells, gives away, or otherwise disposes of the business interest within two years of the purchase, then the seller will recognize gain from the original sale. IRC § 453(e).

(c) Recapture Items. Installment reporting is not available to report ordinary income recaptured under IRC §§ 1245 or 1250. Thus, for a partnership-taxed company, the part of the price on a liquidating distribution or interest sale which is such a recapture item treated as an "unrealized receivable," will not be subject to installment reporting. IRC §§ 453(i) and 751.

(d) Interest Charge. There may be an interest charge on the deferred tax, which will eliminate the benefit of installment reporting as an interest-free loan of the deferred tax. IRC § 453A(c). Unless the interest rate charged by the government is less than that commercially available, much of the benefit of the installment method is lost. The interest charge on the deferred tax will apply:

(i) The charge applies to the extent the face amount of all the installment obligations held by the taxpayer outstanding at the end of a year is over $5 Million. IRC § 453A(b)(2)(B).

(ii) The charge only applies to transactions with a sales price in excess of $150,000. IRC § 453A(b)(1).

(iii) Personal use and farm property are excepted. IRC § 453A(b)(3).

(e) Where Inapplicable. If installment reporting does not apply, either because of a failure to be eligible for it, or because the tax payer elects (under IRC ' 453(d)) not to use it:

(i) Accrual Method. An accrual method taxpayer not using installment reporting takes the full principal amount of the debt as the amount realized at the time of the sale. (However, OID, if any, is treated separately, not as an amount realized.)

(ii) Cash Method. For a cash method taxpayer not using installment reporting, the amount realized at the time of sale is the fair market value of the obligation. (The fair market value is the issue price if OID rules apply.) However, in determining the market value of the obligation:

(A) transferability restrictions are ignored;

(B) the value of the debt will never be less than the value of the property sold, less any other consideration received.

(iii) Publicly Traded Securities. If a cash basis taxpayer sells publicly traded stock on an established securities exchange, then all payments to be received are treated as received in the year of disposition. IRC § 453(k). This is like the treatment of an accrual method taxpayer.

F. **Compensation Issues**. If stock, partnership-taxed organization interests, or other equity interest are issued in connection with the performance of services, IRC § 83 governs the taxation of the receipt of the stock or other equity interest. Gift stock or equity interests will not be subject to § 83 if it is truly a gift. If, however, the stock or equity is really disguised compensation for services, it will be taxable. If the buy-sell agreement contains restrictions on the "gift" stock or equity related to employment, this could be used by the Service to demonstrate that the stock or equity interest is really "in connection with the performance of services," particularly if the restrictions are imposed at about the same time as the stock or equity is given. Thus, if an owner desires to give stock or equity to a family member who works in the business, the buy-sell agreement should be executed some length of time after the gift or should not contain employment related restrictions. Also, various forms of deferred compensation, including such things as consulting and noncompetition agreements with a former owner-employee, can create issues and severe tax consequences on a change in control, if the arrangement does not meet the requirements of the rules under IRC ' 409A as to distribution or payment events, acceleration of benefits, and elections requirements. Further, benefit plan and fiduciary duty issues can arise particularly where the employer stock is held by a retirement plan sponsored by the employer. These are issues which commonly arise, but there are other employment and compensation matters which could arise as well.

G. **Fixing Value for Tax Purposes**. It is often important in planning a buy-sell arrangement that the agreement fix the value of the stock or other business interest for tax purposes, but it is almost always critical that the agreement not fix a low price for state law purposes and yet leave it open to the Service to set a higher value for tax purposes. See *True v. Com'r*, 390 F.3d 1210 (10th Cir. 2004) (large deficiency plus penalty for under statement of value). This has become a much less certain, and thus more risky, area.

(1) **Value and Restrictions**. The provisions of IRC § 2703 apply to agreements entered into or substantially modified after October 8, 1990. Under IRC § 2703(a), the value of stock for gift, estate, and generation-skipping tax purposes is not affected by an agreement to purchase for less than fair market value or by any restriction on the right to use or sell the property. The buy-sell price may, however, fix the value for tax purposes if under IRC § 2703(b) the agreement:

(a) Bona Fide. It is a bona fide business arrangement;

(b) Not Device. It is not a device to transfer property to family for less than adequate consideration; and

(c) Comparable. Its terms are comparable to those entered into in arm's length transactions.

(2) **Comparability**. This third requirement of comparability is new and creates a significant area of uncertainty. The regulations require a showing that the rights and restrictions of the agreement could have been obtained in a fair bargain between unrelated persons in the same type of business. A right or restriction is considered to be such a fair bargain if it conforms with the general practice of unrelated parties under negotiated agreements in the same business considering a number of factors. Isolated comparable transactions are insufficient to show a general business practice. If more than one valuation method is commonly used, the test won't be failed by using one of the recognized methods. Regs. § 25.2703-1(b)(4)(i) and (ii).

(3) **Safe Harbor**. There is a regulatory safe harbor. Regs. § 25.2703-1(b)(3). A right or restriction will be considered to meet the three requirements if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly (under Regs. § 25.2701-6) by individuals who are not members of the transferor's family (under Regs. § 25.2701-2(b)(5) and any other individual natural object of the transferor's bounty) and the property of the nonfamily members is subject to the right or restriction to the same extent as the transferor's property.

(4) **<u>Older Standards</u>**. IRC § 2703 is layered on top of prior rules relating to when agreements may set the value of property for transfer tax purposes. <u>See</u> Regs. § 20.2031-2(h); Rev. Rul. 59-60, 1959-1 C.B. 237, Section 8 at 243. For estate tax purposes, the price setting agreement needs to be:

(a) <u>Binding</u>. It must be binding on the decedent during life, as well as at death (call options may work if supported by separate consideration to make enforceable; <u>see</u> *Armstrong Est. v. Com'r*, 146 F2d 457 (7th Cir. 1944), and *Lamb v. Sagden*, 82 F.2d 166 (2d Cir. 1936); put options don't work, and rights of first refusal don't work);

(b) <u>Bona Fide</u>. It must be a bona-fide business arrangement (ownership group or family control qualify; <u>see</u> *Bishoff v. Com'r*, 69 T.C. 32 (1977), and *N.L. Roth v. U.S.*, 511 F. Supp 653 (D. Mo. 1981) *rev'd on other grounds St. Louis Co. Bnk v. US*, 674 F. 2d 1207(8th Cir. 1982); *Hall Est. v. Com'r*, 92 T.C. 312 (1989)); <u>see</u>, however, *Holman v. Com'r*, 601 F.3d 763 (8th Cir. 2010) (emphasizing the context of the contemporaneous execution of wills, the taxpayer's understanding of the potential tax benefits, and educational goals, and the absence of any business activity, in finding that the restrictions included in the limited partnership agreement were not a bona fide business arrangement); and

(c) <u>Not Device</u>. It must not be a device to pass the interest to the natural objects of the decedent's bounty for less than an adequate and full consideration in money or money's worth. <u>See</u> *True v. Com'r*, 390 F.3d 11210 (10th Cir. 2004).

Even if not sufficient to establish value, contractual rights may have affected value under the old rules, but under IRC § 2703 such rights must meet the new tests to be considered at all.

H. **<u>Lapse of Rights</u>**. Allowing the important rights of voting or of power to liquidate an organization (*e.g.*, held by an older generation member) to lapse can create a taxable transfer or affect the valuation of the interest. Also, where a family controls restrictions on the right to liquidate, this can affect valuation of the interest, as well.

(1) **<u>Lapse of Vote or Liquidation Right</u>**. Under IRC § 2704 a lapse of voting or liquidation rights in a corporation or partnership (including a limited liability company) controlled by a family is treated as a transfer from the holder of the lapsed rights to the other owners of the business of the excess of the value of the holder's interest before the lapse compared to the value after the lapse. Family means a person's spouse, ancestors, descendants, brothers, sisters, and spouse of any of these, and the ancestors and descendants of the person's spouse and any of their spouses. IRC § 2704(c)(2). This provision is intended to overturn *Harrison Est. v. Com'r*, T.C. Memo 1987-8. The idea behind the rule is that, unlike restrictions which depress the value of an interest, voting and liquidation rights enhance the value of the interest and on lapse (with the resultant decrease in value) that value difference should not escape taxation. If the lapse occurs during the holder's life, the value is a gift; if it occurs at death, the value is includible in the holder's estate.

(a) Intention. The rule is intended to apply only to rights similar to liquidation and voting rights and is not intended to generally eliminate minority or other discounts available under the law. Conf. Rep. H.R. Rep 964, 101st Cong., 2d Sess. 1137.

(b) Ownership Attribution. The rule applies the family attribution of indirect ownership rules of IRC § 2701. See IRC § 2704(c)(3). An individual's interest in a company will be deemed to include any family member's interest in an estate, trust, corporation, or partnership which has an interest in the company. See IRC § 2701(e)(3).

(c) Net Effect on Partnership. If a partnership or limited liability company interest were to be sold, the buyer would only receive an assignee's interest under fallback state law, and this kind of interest is, by its nature, very restricted and lacks control and lacks marketability. So the starting value of the interest may be low to begin with, even without additional discounting arising from provisions in the agreement. See *Adams v. U.S.*, 2001 U.S. Dist. LEXIS 13092; 88 A.F.T.R.2d 6057, 2001-2 USTC ¶ 60,418 (US Dist Ct. No. Dist. Texas 8/24/01) after remand from the Fifth Circuit which reversed on failure to appropriately discount value *Adams v. U.S.*, 218 F.3d 383 (5th Cir. 2000). Thus, the transfer value should be the same before and after death, possibly eliminating concern from IRC § 2704(a) on lapses of voting or liquidation rights where the lapse does not actually affect value.

(2) **Limitation on Liquidation**. Also, any limitation (measured against fallback state law applicable to the form of organization) on the ability of the corporation or partnership to liquidate which lapses after the transfer or which may be removed by the transferor or any other family member, then on a family transfer of an interest, the restriction is disregarded in valuing the interest. IRC § 2704(b)(1) and (2). Having a nonfamily charitable member could be useful.

(a) Unanimity. If fallback state law requires unanimity, there would not be an applicable restriction under this section to disregard, even if family owns all interests. See *Kerr v. Com'r*, 292 F.3d 490 (5th Cir. 2002) *aff'g*. 113 T.C. 449 (1999). Whether a "restriction on the right to liquidate" includes a right to withdraw from the company was not reached by the Fifth Circuit in the *Kerr* case cited above although the Tax Court found that a withdrawal could occur without a liquidation, and thus the statute did not apply to the limitation on withdrawal.

(b) Fallback State Law. Under IRC § 2704(b) and Regs. § 25.2704-2(b) on "applicable restrictions" in excess of fallback state law, applicable restrictions do not include restrictions also subject to IRC § 2703 (*e.g.*, rights to acquire or use a partnership interest–such as restrictions on withdrawal or the admission of a new partner). A restriction imposed by a third-party lender, or by state or federal law, is not covered by this rule and thus would not be disregarded. IRC § 2704(b)(3). Regulatory authority has been granted and is expected to be used against a wide range of restrictions which tend to lower valuations.

I. **Section 2036 Problem**. IRC § 2036 is not itself a valuation provision. It is a gross estate inclusion provision. However, it is center stage with respect to the conflict over valuation discounts and needs to be taken into account in structuring a business for succession where a valuation discount is important.

(1) **<u>Basic Rule</u>**. Under this section, the gross estate of the giver may include the value of property given away if too much enjoyment or control is retained with respect to the property given. The section is triggered where a decedent has retained possession, enjoyment, or right to income, or has retained control over who enjoys the income from the property.

(2) **<u>Bona Fide Sale Exception</u>**. The section does not apply to "bona fide sales for an adequate and full consideration in money or money's worth."

(a) <u>Early Cases</u>. A string of early cases has held that this exception generally does not apply to the creation of a family LLC or limited partnership. <u>See</u> *Harper v. Com'r*, T.C. Memo 2002-121; but compare with *Stone v. Com'r*, T.C. Memo 2003-309.

(b) <u>More Recent Cases</u>. The more recent Fifth Circuit case of *Kimbell v. U.S.*, 371 F3d 257, 93 AFTR 2d 2004-2400 (5th Cir., 2004), may have reversed this trend. In that case, the Circuit Court, in reversing the District Court, held that the bona fide sale exception applied to the transfer of assets in exchange for a partnership interest where the interest credited to each partner was proportionate to the fair market value of the assets contributed for it, capital accounts were properly credited, and on dissolution, the partners would be entitled to distributions determined by their capital accounts. In addition, the Court found that sufficient assets were retained outside the partnership to support the decedent, formalities were satisfied on the transfers, the partnership included working interests in oil and gas which required management, and there were nontax business reasons for the use of the partnership.

(i) Although the reasoning of the case is not rock solid, the *Stone v. Com'r* case cited above also gives some hope that Section 2036(a)(1) can be avoided under the bona fide sale exception where the older generation negotiates the agreement with the younger generation, which puts in some substantial assets itself and exercises management control; there is no gift on the creation of the company because interests are received pro rata to the value of property contributed; and there is a substantial business purpose for the arrangement. In such a case, the applicability of valuation discounts alone should not destroy the bona fide sale exception to Section 2036.

(ii) However, the Third Circuit case of *Turner v. Com'r*, 382 F.3d 367 (3d Cir. 2004) upheld the Tax Court in finding that the bona fide sale exception would not apply where there was not an actual business enterprise or business motive. In addition the Court found that sufficient assets to support the decedent were not retained outside the partnerships at issue and that there was an implied agreement to use the assets for decedent's benefit.

(iii) Some Tax Court cases have narrowly treated the bona-fide sale exclusion from Section 2036 and have not applied the exception where it found no substantial nontax purpose to the contributions to the family company. <u>See</u> *Estate of Bongard v.*

Com'r, 124 T.C. No. 8 (2005); *Estate of Korby v. Com'r*, T.C. Memo 2005-102. Both of these cases emphasized four factors: (1) the taxpayer standing on both sides of the transaction, (2) the taxpayer's dependence on distributions from the partnership, (3) the partners' commingling of partnership funds with their own, and (4) the taxpayer's failure to actually transfer the property to the partnership. The court in *Korby* found that creditor protection derived from the partnership was not sufficient to be a significant nontax reason for forming the partnership. Facilitating gift giving has also been found to be an inadequate nontax reason. <u>See</u> also *Estate of Bigelow v. Com'r*, T.C. Memo. 2005-65. <u>See</u>, however, *Mirowski v. Com'r*, T.C. Memo 2008-74, a case quite favorable to the taxpayer, in which family management, gift giving, and (to a limited extent) asset protection (the case involved a limited liability company) were positive nontax factors; in *Mirowski*, the court held that the terms of the bona fide sale exception were met. Also, maintaining a buy and hold investment policy on the stocks of two companies was held to be a sufficient business purpose in *Schutt v. Com'r*, T.C. Memo 2005-126. Whether a substantial nontax purpose needs to arise to the dignity of a business purpose seems to have been a bone of contention between some Tax Court judges. However, a recent case has found limiting exposure to litigation and preventing management problems from fractionalizing an asset in gift transfers to be sufficient so long as saving estate tax is not the predominant motive. *Estate of Shurtz v. Com'r*, T.C. Memo. 2010-21.

(iv) In *Est. of Bigelow v. Com'r*, 503 F.3d 955 (9th Cir. 2007), the court found an implied agreement to trigger IRC § 2036(a) and refused to apply the bona-fide sale exception to IRC § 2036(a), but explained that the Estate needs to demonstrate more than a proportional exchange (*i.e.*, X% in asset before transfer, X% in company after transfer). Rather, it needs to show a genuine pooling of assets (citing *Harper v. Com'r*, 83 T.C. Memo 2002-121) and a potential for intangibles stemming from pooling for joint enterprise (citing *Est. of Thompson v. Com'r*, 382 F.3d 367 (3d Cir. 2004)). The court said that the "bona-fide sale" and the "adequate and full consideration" aspects of the exception are interrelated so that the adequacy of consideration cannot be judged separately from the nontax-related business purpose inquiry.

(v) On the bona-fide sale exception issues, the key cases for a taxpayer are *Church v. U.S.*, 2000 U.S. Dist. LEXIS 714 (W.D. Tex. 2000), *aff"d* 268 F.3d 1063 (5th Cir. 2001) (*per curiam*) (<u>see</u> unpublished decision at 88 AFTR 2d 2001-5352 (5th Cir. 2001)); *Estate of Stone v. Com'r*, T.C. Memo 2003-309; *Kimball v. U.S.*, 371 F.3d 257 (5th Cir. 2004); *Est. of Bongard v. Com'r*, 124 T.C. 95 (2005); *Est. of Schutt v. Com'r*, T.C. Memo 2005-126; *Est. of Mirowski v. Com'r*, T.C. Memo 2008-74; *Estate of Shurtz v. Com'r*, T.C. Memo. 2010-21; *Est. of Stone v. Com'r*, T.C. Memo. 2012-48; *Estate of Purdue v. Com'r*, T.C. Memo 2015-249. The case law is, overall, rather split and very fact sensitive, however.

(3) **<u>Planning Risks</u>**. If an asset is placed in a company, its value typically goes down because it is subject to the rules, restrictions, and similar matters to which a company interest is subject. If the company's foundational organization documents provide excessive control, beyond the usual business controls typical of similar interests, the company may be a mechanism to institute a disguised retention of enjoyment or control under IRC § 2036(a)(1) bringing into the gross estate the entire, nondiscounted value of the underlying assets contributed

to the company. Generally, validly-created business organizations are not disregarded (see *Strangi v. Commissioner*, 115 T.C. 478 (2000)) but if excessive controls over the assets are retained, the result will be different. The areas of greatest risk are generally:

(a) Entity not Honored. The company is not respected as a truly separate entity, for example, by reason of commingling funds, delay in transferring assets, or making disproportionate distributions to the decedent. These kinds of things can cause trouble even where actual control over the organization resides elsewhere. See *Harper v. Com'r*, T.C. Memo 2002-121 (children were the only general partners, but these other factors sufficient to cause inclusion under IRC § 2036, even though decedent had only a limited, not a general, interest).

(b) Implied Agreement. There is an agreement or understanding, even an implied one, allowing the decedent to continue to enjoy the property, for example, where the decedent gives away most of his or her property and has insufficient funds for living expenses absent disproportionate distributions from the company. See *Estate of Thompson*, T.C. Memo 2002-246, *aff'd* by *Turner v. Com'r*, 382 F.3d 367 (3d Cir. 2004). See also *Strangi v. Com'r* (known as *Strangi II*), T.C. Memo 2003-145. *Abraham v. Com'r*, 95AFTR 2d § 2005-1018, 2005 WL 1230774 (1st Cir. 5/25/2005) (implied agreement to use income from transferred property for incapacitated person).

(c) Excessive Power Retained. There is excessive power retained, for example, if a 99% limited partner retains the power to remove the general partner. See *Kimbell v. U.S.*, 244 F. Supp 2d 700 (N.D. Texas) *rev'd on other grounds* by *Kimbell v. U.S.*, 371 F3d 257 (5th Cir. 2004).

(4) **IRC 2036(a)(2) Concerns**. Where there is no third party with an interest in enforcing fiduciary duties which may affect distributions or their timing, the *Strangi II* case (cited above) raises the possibility of inclusion under IRC § 2036(a)(2), as well as under (a)(1). Under IRC § 2036(a)(2), property is includible if the decedent retains "the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom." This includes the power to control the timing of distributions. (See *U.S. v. O'Malley*, 383 US 627, 631 (1966).) In the case of *Byrum* (*U.S. v. Byrum*, 408 US 125 (1972)) the power to designate was limited by corporate fiduciary duties in the case of an operating business subject to practical business realities and concerns. *Strangi II* distinguished *Byrum* and found that in *Strangi II* there was no operating business and no substantial third-party minority interest to enforce any fiduciary duties.

(5) **Planning Considerations**. Some things to take into account in planning to avoid problems under IRC § 2036(a)(1) or (a)(2) include:

- Have, and document, one or more nontax business purposes

- Operate in a business-like way as a joint enterprise for profit

- Maintain good records and accounts
- Convey property to the company as soon as it is created
- Use company assets only for company purposes
- Pay all accrued expenses timely, particularly if to related persons
- Do not commingle company and personal funds or assets
- Do not have numerous transactions between founder and the company
- Do not allow founder to make disproportionate distributions
- Maintain and properly adjust capital accounts
- Continue operations beyond death of the founder
- Do not transfer assets that are subject to liability without also having the company assume the liability (note: there will be income tax issues)
- Do not relieve general partner or managing members of fiduciary duties to other partners or members
- Do not allow person holding power of attorney from founder to be the manager or general partner of the company
- Have a nonfamily member or partner contribute to company and hold a substantial interest
- Have family members contribute to company and hold substantial interests
- Negotiate terms of company with family members who will become partners or members
- Restrict founder's vote on distributions or liquidations
- Consider having voting and management powers held by a noncontributing spouse or other third person
- Consider concentrating voting power in independent trustee of trust to which the founder has made an incompleted gift for gift tax purposes.
- Provide for some change in the management of the assets after transfer to the company

J. **Other Valuation Discount Matters**. Minority and other discounts are useful in saving taxes on gifts during life or at death.

(1) **Minority Discounts**. Minority discounts in valuing interests in family businesses may be available in certain circumstances and they may be substantial (*e.g.*, possibly in the neighborhood of 25% - 45%), however, they can also be controversial with the taxing authorities and there are limits to the circumstances under which they will be allowed by the courts. Undivided interests in real estate may obtain such discounts even without being held through a partnership or other entity; however, the entity may enhance aspects useful in obtaining the discount.

(a) Lack of Control. The basic theory is that where the base value of an interest in a company is not determined by comparable sales of other minority interests (*e.g.*, marketable stocks) but is determined through evaluating the underlying assets of the company, a minority or lack of control discount may be appropriate to take into account the concern of a potential buyer about lack of control. Also, the cases have, for the most part, not been sympathetic to attempts by the Internal Revenue Service to aggregate interests held by family members in an attempt to deny such discounts. There is now clear authority allowing minority discounts among family members. Rev. Rul. 93-12, 1993-1 C.B. 202.

(b) Minority Discount Factors. The basic situation justifying a minority or lack of control discount would be the ownership of an interest in a business organization (corporation, partnership, limited liability company, etc.) of less than 50% in voting control or equity, such that the owner of the interest loses the ability to have significant control over operations, payment of dividends, receipt of salary or compensation, or other matters in the day to day management of the enterprise. The factors used in determining such discounts include:

- nature (limited or general) of interest and size of the interest;
- level of control exerted by recipient of the interest;
- potential for distributions–are there any required distributions and allocations;
- any evidence of a ready market;
- the nature of the underlying assets, for example, price volatility, income production, marketability;
- restrictions in documents on sale or transfer
- length of term of the agreement;
- imminence of liquidation;

- access to information on the business;
- cash calls, voting rights, influence over management;
- ability to force a dissolution.

(c) Limited and General Interests Combined. If the deceased holds both a limited and a general partnership interest, the interests are combined and the general partner's power to cause dissolution will defeat the discount. The limited partner's interest has greater value when held in combination with a general partner's interest. IRC § 2704(a) applies to the lapse on death of the liquidation right and brings the value up by the difference between the value with the right and without the right.

(d) Form over Substance. Form-over-substance principles can destroy the discount in some circumstances. Last minute transfers before death to bring the owner just under 50% for the sole purpose of avoiding taxes will create very difficult problems. The Tax Court case of *Murphy Estate v. Com'r*, 60 T.C.M. 645 (1990) involved just such a situation; the court in that case refused to follow other Tax Court cases that had allowed the discount in situations that were less blatant.

(e) Planning Keys. Thus, the keys to planning with a greater likelihood of withstanding challenge are: do the transaction early, have a purpose for the transaction beyond tax savings, and try to use at least some assets other than marketable securities if possible (real estate is quite good for this). The cautious use of a limited liability company rather than a corporation may well be the best choice in many or even most circumstances, although not risk free.

(2) **Lack of Marketability Discounts**. Even without a minority discount, a lack of marketability discount may be available. For example, in a Tax Court case that was affirmed on appeal, *Mandelbaum v. Com'r.*, T.C. Memo 1995-255, *aff'd per curiam*, 91 F.3d 124 (3rd Cir. 1996), the court allowed a 30% discount in the gift tax value of corporate stock based on a number of factors: financial statements, dividend policy, company's future prospects, management, control in the shares, restrictions on transferability, holding period of the stock, redemption policy, IPO (initial public offering) costs. Although that case involved a stock offering, most of these factors have a partnership counterpart. The expert testimony in the *Mandelbaum* case was for a 35% - 45% discount based upon studies of initial public offerings, but the court only went with a 30% discount.

(3) **Multiple Discounts**. It may be possible to obtain multiple discounts where an interest in a closely held business or an undivided interest in real estate is transferred into a partnership. The underlying asset (*i.e.*, the closely held business or undivided real estate interest) would itself carry some valuation discount, and the interests in the limited liability company or partnership into which assets have been transferred could also carry a discount.

(a) Tandem Minority and Lack of Marketability Discounts. Minority discounts generally also are claimed in tandem with a lack of marketability discount. *In McCormick Estate v. Comr.*, T.C. Memo 1995-371, for example, the Tax Court allowed gift and estate tax discounts of partnership interests for minority interest of 18% - 32% and for lack of marketability of 20% - 22%. Some additional interesting valuation cases include: *McCord v. Com'r*, 120 T.C. 358 (2003), *Lappo v. Com'r*, T.C. Memo 2003-258, and *Perracchio v. Com'r*, T.C. Memo 2003-280, in which the results were 6%-15% minority interest discount and 20%-25% lack of marketability discount for an effective overall discount of 29.5%-35.74%.

(b) Other Discounts Available. Other valuation discounts which should be considered include, at the entity level, key person discount (*Estate of Furman v. Com'r*, TCM 1998-157), personal good will (*Estate of Adell v. Com'r*, TCM 2014-155; *Bross Trucking v. Com'r*, TCM 2014-107), portfolio discount (*Estate of Bennett v. Com'r*, TCM 1993-34), trapped in capital gain discount (see, *e.g.*, *Estate of Davis v. Com'r*, 110 TC No. 35 (1998); *Estate of Jelke v. Com'r*, TC Memo 2005-131 (discount allowed based on history of securities turnover) which was reversed by the Eleventh Circuit at 507 F.3d 1317 (11th Cir. 2007) (dollar-for-dollar discount for the entire built in gain allowed); see also *Estate of Jensen v. Com'r*, T.C. Memo. 2010-182; *Dunn v. Com'r*, 301 F.3d 339 (5th Cir. 2002) (allows discount of 35% of built in gain where Tax Court only allowed 5%)), litigation risk, environmental risk, and, at the owner level, blockage. See Shannon Pratt, The Lawyers Business Valuation Handbook (ABA 2000) at Chapter 13.

(4) **Single Member LLC**. Even transfers of a single member limited liability company interest may be entitled to these discounts. *Pierre v. Com'r*, 133 TC No. 2 (2009) (interests in a single-member LLC treated as a disregarded entity under the check-the-box regulations, are valued for gift tax purposes as transfers of interests in the LLC subject to valuation discounts for lack of marketability and control).

K. **Family Partnerships**. Giving family members interests in a partnership-taxed organization may be a critical feature of a succession plan. It is important that the organization be recognized both for income and gift tax purposes.

(1) **Income Tax Recognition**. In order to have the income treated as the income of the persons given interests in family partnerships or family limited liability companies taxed as partnerships (for convenience, let's refer to all organizations taxed under the partnership tax rules as "partnerships"), the following standards must be met (see IRC § 704(e)):

(a) Capital. Capital must be a material income producing factor as opposed to fees, commissions, or other compensation for personal services (it is important to have a manager or general partner adequately compensated for services to the partnership) to avoid assignment of income issues.

(i) Capital will be material if a substantial portion of the gross income of the business is attributable to the employment of capital (there could be a loss and still have gross income which meets this test).

(ii) Consider the nature of the business and consider goodwill, too, even if not on the balance sheet and consider licenses, contracts, fully-depreciated assets, etc., which are not on the balance sheet.

(iii) Be careful of large amounts of borrowed capital. See *Carriage Square, Inc. v. Com'r*, 69 TC 119 (1977).

(b) Reality of Interest. The person receiving the gift (a "donee") must obtain a real ownership interest in capital (not just income). Thus, the donee should have a right to obtain assets on liquidation or withdrawal. To be real, the gift must be legally effective; children or disabled persons will likely need trusts, conservatorships, or Uniform Transfer to Minors Act custodianships.

(c) Avoid Excess Controls. Also, the donor should avoid retaining too many controls. See *Hackl v. Com'r*, 118 T.C. 279 (2002).

(i) Negative Factors. Some negative factors for a donor would be: power to control net income distributions (reasonable retention of profit for needs of the business will be alright); power to control essential assets (*e.g.*, leased assets); power to restrict a disposition (particularly liquidation or sale) by the person receiving the interest (the donee) (a right of first refusal will not be a problem, however); super-powers beyond the customary management powers (at least unless the donee has a power to compel liquidations); and voting and management consistent with ordinary business practices will be alright.

(ii) Positive Factors. Some positive factors for a donee would be: the donee is able to participate in management, in reality and not just formally; actual distribution of income is made to the donee (this is very important to the Service); the donee's interest is publicly recognized in public filings, insurance policies, financings, etc.; and the donee can dispose of his or her interest without financial detriment.

(2) **Gift Tax Present Interest**. If the interest given to the donee is real under these standards, a gift of it should generally be treated as a gift of a present interest qualifying for the annual gift tax exclusion, unless otherwise limited (*e.g.*, by use of a trust without "Crummy powers" to hold the interest). Note: some family partnerships contain Crummy withdrawal powers as to newly contributed gift assets from the donor to the partnership and thus for the benefit of the other members.

Let's turn next to some issues to be taken into account in planning succession or transition transactions either in advance as part of a buy-sell arrangement or at the time of death. There are some special tax rules intended to help the holders of small businesses. Some of these provisions require that certain tests be met to qualify for the tax benefits by demonstrating that the business or property affected is a closely held business or used in such a business and that the business or property is a sufficiently large part of the decedent's estate. Thus, for some holders, it would be well to maintain a sufficient portion of the estate in such a business. Such provisions relate to valuing real property at actual use value, redeeming stock to pay taxes or administrative expenses, or deferring the payment of estate taxes related to the business.

L. **Special Valuation of Real Property**. The standard of value is normally fair market value at highest and best use. See Regs. § 20.2031-1(b). Real estate held in a closely held business or as a farm may qualify for special valuation rules designed to value the property at actual use rather than at highest and best use where the business and the real estate meet percentage tests which indicate that they are a large part of the estate. IRC § 2032A. This elective procedure cannot, however, reduce the gross estate by more than $750,000 adjusted for inflation after 1998. IRC § 2032A(a)(2). For decedent's dying in 2016, the amount is $1,110,000. The special value rule is an estate tax rule and does not apply for gifts and only applies to certain direct skips for generation-skipping tax purposes. If the applicable percentage limits cannot be met, the client may desire to give away other property to increase the percentage of the estate of potentially special valued property, or may desire to change other property into qualifying property.

(1) **Qualification**. Some of the most significant qualification requirements are:

(a) General. The decedent must be a citizen or resident of the United States and the land must be located in the United States.

(b) Business Proportion of the Estate. 50% or more of the adjusted value of the gross estate (with the property valued at highest and best use for this purpose) must be real or personal property which was being used as a farm or in a trade or business (a "qualified use") by decedent or decedent's family and which passes from (or was acquired from) decedent to a member of decedent's family.

(i) The adjusted value of the gross estate is the gross estate plus gifts within three years of death (except annual exclusion gifts) less mortgages or secured indebtedness with respect to the property. The adjusted value of the real and personal property is its highest and best use value less mortgages and secured indebtedness on that property. There is an issue as to what liquid assets are to be treated as part of the business in applying this test.

(ii) Family includes ancestors, spouse, descendants, descendants of parents, spouse's descendants, and spouses of lineal descendants, but does not include such relatives as uncles, aunts, or first cousins. After death disclaimers are not the same as passing from or being acquired from the decedent.

(iii) There is an issue as to when it is appropriate, if ever, to combine interests for this test. Rev. Rul. 85-168, 1985-2 C.B. 197 (bank and farm aggregated); *Gerger Est. v. Com'r*, 80 T.C. 484 (1983) (separate business not aggregated where one not in danger of over valuation); *Sherrod Est. v. Com'r*, 774 F.2d 1057 (11th Cir. 1985), *rev'g* 82 TC 523 (1984) (no aggregation of nonqualified use property not functionally related).

(c) Proportion of Estate of Property. 25% of the adjusted value of the gross estate (again, at highest and best use) must consist of the farm or closely held business real property being so used in a qualified use by decedent or a family member.

(d) Time Used Before Death. Also, such real property must have been owned and so used by decedent or family members for 8 years immediately before the decedent's death.

(e) Material Participation. The decedent or family member must have materially participated in the farm or business for 5 of the 8 years immediately before the earlier of decedent's death, disability, or the commencement of decedent's social security benefits.

(i) Where a surviving spouse acquired qualified property from his or her deceased spouse, then active management in the predeath period by the surviving spouse will be sufficient. IRC § 2032A(b)(5).

(ii) Material participation is not defined in IRC § 2032 A, but that section requires its determination in a manner similar to that used for IRC § 1402(a)(1) to distinguish rents from self-employment income. See also IRC §§ 469 on passive losses and 2057 on the now repealed family-owned business deduction, and Social Security Act § 211(a)(1), which all also use the term "material participation."

(2) **Valuation**. The Special Use Value is determined under one of two methods.

(a) Capitalization of Rents. The first is a capitalization of rents method, which being objective, is almost always used where it applies. IRC § 2032(A)(e)(7) and (8); Regs. § 20.2032A-4. It applies only to farm real estate. It is the annual gross cash rental (after real property taxes are paid) for comparable land for the 5 most recent full calendar years ending before death, divided by the average annual effective interest rate for all new Farm Credit Bank loans for the year of death.

(b) Five Factors. The other method is the five-factor method. The factors are:

(i) The capitalization of income which the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors;

(ii) The capitalization of the fair rental value of the land for farmland or closely held business purposes;

(iii) Assessed land values in a state which provides a differential or use value assessment law for farmland or closely held business;

(iv) Comparable sales of other farmland or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and

(v) Any other factor which fairly values the farm or closely held business value of the property. IRC § 2032A(e)(8).

(3) **Business or Organization**. The real property may be held in a partnership-taxed company, corporation, or trust and still qualify but only if the business is closely held and the property would qualify if held directly by decedent. IRC §§ 2032A(g); 6166(b). (See discussion below of the closely held requirement under IRC § 6166, the payment deferral provision.) If the real property is so held by a business organization, the minority and lack of marketability discounts are applied first to the entity and then the special use valuation reduction is applied. See *Clara Hoover Estate v. Com'r*, 69 F.3d 1044 (10th Cir. 1995) *rev'g* 102 TC 777 (1994) *acq* 1998-2 CB 254; PLR 200448006.

(4) **Election and Agreement**. The election is made on the estate tax return (even on a late filed return) and requires a signed agreement by each person with a present or remainder interest in the property consenting to the application of the recapture tax. There are rules for correcting certain defective elections. A partial election may be possible if the elected part taken alone meets the requirements. It is often best to elect Special Use Value only to the extent needed, and keep a higher stepped-up basis on the rest of the property.

(5) **Recapture**. If the property is sold or otherwise disposed of to nonfamily members within 10 years of death, or ceases to be used for farming or business, or if the property ceases to be so used by a family member for an aggregate of 3 of the 8 years after the decedent's death (with a two year grace period immediately after death), then in any such event an additional estate tax is imposed. IRC § 2032A(c)(1). Cash leases by the spouse or a lineal descendant of the decedent to another family member who materially participates, will not cause the recapture tax to apply.

(a) Tax. The tax is (i) the difference between the tax that would have been imposed and the tax imposed using special valuation or (ii) the difference between the amount realized on disposition and the special use value, whichever is less. IRC § 2032A(c)(6).

(b) No Interest. There is no retroactive interest on the tax recaptured (absent an elective basis adjustment).

(c) Elective Basis Adjustment. When the recapture tax has been paid, the basis of the affected property may be adjusted at the irrevocable election of a qualified heir to fair market value as of decedent's death (or alternate valuation date if applicable) effective as of immediately before the disposition or cessation of qualified use. IRC § 1016(c). There is no retroactive adjustment to depreciation or other items. Upon such an election to adjust basis, interest at the deficiency rate must be paid on the recapture tax from the date nine months after decedent's death to the due date of the recapture tax. IRC § 1015(c)(5)(B).

(d) Liability and Lien. The family members are personally liable for the recapture tax. IRC § 2032A(c)(6). Also there is a lien on the specially valued real property until the tax recapture has been paid or potential liability expires. IRC § 6324B.

M. **Future of Valuation Planning**. Traditionally, the trade-off for valuation planning between the estate tax consequences of such planning and the income tax consequences tended to favor the estate tax savings which can be derived from it. However, this trade-off may not be there for many families. The estate tax threshold in 2016 is $5.45 Million and will increase by inflation indexing. If the threshold is relatively high, the trade-off will tend to shift for many business owners toward establishing as high an income tax basis at the time of death as possible. Thus, maintaining flexibility in planning will be important. Also, the ability to challenge and rethink planning premises will only grow in importance. At the very least, it would seem safe to say that a sensible, economic transaction should generally take precedence over valuation planning where there is a conflict between these goals.

N. **Stock Redemption to Pay Estate Tax**. A small business owner where the business is incorporated may want to plan to be able to qualify for the special provisions under IRC § 303 that allow a corporate redemption of stock in order to pay estate taxes and administrative expenses. This can help with liquidity by enabling the release of funds from the corporation without dividend (*i.e.*, double tax) treatment, and is particularly useful where the stock is not all being sold pursuant to a buy-sell agreement. The basis for the stock being redeemed will be the stepped-up basis at death under IRC § 1014, so generally there will not be gain or loss realized on the stock itself at the stockholder level. (Sales or distributions of corporate assets will trigger taxation at the corporate level.) In order to meet the qualifications for the special redemption the business owner may desire to give away other assets in order to meet the percentage requirements, combine corporations that alone do not meet the percentage requirements, contribute other assets to the corporation, or value the corporation at the higher end of the fair market value range on the estate tax return. Also a recapitalization with a redemption of preferred stock should be considered since the IRC § 303 redemption can eliminate the IRC § 306 preferred stock bailout taint. The major requirements for qualification include:

(1) **Amount**. The redemption is limited to the amount of death taxes (including generation skipping) and the funeral and administrative expenses deductible by the estate. IRC § 303(a)(2). Stock used for a marital deduction gift may not qualify for an IRC § 303 redemption; also, the IRC § 303 redemption is not available for stock used to satisfy a pecuniary bequest because this is treated as a sale of the stock. Regs. § 1.303-2(f).

(2) **Percentage Test**. The value of the stock of the closely held business must be more than 35% of the adjusted gross estate. IRC § 303(b)(2)(A). The stock value of two or more corporations can be combined if 20% or more of the value of each corporation is owned by decedent and included in the gross estate or is held by the surviving spouse with decedent as joint tenant, tenants in common, or community property. IRC § 303(b)(2)(B).

(3) **Time**. The redemption must occur after death, and occur three years plus 90 days from the later of the due date of the return (without extension) or the actual filing, 60 days after a final Tax Court decision, or before the last installment is due on a payment deferral election under IRC § 6166. IRC § 303(b)(1). If this stretches more than four years after death, redemptions qualify only for the lesser of taxes and expenses unpaid immediately before the distribution or the amount of these items paid within one year after the redemption distribution. IRC § 303(a)(4).

O. **Elective Deferral of Payments**. Under IRC § 6166 the estate of a closely held business owner may elect to stretch estate tax payments over a period of up to 10 years in annual installments with the first installment due within 5 years of the due date (without extensions) of the estate tax return, subject to the payment of interest during this 5-year period in four annual installments. IRC § 6166(a)(1) and (3) and (f)(1). Planning for this deferral is similar to planning for the other special closely held business provisions discussed above.

(1) **Low Interest**. The interest on the first $1 million of taxable value (indexed for inflation) is 2%, and the balance bears interest at only 45% of the rate of IRC § 6601(a). However, no estate tax or income tax deduction will be available for any such interest paid.

(a) Taxable Value. The special 2% rate applies to the portion of the deferred estate tax that is attributable to the first $1,480,000 (in 2016; subject to adjustment for inflation; see Rev Proc 2015-53, Sec. 3.42, 2015-44 IRB) in taxable value of the closely held business. The first $1,480,000 in "taxable value" of the business is the first $1,480,000 above the applicable exclusion amount (under the unified credit). IRC § 6601(j)(1)(A). Thus, for example, in 2016, when there is an effective estate tax exclusion of $5.45 million (also subject to adjustment), the amount of estate tax attributable to the value of the closely held business between $5.45 million and $6.93 million is eligible for the 2% interest rate.

(b) Other Rate. Where tax is deferred but the 2% rate does not apply, a smaller reduction applies. The interest rate on deferred estate tax attributable to (1) the taxable value of the closely held business in excess of $1,480,000, (2) holding companies, and (3) nonreadily tradable business interests where the decedent qualified for the 20% interest test (described below) using family attribution, is reduced to an amount equal to 45% of the tax applicable to underpayments of tax. IRC § 6601(j)(1)(B).

(c) Application of Payments. Tax payments on the deferred amounts will be applied to each portion of the liability proportionately. IRC § 6601(j)(1). (For example, assume one-third of the deferred amount qualifies for the 2% rate, and the remaining two-thirds is subject to the regular rates. A tax payment of $90,000 reduces the 2% portion by $30,000 (1/3) and the regular portion by $60,000.)

(2) **Qualification**. The major qualification requirements include:

(a) Amount of Deferral. The portion of the estate tax that can be deferred is the portion that is in the same proportion as the value of the closely held business is to the value of the adjusted gross estate. IRC § 6166(a)(2).

(b) Percentage Test. The business must be more than 35% of the adjusted gross estate less deductions for administrative expenses, losses, etc. under IRC §§ 2053 and 2054 (*i.e.*, no marital or charitable deduction is taken into account here). The value of more than one business may be combined if 20% of the value of the business is included in the gross estate or is held by the surviving spouse in joint tenancy, tenancy in common, or community property. IRC § 6166(c). Special use value of real estate will be used where this has been elected because the values used are estate tax values. IRC § 6166(b)(4). Passive assets are excluded from value. IRC § 6166(b)(9).

(c) Closely Held Business. The business must be closely held but may be in the form of a sole proprietorship, or a partnership or corporation of which 20% or more of the total capital interest or voting stock value is included in the gross estate or which have 45 (15 prior to 2002) or fewer partners or shareholders. IRC § 6166(b)(1).

(i) Attribution of Ownership. Attribution rules apply to deem the ownership of related parties to belong to decedent (interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent, and there is attribution for certain indirect ownership through entities), and gifts within three years of death are included for this purpose as well. IRC §§ 6166(b)(2), 2035(d)(3)(C). In applying the 45 partner or shareholder test, above, interests or shares owned by the decedent's spouse, siblings, ancestors, and descendants are treated as owned by the decedent. Any interest owned jointly by a married couple is counted as one partner or shareholder.

(ii) Attribution Election for Qualification. In applying the 20%-interest test, the executor may elect to have the interests of these family members counted as the decedent's. However, if this is the way the decedent's interest qualifies for the deferral, then (1) the 5-year deferral period is lost (*i.e.*, the ten-year payment period starts right away), and (2) the favorable 2% interest rate is not available on deferred amounts. IRC § 6166(b)(7).

(d) Active Trade or Business. The business must actually be engaged in an active trade or business at the time of death where active management has been provided by decedent or decedent's agent. IRC § 6166(b)(1); Rev. Rul. 75-365, 1975-2 C.B. 471. Farms can include residential property occupied on a regular basis by the owner or lessee for operating the farm. IRC § 6166(b)(3). Stock cannot be readily tradeable on an exchange or over the counter market. IRC § 6166(b)(7).

(e) Active Business of Farming. For a farm to meet the active trade or business requirement, the decedent must be engaged in the business by cultivating, operating, or managing the farm for profit, either as an owner or tenant, and receive any rental based on farm production rather than a fixed amount. Ltr. Ruls. 8020143 and 8136022; Rev. Rul. 75-366, 1975-2 C.B. 472. Management may be through an agent. Ltr. Rul. 8133015. It is helpful to show management and participation to have participation in important decisions (*e.g.*, crops to plant, use of subsidies, marketing plans), to visit the operation regularly, to make crop-sharing arrangements, and to bear certain costs (*e.g.*, maintenance, property taxes, fertilizer).

(f) Election. The election must be made on a timely filed return or, in some cases, on the deficiency assessed during audit if values increase to a point that qualification becomes possible. IRC § 6166(d) and (h). See Regs. § 20.6166-1. It may be best to file a protective election if qualification is possible.

(3) **Termination**. Deferred tax will be accelerated if:

(a) Disposition. A sale or other disposition (other than certain reorganizations (see IRC § 6166(g)(1)(C)) or transfers by reason of death under the will, trust, or intestacy (see IRC § 6166(g)(1)(D)) of 50% or more in the aggregate of the value of the decedent's interest occurs (IRC § 6166(g)(1)(A));

(b) Estate Redemption. Redemptions under IRC § 303 occur, to the extent not used to pay the next installment of taxes (IRC § 6166(g)(1)(B));

(c) Undistributed Income. The estate has undistributed income for any year ending on or before the first installment becomes due (*i.e.*, after four taxable years) (IRC § 6166(g)(2));

(d) Default. The required installments are not paid when due (IRC § 6166(g)(3)(A)).

(4) **Bonds, Liens, Liability**. A bond of up to double the tax deferred may be required by the Service. IRC § 6165. The personal representative is personally liable unless discharged by the posting of the bond, the payment of the tax, or following of the special lien procedure. IRC § 2204A. A special lien in lieu of the regular tax lien may be elected by all persons with an interest in the property filing an agreement consenting to the lien and naming an agent to make payments, receive notices, and otherwise deal with the Service. The lien applies to all real property and assets expected to survive the deferral period. IRC § 6324A. The lien is on an amount not to exceed the principal of the deferred taxes and four years of interest. IRC § 6324A(b)(2) and (e)(2). The value is estate tax value after reduction for encumbrances such as mortgages and any liens under the special valuation provisions. IRC § 6324(b). If the lien is insufficient, a bond may be accepted for the remaining amount. IRC § 6324A(b)(3). Additional security may be required on 90 days' notice if the value of the liened property becomes less than the required amount, and if not provided, the tax will be accelerated. IRC § 6324A(d)(5).

P. **Discretionary Deferral of Payments and Deferrals for Remainders and Reversions**. A discretionary deferral of payments may be available for a reasonable period not to exceed twelve months from the original due date of the return (*i.e.*, up to 21 months from the date of death). IRC § 6161. An additional extension for up to ten years may be available if reasonable cause is demonstrated. IRC § 6161 discretionary deferrals may also apply to installments due under IRC § 6166. Security may be required under IRC § 6165. The Code also provides a separate deferral mechanism under IRC § 6163 which provides for a deferral until six months after the end of the prior interest for tax attributable to a reversion or remainder interest. An additional three years deferral may be possible under this provision if reasonable cause is demonstrated. Security may be required under IRC § 6165.