Vanderbilt Law Review

Volume 5
Issue 1 *Issue 1 - December 1951*

Article 5

12-1951

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Recommended Citation

William J. Bowe, Estate Liquidity and the Family-Owned Business, 5 *Vanderbilt Law Review* 68 (1951)
Available at: https://scholarship.law.vanderbilt.edu/vlr/vol5/iss1/5

ESTATE LIQUIDITY AND THE FAMILY-OWNED BUSINESS— A TAX PLAN UNDER THE RECENT AMENDMENTS TO SECTION 115(g)

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Every community in the country has its quota of successful merchants, manufacturers and businessmen whose enterprises have, as a result of management or planning, grown and prospered over the years. To value the worth of such businesses for estate tax purposes is perhaps the most difficult fact-issue in the whole field of taxation. Indeed it is doubtful if there is any problem in law or economics where the criteria are so vague and uncertain and where the permissible range for honest differences of judgment is so great. Expert opinion may vary by more than 100%. For purposes of illustrating the nature and extent of the problem, let us assume a case where a low of $300,000 is hoped for by the client but a high of $600,000 must be faced as a possibility.[1]

The difference in his estimated federal estate taxes, assuming $90,000 of other assets[2] and excluding consideration of the marital deduction, between the low and high valuations suggested is $98,000 at present rates. He will need a minimum of $82,000 and a maximum of $180,000 to meet his estimated death taxes.

1. Estimated Net Estate		
Business Interest		$300,000
Other Assets		90,000
Total		$390,000
Less Specific Exemption	$60,000	
Debts and Administration Expenses	30,000	
		$ 90,000
Taxable Estate		$300,000
Estate Tax	$82,000	
2. Estimated Net Estate		
Business Interest		$600,000
Other Assets		90,000
Total		$690,000

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1. That this is within a possible range for difference of opinion, see Henry T. Sloane, 13 P-H 1944 TC MEM. DEC. ¶ 44206 (1944).
2. Residence $40,000, insurance $25,000, securities $15,000, miscellaneous personal property, $10,000.

Less Specific Exemption	$ 60,000	
Debts and Administrative Expenses	30,000	
		$ 90,000
Taxable Estate		$600,000
Estate Tax	$180,000	

Unless he makes adequate provision for this unpredictable sum, the tax will be paid in costly dollars since the sale of a partial interest in his business, if this becomes necessary, is almost certain to be at a sacrifice price. Nor is it economically feasible to purchase insurance to cushion the blow. He would need not merely $180,000 of insurance to pay the top estate tax of that amount, but $280,000 since the insurance proceeds themselves become taxable.

Estimated Net Estate		
Business Interest		$600,000
Insurance Proceeds		280,000
Other Assets		90,000
Total		$970,000
Less Specific Exemption	$ 60,000	
Debts and Administration Expenses	30,000	
		$ 90,000
Taxable Estate		$880,000
Estate Tax	$281,000	

Where the business is controlled by several families, a purchase agreement may solve the difficulty. All owners may agree to purchase the interest of any deceased owner for a stipulated price or for an amount to be determined by the application of a fixed formula. This will remove all or much of the uncertainty created by the valuation problem. Each owner may purchase enough insurance on the lives of the others to assure his ability to perform promptly his part of the contract, should he be among the survivors. So long as he owns the policies and pays the premiums no tax problems with respect to the insurance will arise to plague the estate of the insured. But these business purchase agreements may lead to litigation with the taxing authorities whenever the contracting parties are members of an intimate family group on the theory that they represent transfers for less than an adequate and full consideration. Only when the contract is clearly the result of an arm's-length business transaction will it be immune from attack.[3]

Where a sole owner or an intimate family group is involved, insurance may be carried on the life of the owner or owners by *other* members of the

3. Bowe, Life Insurance and Estate Tax Planning 87 (1951).

family. The proceeds may be used to purchase estate assets and thus furnish the needed cash. But unless the premiums are paid with funds not traceable directly or indirectly to the insured, the insurance may be included as part of the owner's estate, swelling the tax to the point where the insurance proceeds are of little help.

A sale of a part interest during life, or a merger with a larger company may increase liquidity. A recapitalization followed by gifts may present a partial solution.[4] But the marital deduction and the "redemption ot stock to pay dcath taxes" provision of the Code offer the greatest hope to owners of businesses who would keep control within the family. That Congress appreciated the seriousness of this problem is evidenced from the Senate Finance Committee Report on the Revenue Act of 1950. "It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. . . . Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free enterprise."

This remedial legislation was accomplished by amending section 115 of the Internal Revenue Code. Section 115 deals with distributions by corporations. Subsection (c) states that amounts received by stockholders in complete or partial liquidation of a corporation shall be treated as if received on a sale or exchange of the stock. This permits stockholders, if stock is redeemed, to report any profit as a long term capital gain at a maximum tax rate of 26%.[5] But to prevent stockholders from siphoning off corporate profits at favorable capital gains rates, Section 115 (g) (1) provides that if a corporation cancels or redeems its stock in a manner that makes the distribution "essentially equivalent" to a taxable dividend, then the amount so distributed shall be treated as a taxable dividend to the extent that the corporation had earnings and profits.[6] Thus, an executor whose estate assets consisted in large part of stock in a family corporation was faced with a difficult dilemma. If only a portion of the stock was redeemed to provide funds to pay the death taxes, he might have to pay a high income tax on the proceeds of redemption.[7] To avoid the income tax and yet obtain the

4. But see Bazley v. Commissioner, 331 U.S. 737, 91 L. Ed. 1782, 67 Sup. Ct. 1489, 173 A.L.R. 905 (1947).

5. This assumes the stock was held for more than six months.

6. Assume *A*, *B*, and *C* formed the *X* Corporation. Each subscribed for 1,000 shares at $50 per share. At the end of the first year of operation the corporation had $30,000 of earnings. Instead of declaring a dividend, it redeemed 300 shares of its stock. Thus *A*, *B*, and *C* each surrendered 100 shares and received $10,000 in exchange therefor. Such a distribution is clearly taxable as a dividend under INT. REV. CODE § 115(g).

7. Assume he needs $100,000 to pay death taxes and the estimated value of the total stock owned by the estate is $600,000. Further assume the Corporation redeemed 1/6 of the estate's stock. If this is found to constitute a taxable dividend, the income

needed cash, he would have to sell a part interest to outsiders or the company would have to redeem the estate's entire holdings. But this would force the family out of control, as noted by the Senate Finance Committee.

Under the new amendment, Section 115(g)(3), an executor can surrender for redemption family corporation stock held in the estate[8] and the proceeds of this redemption in an amount equal to death taxes levied against the estate (state and federal) will not be taxed as a dividend under Section 115 (g). Further, the cost basis for determining gain or loss on the redemption will be the date-of-death value rather than the decedent's original cost.

This favorable exemption from the perils of Section 115(g)(1) is available only if the value of the family stock included in the estate for tax purposes comprises more than 35% of the value of the gross estate and the redemption is made within the three-year period of limitation for assessment of estate tax or within 90 days after such period.

Let us revert to the case of the owner whose business might be valued at anywhere from $300,000 to $600,000 and whose other assets total $90,000 to illustrate what may be done.

By taking full advantage of the marital deduction he may reduce his maximum estimated estate tax from $180,000 to $72,000.

Gross Estate		$690,000
Debts & Administration Expenses		30,000
Adjusted Gross Estate		$660,000
Specific Exemption	$ 60,000	
Marital Deduction	330,000	390,000
Net Estate		$270,000
Federal Tax	$ 72,000	

On the assumption that the corporation will be in a position to redeem 12% of his stock at the price at which it is estimated it will be valued for estate tax purposes, his liquidity problem will be solved. It is possible that any accumulation of corporate earnings for the purpose of redeeming stock may run afoul of another section.[9] Section 102 imposes a special tax on the accumulation of corporate earnings beyond the reasonable needs of a business for the purpose of avoiding surtax to its stockholders. The question here is

tax on the distribution would amount to $67,300, leaving only $32,700 available for payment of the death taxes. At present progressive rates more than $500,000 of stock would need to have been redeemed to net $100,000.

8. It does not matter whether the stock is owned by the estate or by a beneficiary, so long as it is inclnded in the estate for tax purposes. Thus the new provision applies to a redemption of stock held by a revocable trust or given away in contemplation of death.

9. INT. REV. CODE § 102.

whether the building up of a reserve fund for the purpose of redeeming common stock constitutes a proper business purpose. While most writers have taken the view that it does, the answer is at best doubtful.[10] For the same reason it is doubtful whether the corporation may safely purchase $72,000 of life insurance on the owner's life for this purpose.[11] There is, however, no question that a corporation may purchase key-man insurance on its personnel provided the policies are limited in amount to reasonable indemnification. Preferably, the key-man insurance will not be on the life of the sole owner because of the risk that the corporation may be regarded as his *alter ego*.[12] It may be purchased on the lives of other key personnel. Upon the death of the owner, such policies, even if not yet matured, would serve as a source of raising cash to the extent of their cash surrender values. Other methods of proper accumulation of earnings will readily occur and in large part will be based upon the particular type of business involved. Liquid assets may be accumulated against future hazards or for the acquisition of a building to house the enterprise or mortgage or other long term debts may be discharged so that the corporation will be in a position to borrow funds with which to redeem. Any one of these plans involving the need for reserves may be altered in the event of death and the funds used to redeem stock; or if any plan outlined above has been accomplished, it will render the corporation better able to raise needed cash by the sale of assets acquired or by borrowing on assets heretofore freed from debt.

The objection to the plan is that it apparently merely postpones the problem of a forced sale of the business pending the death of the wife, since her death taxes, because of the marital deduction gift, will be approximately $72,000 and the normal corporation cannot stand the strain of repeated redemptions. But this plan need not effect merely a putting off of the evil day. A definite value will have been determined for the stock in the estate tax proceedings. While this valuation will not be binding on the Commissioner with respect to later gifts, it represents a fairly reliable estimate of what may be expected in future disputes over this issue in the absence of abnormal changes. Therefore, the widow can safely begin to make the gifts to the children and grandchildren, using her exemption and annual exclusions, which the perplexing valuation problem discouraged her husband from making during his life.

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10. See BOWE, INCOME TAX TREATMENT OF LIFE INSURANCE PROCEEDS 53 (1951); Danzig, *Taxes—Insurance—and Stockholders—Survivor Agreements*, 28 TAXES 213 (1950). *Contra:* Mannheimer and Friedmann, *Stock Retirement Agreements*, 28 TAXES 423 (1950); Smith, *Disposition of Business Interests*, 28 TAXES 1238 (1950). See The Emeloid Co. v. Commissioner, 14 T.C. 1295 (1950), *rev'd*, 189 F.2d (3d Cir. 1951).

11. See note 10 *supra*.

12. BOWE, LIFE INSURANCE AND ESTATE TAX PLANNING 59 (1951).

If the husband survives his wife, his problem becomes much more acute. He will hesitate to make substantial gifts of partial interests in the business to the children while he lives, because, due to the uncertainty of the valuation which may be placed on the interest transferred, it will be impossible for him to approximate even roughly the amount of the gift tax liability he would be likely to incur. Such gifts may involve him in costly litigation and, if the value fixed is substantially higher than he contemplated, he may have difficulty finding the funds to pay the tax.

To protect himself against the eventuality of his wife's dying before he does, he may insure his wife's life for $100,000—this approximates the estimated loss his estate will sustain as a result of her death since the marital deduction will in that event not be available.[13] To avoid swelling his estate tax, by the cash surrender value of the policy if he predeceases his wife or by the full amount of the proceeds if he survives her, the policy should be irrevocably transferred in trust for the benefit of his children. Each time he pays a premium he will be making a gift and since it is a gift of a future interest, he may not take advantage of his $3,000 annual exclusions, but he may charge these payments against his $30,000 exemption ($60,000 if his wife consents to have half of each premium payment charged against her exemption). The trustee should be authorized but not required to purchase assets from his estate.[14] In this way the $100,000 may be made available to his estate if needed to pay the enlarged estate tax due to the unavailability of the marital deduction.

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13. BOWE, INCOME TAX TREATMENT OF LIFE INSURANCE PROCEEDS 39 (1951): "The marital deductions provisions of the Code have opened up a completely new field for the use of such plans. Prior to 1948, it was frequently impossible to arrange for the payment of the premiums by someone other than the family member who needed insurance protection. Thus, where a husband had $250,000 and his wife was without substantial independent means, his was the life to be insured. His estate would need approximately $47,000 to pay his death taxes. His wife could not pay for the insurance except with funds traceable to him and the indirect payment rule would operate here to cause the insurance proceeds to be taxed as part of his estate. But today the death of the wife before the husband would, in the case suggested, result in a major economic loss to the family as a unit. The husband's estate tax if he predeceases his wife, and if he takes full advantage of the marital deduction, would be $11,000, whereas if his wife predeceases him, his estate tax would be, as before 1948, $47,000. Thus, the risk to be insured against is the premature death of the wife, since her death before his will increase his potential estate taxes from $11,000 to $47,000. In cases such as this, it will be advisable for the husband to pay for and own insurance on his wife's life. The proceeds will then be received by him free of both income, estate and state inheritance taxes and will provide the additional cash needed for death costs should he survive his wife."

14. U.S. Treas. Reg. 105 § 81.26. See PAUL, SUPPLEMENT TO FEDERAL ESTATE AND GIFT TAXATION § 10.33 (1946).