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Notes

Estate Planning for the Disposition of Control of a Family Corporation*

I. INTRODUCTION

Buy-sell agreements and recapitalizations are familiar methods of transferring corporate control in close corporations. However, where the vast majority of shares is owned by members of the same family and the transfer is to be from father to son, these plans encounter several problems which do not occur when the shareholders are unrelated. For example, if a plan calls for the redemption of stock from a deceased shareholder’s estate, the tax attribution rules operating on the close family relationship may cause the entire corporate distribution received in the transaction to be treated as ordinary income. In addition, corporate manipulation to suit the controlling shareholder’s estate planning needs, rather than corporate needs or the needs of nonfamily interests, may well meet opposition from corporate creditors and minority shareholders. Indeed, designing corporate changes to accommodate the diverse personal requirements of a controlling shareholder’s beneficiaries presents a problem in itself. It is the purpose of this Note to examine some of the difficulties faced by the estate planner who must devise a buy out or recapitalization to transfer a controlling interest from father to son in a family corporation.

Throughout the following discussion it will be assumed for the purpose of illustration that the client’s corporation has 1,000 outstanding shares of common stock divided as follows: the client-testator owns 750 shares, his adult son owns 150 shares, and an unrelated employee of the corporation, X, owns 100 shares. The corporation is worth $1,000,000, and each share has a cost basis of $100. The testator is married and has two children, the son and a daughter. The corporation is most valuable as a going concern, and testator’s stock will be the principal asset of his estate. While this latter postulation will often prove untrue, it is useful here in order to highlight possible liquidity problems arising upon testator’s death. The testator has two principal objectives: he wishes to pass control of the corporation to his son who is skilled in, and has participated in, the management of the business; and he wants his interest in the corporation to

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provide for his widow and daughter.

II. BUY OUTS

A. ENTITY BUY OUTS

The entity buy out provides a mechanically simple device for carrying out the testator's wishes. Upon his death, the corporation purchases testator's stock from his estate, thereby leaving his son in control of the corporation. The estate then uses the proceeds from the sale to satisfy testator's bequests and legacies to his wife and daughter. The plan insures a market for testator's stock, thus eliminating potential liquidity problems, and the surviving shareholders have no fear of an outsider's buying into the corporation.

Funding the buy out may present a problem, since the death of a shareholder could occur prematurely when the corporation is without enough capital surplus to make the agreed purchase. Moreover, in the present case it would be extremely difficult for the corporation to buy three quarters of a million dollars worth of stock even if testator lived out his expected life span. Also, the accumulation of a surplus large enough to fund the purchase might subject the corporation to the accumulated earnings tax.

1. The mechanics of buy out agreements have been the subject of much comment. See, e.g., Gordon, Buying Out the Deceased Co-Adventurer: The Use of Insurance, N.Y.U. 19TH INST. ON FED. TAX. 673 (1961); Hull, Advantages of Cross-Purchase Plan Over Redemption in Certain Situations, 14 J. TAXATION 84 (1961); Neuhoff, Life Insurance Funding of Business Buy-Out Agreements, 25 Mo. L. REV. 3 (1960); Weinstock, Stock Purchase Agreements, 40 TAXES 561 (1962).

2. State law may impose restrictions on the purchase by a corporation of its own stock. See Note, Stock Repurchase Abuses and the No Prejudice Rule, 59 YALE L.J. 1177, 1182-83 (1950) (general survey). In addition, almost all states place restrictions on the funds from which redemptions can be made. See, e.g., ABA-ALI MODEL BUS. CORP. ACT §§ 5, 60 (1950); MINN. STAT. § 301.22(6) (1965).

3. INT. REV. CODE of 1954, §§ 531-37 [hereinafter cited by section number only]. Section 532 provides that the accumulated earnings tax shall apply where corporate earnings and profits are accumulated "for the purpose of avoiding the income tax with respect to its shareholders . . ." Section 533 provides that accumulations "beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax . . ." Thus a question exists as to whether accumulations for the purpose of redeeming the interest of the controlling shareholder of a close corporation are beyond the reasonable needs of the business. Resolution of this question requires that inquiry be made into whether accumulations for redemption serve a corporate purpose, as opposed to a shareholder or other purpose, and therefore satisfy a business need. Whether the retention of earnings is for the redemption of a majority or minority shareholder has sometimes been deemed a crucial fact in finding a corporate purpose. See Gazette Pub. Co. v. Self, 103 F. Supp. 779 (E.D. Ark. 1952); Pelton Steel Casting Co. v. Commis-
Normally, such agreements are funded by insurance. Under an entity buy out funded by insurance, the corporation insures the lives of its shareholders naming itself as beneficiary. While


5. Under no circumstances should testator retain incidents of ownership in the policy, or the proceeds plus his stock interest will be included in his gross estate. Section 2042. This may pose a problem when the son predeceases testator. If the testator has the power to change beneficiaries upon the occurrence of that contingency, he has a § 2042 incident of ownership. Treas. Reg. § 20.2042-1(c) (2) (1966). See Stern, Buy-Sell Agreements, N.Y.U. 19TH INST. ON FED. TAX. 653, 675 (1961).

For accumulated earnings tax purposes, it is advisable not to tie the purchase of insurance by the corporation to the redemption of any particular shareholder's stock because a showing of a business purpose, as opposed to a purely shareholder purpose, seems to be a prerequisite to a finding of a reasonable business need. See note 3 supra. One method of accomplishing this is the purchase of "key-man" insurance by the corporation to protect itself against the loss of valuable personnel. While the buildup of cash values would be deemed the retention of earnings, a valid business need could easily be shown. To characterize the retention of earnings in this manner is not without problems, however. For example, in the hypothetical posed, the value of the loss of testator's services may well be less than the value of his stock, in which case there will be insufficient funds for a complete redemption. If more insurance is purchased than is needed to cover the loss of testator's services, the benefit of this plan may be lost. The fact that the declared purpose of accumulations is to provide for the loss of key men is not binding on the Commissioner if the funds are in fact used for a redemption. S. REP. No. 1622, 83d Cong., 2d Sess. 69-70, stated:

If the retention of earnings is justified as of the close of the
its payment of the premiums is not deductible, the premiums are paid with once-taxed dollars rather than twice-taxed dollars, which would be the case were the shareholders to insure each others' lives, paying the premiums themselves. Even so, the annual premiums on a million dollars of life insurance will amount to thousands of dollars and may reduce corporate income after their payment to an unacceptable level. Also, the cash value of the policies will be subject to the claims of corporate creditors. On the other hand, receipt of the insurance proceeds is tax-free. The agreement as to the price at which the corporation will purchase testator's stock may fix its value for estate

taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year. However, subsequent events may be considered to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated.

6. Section 264(a)(1). There is a danger that the Commissioner might contend the payment of premiums by the corporation constitute dividends to the son and X, because the effect of the transaction is tantamount to the son and X taking out the policy on testator's life and having the corporation pay the premiums.

In Wall v. United States, 164 F.2d 462 (4th Cir. 1947), a close corporation controlled by the taxpayer assumed the personal obligation of the taxpayer to buy out another shareholder. It was held that payments by the corporation on the assumed contract constituted dividends to the taxpayer. Cf. Paramount-Richards Theaters, Inc. v. Commissioner, 153 F.2d 602 (5th Cir. 1946) (policy could not be reached by corporate creditors). Other cases have held, however, that where a corporation insures the life of its majority shareholder, payment of the premiums does not constitute dividends to those who will have control following that shareholder's death and the purchase of his interest by the corporation. See, e.g., Sanders v. Fox, 253 F.2d 855 (10th Cir. 1958); Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957); Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957). These cases have been affirmed by the Treasury. Rev. Rul. 614, 1958-2 Cum. Bull. 920. See Rev. Rul. 184, 1959-1 Cum. Bull. 65; Comment, 33 N.Y.U.L. Rev. 89 (1958) (and cases there cited). The Wall case would seem to present problems only where the corporation assumes a cross purchase buy out arrangement, thus rendering it a trap only for the uninformed.

7. See Flitcraft Compend, published by Flitcraft, Inc., which compiles current life insurance rates. Term insurance may be a partial solution to the problem of high premiums, as may the transfer of existing policies where testator is uninsurable.

8. Section 101(a)(1). There is little chance that the Commissioner will claim that purchase of testator's interest constitutes a dividend to the surviving shareholders because their respective interests in the corporation are increased by the redemption. Rev. Rul. 614, 1958-2 Cum. Bull. 920, provides:

[T]he Service will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased. On the other hand, if the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of the transaction, the
tax purposes. And the plan as a whole preserves to the stockholders the opportunity to make a subchapter S election, because it does not create a new class of stock nor give rise to a nonindividual stockholder. 

While insurance appears to be a practical way to handle the funding problem, difficulties may arise where, as here, there is a great disparity between the ages of the stockholders and the sizes of their respective interests. For instance, the premium payments will be paid from corporate income, in which the son and X both have a substantial salary interest. Yet the bulk of the insurance cost will be attributable to the much larger policy on testator's life. Consequently, the son and X will in effect be subsidizing part of the testator's portion of the buy out. The son and X, however, will gain a substantially greater interest in the corporate assets following testator's death. Similarly, testator, who in all likelihood will die first, will not realize his proportionate share of the increase in corporate worth due to the corporation's receipt of insurance proceeds at his death. 

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10. See §§ 1371-77. A corporation meeting the subchapter S requirements can elect to be taxed as a partnership. Section 1371 limits the types of corporations which may elect under subchapter S to those which do not

(1) have more than 10 shareholders;
(2) have as a shareholder a person (other than an estate) who is not an individual;
(3) have as more than one class of stock.


12. Receipt of proceeds in excess of the amount of premiums paid will increase the corporation's earnings and profits, thereby in-
illustrate, the corporation will be worth approximately $1,000,000 plus the $750,000 insurance proceeds at testator's death. Though testator's interest in the corporation is 75% of this sum, his stock will be purchased, absent provisions to the contrary, for only $750,000. Likewise, and again absent provisions to the contrary, testator's estate will not share in the increase in corporate worth due to the cash values of the policies on X and the son. Formulas exist which include the insurance proceeds and the cash values of the surviving shareholders' policies in valuing a testator's interest prior to purchase, but these do not take into account such factors as the decrease in the corporation's value attributable to the shareholder's death. While such formulas are helpful, they are not a panacea.

Sections 302 and 318 of the Internal Revenue Code of 1954 pose a most serious drawback to the entity buy out of testator's interest. Section 302 determines when a redemption of a shareholder's interest by a corporation will be deemed a sale and the gain given capital gains treatment, and when a redemption will be deemed to be a distribution essentially equivalent to a dividend and subject to ordinary income treatment. Under section 302, a redemption will result in capital gains treatment only if (1) it is not essentially equivalent to a dividend, or (2) it is substantially disproportionate to the shareholder's prior interest, or (3) it is a complete termination of the shareholder's interest in the corporation. It would be a relatively easy task to create an estate plan which would meet one or more of these criteria if section 302 did not specifically provide that the attribution rules of section 318 shall apply in determining whether the above tests have been met. Section 318 provides that an individual shall be deemed constructively to own stock owned by members of his family. It further provides that stock owned by an estate will be deemed constructively to own stock owned by members of his estate. The consequences of applying these sections to the hypotheti-
cal situation now under consideration are as follows. Assuming the wife to be a beneficiary of testator's estate, upon testator's death the son's 150 shares will be attributed to his mother, and, in turn, this interest will be attributed to the estate. Consequently, the estate will be deemed to own constructively all the stock in the corporation except that interest owned by X. After the corporation redeems testator's stock from his estate, the estate will still constructively own the son's 150 shares. Hence with regard to the termination of interest test the redemption will not be a complete termination of the estate's interest, and, if the proceeds are not to be treated as the receipt of a dividend, they must qualify under another of the alternative provisions of section 302.

The "substantially disproportionate" test of section 302(b)(2)(B) provides that a redemption will not be substantially disproportionate with respect to the redeeming shareholder unless he owns less than 50 per cent of the combined voting power of all classes of stock entitled to vote following the redemption. Section 302(b)(2)(C) adds a second requirement that a redemption is not substantially disproportionate unless there is a decrease of more than 20 per cent in the voting control of the shareholder whose stock is redeemed. In the present case, the estate's constructive voting control is 90 per cent before the redemption and afterwards 150 of 250 shares, or 60 per cent. While this meets the second requirement, it does not meet the first because the estate still has more than 50 per cent of voting control.

It would appear that the 50 per cent requirement can never be satisfied where testator's spouse is a beneficiary of his estate and the son must have control following the redemption. The son must ultimately own more than 50 per cent of the voting stock in order to be in control, and the attribution rules will attribute this interest through the mother to the estate. Consequently, the estate will always constructively own more than 50 per cent of voting control following the redemption.

18. The problems raised by the application of the § 318 attribution rules to § 302 redemptions are discussed at length in Note, Stock Redemptions From Close Family Corporations Under Section 302, 47 Minn. L. Rev. 853 (1963). Though § 302(c)(2) provides a waiver of the attribution rules in the § 302(b)(3) termination of interest situation, only the family attribution rules may be waived and not the entity attribution rules. Rev. Rul. 233, 1959-2 Cum. Bull. 106. Hence the son's stock must be attributed to the estate.

19. In a situation where a redemption by testator's estate could meet the termination of interest provision of § 302 if it were not for the fact that bequests to nonfamily beneficiaries will be attributed to the
The final way to avoid ordinary gain on the redemption lies in the "not essentially equivalent to a dividend" test of section 302(b) (1). Judicial construction of this section and its predecessor under the 1939 Code emphasizes the "net effect" of the distribution and whether or not it has a legitimate business purpose. While many factors are considered as relevant under the net effect test, the most important one is whether the redemption causes a change in the proportionate voting position of the shareholder receiving the distribution. For example, a pro rata distribution to all shareholders in no way alters respective voting control, and for this reason such a distribution would be taxed as a dividend. Cases have extended this reasoning to non-pro rata redemptions which cause only slight change in the voting control of the recipient by calling them essentially pro rata.

When the attribution rules are applied to section 302(b) (1)
the result is similar to that demonstrated in the discussion of the substantially disproportionate test. Because the son's stock is attributed through his mother to the estate, the estate never loses voting control. Consequently, despite X's large percentage increase in control, there is a high probability that the net effect of the redemption of testator's stock would be called essentially pro rata and deemed a dividend.

When a redemption fails to qualify for capital gain treatment under any of the provisions of section 302(a), section 301(c) controls taxation of the corporate distribution and provides that any portion which is a dividend must be included in the gross income of its recipient. Where the entire distribution is a dividend, difficulty may arise in determining the effect on the basis of the stock redeemed. Treasury regulations provide that if the redeeming shareholder owns other shares in the corporation, the basis of the redeemed shares shall be added to the basis of the shares retained. These regulations also suggest that where the redeeming shareholder has made a prior gift of a portion of his shares and completely terminated his interest, the basis of the shares redeemed can be added to the shares of the donee provided the donee is a family member. Where, however, the redeeming shareholder has made no prior gifts of shares to a family member and where he completely terminates his actual as opposed to constructive interest, it would

24. In Estate of Arthur H. Squier, 35 T.C. 950, acqiesced in, 1961-2 Cum. Bull. 5, the Tax Court held that § 318 as applied to § 302(b)(1) was not controlling where the voting control of Squier's estate was reduced upon a partial redemption of his stock and a dispute was shown to exist between the family members and the estate to which their stock was being attributed. While this case may benefit those who find themselves in a similar situation, it must be noted that family estrangement is a factor of little use from a tax planning point of view. Cf. Perry S. Lewis, 47 T.C. 129 (1966) (attribution rules not controlling where pro rata distribution was at issue under § 302(b)(1)); Ralph L. Humphrey, 39 T.C. 199 (1962).

25. Planning under §302(b)(1) is difficult because revenue rulings are seldom given on factual questions, such as whether a transaction is essentially equivalent to a dividend. Rev. Proc. 31, 1964-2 Cum. Bull. 947, specifically declares that rulings will not be given under § 302(b) where the redemption distribution consists of corporate notes.

26. See §302(d).

27. Section 301(c)(1) incorporates by reference the definition of "dividend" in §316. Section 316 defines a dividend as a corporate distribution made out of earnings and profits. Therefore, a redemption distribution will be deemed a dividend only to the extent it is made out of earnings and profits.


appear that the basis is lost.  

A possible way to avoid the effect of the attribution rules is suggested by Revenue Ruling 58-111. Treasury Regulation section 1.318-3(a) provides that a person ceases to be the beneficiary of an estate within the meaning of section 318 when all the property to which he is entitled as a beneficiary has been received by him. Hence if the testator’s estate satisfies the widow’s bequests and legacies out of assets other than stock before the redemption, she will cease to be a beneficiary and the son’s stock will not be attributed through her to the estate. However, this device will work only if the son is not a beneficiary. If he is, his stock will be attributed directly to the estate. In addition, Revenue Ruling 60-1832 provides that a residuary legatee has an interest and is therefore a beneficiary until the estate is finally closed. This would foreclose the use of formula fractional share marital gifts to the widow.

Webber v. United States casts further doubt on the usefulness of this approach. In that case a father and son each owned 50 per cent of the voting control of a family corporation. At the father’s death, the son was the beneficiary of a cash legacy which was satisfied out of assets other than the corporate stock. The estate then redeemed all the father’s shares. The court attributed the son’s shares to his father’s estate and held that under the laws of Kentucky the estate had a claim against the son’s legacy at the time of the redemption for any death taxes which the estate might not be able to pay. Therefore, his interest in the estate was not terminated within the meaning of Treasury Regulation section 1.318-3(a). It is noteworthy that the court cited no tax cases to support its position but if its reasoning is adopted generally, the success of satisfying cash legacies to related shareholders prior to redemption in order to avoid application of the attribution rules will turn on the construction given a state’s death tax laws.

In view of the foregoing, it would seem that an entity buy out is extremely dangerous because of the potential tax conse-

30. In the hypothetical, testator’s stock has a basis of $75,000. Were the redemption distribution of $750,000 to be deemed a dividend, the entire distribution would receive ordinary gain treatment, and the basis would be lost. Katcher, The Case of the Forgotten Basis: An Admonition to Victims of Internal Revenue Code Section 115(g), 48 MICH. L. REV. 465 (1950).
sequences. If the redemption does not fall within one of the safe harbor provisions of section 302, the loss to the estate may be disastrous.\textsuperscript{34}

B. Cross Purchase Buy Out

A cross purchase buy out\textsuperscript{35} avoids many of the problems presented by an entity buy out. To implement such a plan, each participating shareholder takes out insurance on the lives of the other shareholders.\textsuperscript{36} They then agree that upon the death of one of them, the others will use the proceeds of the insurance to purchase his interest from his estate.\textsuperscript{37}

Such a plan eliminates the section 302 quandry,\textsuperscript{38} presents no accumulated earnings problem to the corporation,\textsuperscript{39} and the surviving shareholders receive the decedent's shares at a stepped-up basis equal to their purchase cost.\textsuperscript{40} Moreover, the policies cannot be reached by corporate creditors.\textsuperscript{41}

The chief difficulty with the cross purchase plan is a practical one. The immediate annual cost of a policy large enough to purchase testator's $750,000 interest may be prohibitive.\textsuperscript{42} If the father is fifty years of age and insurable, the annual pre-

\textsuperscript{34} For instance, in the hypothetical case posed, the income tax on the $750,000 would be $559,340 if the entire amount were deemed a dividend, while the estate tax would only be $233,200. See § 1 and § 2001 respectively.

\textsuperscript{35} See note 1 supra. Often a cross purchase buy out will be implemented through a trust. The trust holds the policies and the participating shareholders' stock, the shareholders retaining voting and dividend rights. Upon the death of a shareholder the trust collects the insurance proceeds and distributes the deceased shareholder's stock pursuant to the terms of the plan. If this method is used, it is advisable to provide for termination of the agreement upon the simultaneous deaths of the shareholders or upon a radical change in the tax laws applicable to the plan.

\textsuperscript{36} For a discussion of the insurable interest of corporate shareholders in one another, see 2 J. Appleman, Insurance Law and Practice §§ 871, 872 (1966).

\textsuperscript{37} Where two brothers each established a trust naming the other the income beneficiary and the other's issue the remaindermen, it was held that each trust was established in consideration of the other and that each brother would therefore be deemed the settlor of the trust for which he was income beneficiary. Lehman v. Commissioner, 109 F.2d 99 (2d Cir.), cert. denied, 310 U.S. 637 (1940). The Treasury has ruled that this reciprocal trusts doctrine does not apply to cross purchase buy-outs. Rev. Rul. 397, 1956-2 Cum. Bull. 599.

\textsuperscript{38} Section 302 applies only to corporate redemptions.

\textsuperscript{39} See note 3 supra.

\textsuperscript{40} Section 1012.

\textsuperscript{41} See note 6 supra.

\textsuperscript{42} See note 7 supra.
miums will exceed $20,000. While the testator could make gifts of a portion of the premium each year, only $3,000 per year would be exempt from tax, and in any event it is improbable that the testator and his son, even jointly, could afford such premiums on their corporate salaries.

The premium burden can be eased by increasing the corporate salaries of father and son, thereby causing the corporation to bear part of the cost. Such salary increase is deductible to the corporation, and where the tax bracket of the corporation exceeds that of its officers the cross purchase buy out thus incurs less overall tax than an entity buy out. Such a scheme demands careful planning, however, or the Commissioner may deem such increased salary payments to be dividends.

Another means of easing the premium burden is to lower the amount of stock to be purchased from testator's estate. This can be accomplished through a plan of inter vivos gifts of stock from testator to his son. If the wife joins the testator in the gifts, they will be free of gift tax liability up to $6,000 per year, and over a twenty year period annual gifts worth $6,000 will reduce the father's holdings by $120,000.

43. Note 47 infra.
45. See id.; Treas. Reg. § 1.162-8 (1958); Patton v. Commissioner, 168 F.2d 28 (6th Cir. 1948).
46. The premium burden may be somewhat mitigated by use of a split-dollar scheme. Each participating shareholder collaterally assigns his policies on the lives of the others to the corporation. The corporation then pays that portion of the premiums each year which is equal to the increase in the policies' surrender values thereby sharing the premium burden with the stockholders. When a shareholder dies, the corporation's loan is repaid from the insurance proceeds and the remainder is used for the stock purchase. Unfortunately, the plan becomes less useful the longer each shareholder lives because the corporation's claim against the proceeds becomes larger each year leaving a correspondingly smaller amount for purchase money. For a discussion of the problems surrounding split-dollar, current loan, and minimum deposit plans, see Polasky, Planning for the Disposition of a Substantial Interest in a Closely Held Business—Part Three—The Corporation: Stock Purchase Agreements and Redemption of Shares, 46 Iowa L. Rev. 516, 520 nn.21 & 22 (1961).
47. Section 2503 provides an annual exclusion from gift taxes of $3000 made to any one person. Section 2513 permits a husband and wife to combine their individual annual exclusions and make yearly gifts of $6000 to any one person without incurring gift tax consequences.
48. Attention should be paid to the respective sizes of the donor and donee estates. While the donor's estate is diminished by gifts, the donee's is correspondingly increased. If the two estates are approximately equal, a gift may have the effect of taking property from a 50% tax bracket, for example, and transferring it into a 60% bracket.
gifts in excess of the annual exclusion and subject to the gift tax would serve as a tax barometer. If the Commissioner does not challenge the stock's value for gift tax purposes, a measure of assurance is achieved with respect to valuation of the stock upon testator's death. On the other hand, the basis of the stock in the son's hands would be stepped-up only by the amount of the gift tax paid, rather than being stepped-up to its fair market value which would be the case if the stock passed through testator's estate.

Setting the price at which the stock will be purchased may give rise to unwelcome tax consequences. If the buy out agreement restricts inter vivos transfers and binds the deceased shareholder's estate to sell, even at the option of the prospective purchasers, such agreement normally fixes the value of the stock for estate tax purposes. Where the parties to the agreement are close family members, however, this generalization may not hold true. The Commissioner may well decide that the family relationship between father and son seriously impairs the evidentiary value of the agreement as to price. In that case, the basis of the stock in the son's hands may be its cost to him and not its fair market value on the date of testator's death. Thus, it would seem advisable to obtain an independent appraisal before setting the purchase price.

Following testator's death, the son will want to purchase the policy on his life from the father's estate. Since the son is

49. Section 1015.
50. Section 1014.
52. Regarding the weight of restrictive agreements and options among family members in valuing closely held stock, Rev. Rul. 60, 1959-1 CUM. BULL. 237, comments:
   It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona-fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.
53. Valleskey v. Nelson, 271 F.2d 6, 9 (7th Cir. 1959); cf. Helvering v. San Joaquin Fruit & Inv. Co., 297 U.S. 496 (1936); Mack v. Commissioner, 148 F.2d 62 (3d Cir. 1945) (taxpayer purchased stock for $5 when it was worth $10, sold at $9 and attempted to take capital loss).
the insured, there will be no transfer for value problem.\textsuperscript{54} If $X$ participates in the plan, however, there will be a transfer for value problem.\textsuperscript{55} If the son purchases the policy on $X$'s life, and $X$ purchases the policy on the son's life, receipt of the proceeds on these policies will be exempt from taxation only to an amount equal to the consideration paid for the policies plus the subsequent premium payments made on them.\textsuperscript{56}

An additional funding problem may arise because the son and $X$ will be unable to purchase testator's interest until testator's death. Before that time, the father may want to retire. Since an officer in a closely held corporation normally derives the bulk of his income from salary as opposed to dividends, the father may want to dispose of the corporate stock in order to reinvest the proceeds in property capable of generating more income. If such a contingency occurs, the son and $X$ will not have sufficient funds to make the purchase.\textsuperscript{57}

On the whole, a cross purchase buy out seems far superior to an entity buy out in the type of corporate situation under consideration. Because there is no redemption, there is no section 302 risk that testator's estate will be taxed at ordinary income rates. In addition, the freedom to make inter vivos gifts of stock to the son without adverse redemption and attribution consequences is of great advantage, since testator can thereby remove a large portion of his assets from his estate.

### III. RECAPITALIZATIONS

The foregoing section has pointed out that the major drawback of a buy out arrangement is that it will often have to be financed by insurance, which is expensive and which may be

\textsuperscript{54} Section 101(a)(2) provides that the value of an insurance policy when transferred is equal to the consideration given for the policy by the transferee plus any premiums subsequently paid by the transferee. Any proceeds ultimately received from the policy in excess of this amount are deemed compensation in addition to the transfer for value and taxed as ordinary income. However, § 101(a)(2)(B) provides an exception to the foregoing provision where the transfer is to "the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer." Consequently, there is no transfer for value problem here since the son is the insured.

\textsuperscript{55} See § 101(a)(2).

\textsuperscript{56} See id. A transfer to a shareholder is clearly not embraced by the § 101(a)(2)(B) exception.

\textsuperscript{57} If testator becomes disabled, a waiver of premium rider on the policy will allow the son to divert his premium payments to meet installment payments for testator's stock.
impossible to obtain. The chief advantage of a recapitalization over the buy out is that it avoids these funding problems and does not cause a substantial reduction in the combined income of the testator and his wife.

The Supreme Court has defined recapitalization as a "re-shuffling of a capital structure within the framework of an existing corporation." Because such a reshuffling can be initiated and carried out in a short period of time, a recapitalization is well suited to the needs of older testators who wish to avoid the cost of an insurance funded buy out, or who are uninsurable, or who wish to retire.

In view of the broad range of capital changes which conceivably fall within the definition of a recapitalization, the estate planner has considerable flexibility in creating a plan which will dovetail the testator's needs with the tax consequences of the possible arrangements. From a nontax standpoint, it is clear that the plan chosen must not seriously impair the testator's income before he retires and must provide him with an income after he does so. In addition, the method devised to meet these inter vivos requirements must be coordinated with the testator's testamentary objectives. In this case, the testator wants to pass control of the corporation to his son and wants to provide his wife and daughter with income producing assets.

With regard to the tax incidents of the plan selected, the recapitalization itself should be tax-free under sections 368 and 354. It must enable testator to reduce his gross estate through inter vivos gifts, and it should not give rise to testator or other shareholder-employees receiving dividends on top of their salaries. Perhaps most importantly, the plan should not endanger marital deduction gifts to the wife.

For the purpose of suggesting a model plan of recapitalization, it will be necessary to make certain assumptions in order to narrow the numerous variables which must be considered. While the following assumptions will often prove to be factually untrue, they are not atypical and they fairly raise many of the problems to be encountered in an inter vivos recapitalization.

59. Sections 2523 and 2056 provide a gift tax and estate tax deduction for up to one half the value of gifts made to one's spouse.
60. If testator does not want to recapitalize during his lifetime, he may be able to direct his executor to implement such a plan. Whether the executor will have sufficient voting power will depend on state law. Minn. Stat. § 301.37 (1965) provides that the affirmative vote of 2/3 of the shareholders entitled to vote is needed to amend
First, it will be assumed that the testator has no source of income apart from his corporate salary and dividends.\(^{61}\) Second, the assumption will be made that the testator does not anticipate retiring in the immediate future, although he eventually intends to do so.\(^ {62}\) Finally, it will be assumed that testator owns only 510 shares, the remaining stock being evenly split between the son and X. This slight change in the hypothetical set forth originally will foreclose the testator from making inter vivos gifts of voting common without relinquishing control and will

the articles of incorporation unless otherwise provided in the articles of incorporation. ABA-ALI Model Bus. Corp. Act § 54(c) unqualifiedly requires the affirmative vote of \(\frac{2}{3}\) of the shareholders entitled to vote in order to change the articles of incorporation.

Dissenting shareholders will probably not be able to block the plan without showing mismanagement or fraud. In Minnesota, abuse of authority or persistent unfairness toward minority shareholders is grounds for involuntary dissolution. Minn. Stat. § 301.40(3) (1965). But shareholders have no appraisal rights unless a proposed amendment to the articles of incorporation would substantially change the corporate purposes or extend the duration of the corporation. Minn. Stat. § 301.40 (1965). The Model Business Corporation Act does not provide appraisal rights upon a reorganization. See ABA-ALI Model Bus. Corp. Act §§ 73, 74. Nor is a reorganization grounds for involuntary dissolution.

Assuming, then, that testator's executor has the power to effect a recapitalization, he would vote testator's stock to authorize the exchange of common for nonvoting, cumulative preferred. Pursuant to direction under testator's will, he would then give a portion of the common to the son and exchange the remaining common for preferred to give to the widow and daughter. The preferred would not be § 306 stock because there would have been a simultaneous disposition of the underlying common. See § 306(b) (4) (B). Note, however, the potentially large gift tax on the transfers. This can be mitigated if the testator makes gifts of the preferred in a piecemeal fashion, thereby taking advantage of his annual $3,000 exclusion, but any gifts made within three years of his death may be included in his gross estate. See § 2035.

If the testator does not have an independent source of income but wishes to retire immediately, he can exchange his common for new common and nonvoting, cumulative preferred, giving all the common to his son and all the preferred to his wife and daughter. This will lower his gross estate by the entire value of his interest in the corporation. There will be no § 306 problem because he will have made a prior or simultaneous disposition of the underlying common stock. See § 306(b) (4) (B). Note, however, the potentially large gift tax on the transfers. This can be mitigated if the testator makes gifts of the preferred in a piecemeal fashion, thereby taking advantage of his annual $3,000 exclusion, but any gifts made within three years of his death may be included in his gross estate. See § 2035.

\(^{61}\) If testator does have a source of income other than the corporation, the following plan is available to him. At retirement, he can recapitalize by exchanging his common for new common and nonvoting, cumulative preferred, giving all the common to his son and all the preferred to his wife and daughter. This will lower his gross estate by the entire value of his interest in the corporation. There will be no § 306 problem because he will have made a prior or simultaneous disposition of the underlying common stock. See § 306(b) (4) (B). Note, however, the potentially large gift tax on the transfers. This can be mitigated if the testator makes gifts of the preferred in a piecemeal fashion, thereby taking advantage of his annual $3,000 exclusion, but any gifts made within three years of his death may be included in his gross estate. See § 2035.
thereby highlight the problems which may be encountered in reducing a testator's gross estate.63

The estate plan to be proposed contains two chronological phases. The initial phase is intended to diminish testator's gross estate and can be implemented immediately. The purpose of the second phase, to be effected when the testator wishes to retire from an active role in the business, is to pass control of the family corporation to the son and to provide testator and his wife with retirement income.

A. DIMINISHING TESTATOR'S GROSS ESTATE

While the testator's gross estate can be diminished through inter vivos gifts, timing is important. Several reasons militate against the testator delaying until his retirement to make such gifts. For one, testator will lose the annual gift tax exclusions.64 Joint gifts by himself and his wife to the daughter will incur no tax up to $6,000 per year,65 and gifts to the wife will incur no tax up to $3,000 per year.66 In addition, testator and his wife can combine their $30,000 lifetime exemptions for the purpose of joint gifts to the daughter.67 Over a ten-year period, this would amount to $150,000, or approximately one-fourth of testator's gross estate. Also, if testator makes one large, lump sum gift at retirement, he may be unable to pay the high gift tax which would arise from such a gift. Finally, the premature death of the testator would prevent him from making any gifts, and all his assets would be included in his gross estate. For these reasons, it will be assumed that the testator wishes to make inter vivos gifts before his retirement.

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63. Some states make cumulative voting mandatory while others do not. See, e.g., MINN. STAT. § 301.26(3) (1965) (cumulative voting at option of shareholders). If the state of incorporation requires cumulative voting, testator will lose his power to elect two members of a three-man board of directors if his percentage of voting control drops below 50%. With regard to the voting power needed to amend the articles of incorporation, see note 60 supra.

64. Section 2503(b); see note 47 supra.

65. Section 2513; see note 47 supra.

66. Gifts may be tax-free up to $6,000 if they qualify for the gift tax marital deduction. § 2524. See notes 73-76 and accompanying text.

67. Section 2521 provides that each donor has a $30,000 life-time exemption for all gifts in excess of the annual exclusion, and § 2513 allows testator and his spouse to combine both their exemptions and exclusions for the purposes of gifts to other persons. Testator will no doubt want to exhaust both his and wife's lifetime exemptions with gifts to the daughter, since he can utilize the marital deduction in gifts to his wife. See § 2523 and note 59 supra.
The question then arises of what the subject matter of the gifts should be. Because testator will not want to give away any voting control before his retirement, the answer, clearly, is some kind of nonvoting stock, but whether it should be preferred or common presents a problem. If the testator initiates a recapitalization whereby one share of old common may be exchanged for one share of new common plus one share of preferred stock, he will retain voting control of the corporation and simultaneously have preferred stock available with which to make gifts to his wife and daughter. However, careful note must be taken of section 306 which provides that gain from the sale of stock which is deemed section 306 stock will be taxed as ordinary income. Section 306(c)(1)(B) defines 306 stock as any stock “which is not common stock and which was received, by the shareholder . . . disposing of such stock, in pursuance of a plan of reorganization.” Hence if the testator receives such preferred stock in pursuance of the plan of recapitalization, it will be tainted by section 306.

Although the testator may not contemplate selling tainted stock, the problem is compounded by Treasury Regulation section 1.306-3(e), which provides that “[s]ection 306 stock transferred by gift remains section 306 stock in the hands of the donee.” Therefore, if testator makes inter vivos gifts of tainted preferred to his wife and daughter, it will be tainted in their hands. This will be a grave drawback if, following testator’s death, the widow for economic or other reasons must sell or redeem the stock.68

Another equally serious problem with the creation of preferred stock may exist. If the preferred stock has cumulative

68. Section 306 stock given inter vivos to the wife and daughter loses its taint upon testator’s death if it acquires a new basis at that time. Treas. Reg. § 1.306-3(e) (1955). Section 1014(a) provides that the basis of property in the hands of a person . . . to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent’s death . . . be the fair market value of the property at the date of the decedent’s death. Treas. Reg. § 1.1014-1(a) (1957) declares that the general purpose of § 1014 is “to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for the purposes of the Federal estate tax.” Hence, for property transferred inter vivos to qualify as property passing from a decedent it would appear that it must be included in the donor’s gross estate. Therefore, § 306 stock cannot be transferred inter vivos in such a way as to eliminate it from the transferor’s gross estate and at the same time remove the taint in the hands of the donee at the date of donor’s death.
dividend rights, this will most likely force the regular declaration of dividends. The testator has no need for these twice-taxed dollars on top of his corporate salary. The fact that the wife will eventually become the donee of part of the stock does not solve the problem if she and testator file joint income tax returns. Also, the declaration of preferred stock dividends will divert corporate income from expansion.

The creation of nonvoting common stock will bypass the problem of testator and his wife receiving preferred stock dividends on top of his salary and will probably avoid the 306 taint. To create such stock, testator amends the articles of incorporation to allow the exchange of stock at the rate of one share of old voting common for one share of new voting common plus one share of nonvoting common. The testator then exchanges enough shares of voting common to receive a block of nonvoting common approximately equal in value to the sum which he anticipates giving away before his retirement. This exchange will be tax-free under section 1036 which provides that “no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation . . . .” Furthermore, Treasury Regulation section 1.1036-1(a) provides that section 1036 “applies even though voting stock is exchanged for nonvoting stock . . . .” Testator is now in a position to give his wife and daughter part of his capital in the corporation in the form of nonvoting stock on which no dividends need be declared while still maintaining his level of voting control in the corporation.

Section 306 dangers have hopefully been avoided by this plan, though several caveats must be noted. Section 306(c)(1)(B) defines 306 stock as stock received “in pursuance of a plan of reorganization.” Despite the fact that the exchange is made pursuant to section 1036, Treasury Regulation section 1.1036-1(a) recognizes that “a transaction between a stockholder and the corporation may qualify not only under section 1036(a), but also under section 368(a)(1)(E) (recapitalization) or section 305(a) (distribution of stock and stock rights).” Hence the Commissioner may deem the transaction a reorganization as well as a section 1036 exchange.

If the Commissioner does so, the question will arise whether section 306(c)(1)(B), which defines as 306 stock only “stock which is not common stock,” encompasses the nonvoting common created by testator in this transaction. There is no clear solu-

69. See §§ 2, 6013.
tion to this problem since the term "common stock" is not clearly defined in the regulations and is inherently vague in the context of the many types of hybrid securities which exist. Commentators disagree whether nonvoting stock which has no prior rights or preferences, but which can be used for the purpose section 306 was intended to prevent, is "common stock." Carnahan v. United States casts doubt on the use of section 1036 cases for analogous aid by suggesting that stock which is common for the purpose of section 1036 may not be deemed stock which is not common for the different purpose of section 306. Of the authority bearing directly on section 306, the closest on point is Revenue Ruling 57-13272 which provides that nonvoting common which is redeemable at the discretion of the corporation at a price which is 110 per cent of its book value is stock which is not common for the purpose of section 306(c) (1)(B). But what the result would be absent the redemption provision is unclear.

In view of this uncertainty, sound discretion would seem to dictate that the nonvoting common be made nonredeemable as well, thereby preventing the stock's use in a manner which section 306 was designed to discourage. While this provision will foreclose redemption, it is not contemplated that testator or his wife and daughter would desire to redeem before his retirement, and pursuant to the present plan he will make redemption possible at that time through a recapitalization.

A second potential difficulty with the creation of nonvoting common lies in section 2523. That section provides a deduction of one half the value of gifts made to one's spouse. Therefore, if in any year testator makes a gift of stock to his wife in excess of his $3,000 annual exclusion, he would wish to achieve the benefits of this section. However, testator may want to make the gifts in trust, in which case section 2523 provides that a gift in trust will receive the gift tax marital deduction only if the wife is entitled for life "to all the income from the entire interest . . . payable annually or at more frequent intervals . . . ." Treasury Regulation section 25.2523-1(f) construes this language to mean that the wife must have "substantially that degree of beneficial enjoyment of the trust property during her

70. Compare D. Herwitz, Business Planning 388 (1966) (nonvoting common stock is still "common stock"), with B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 329 (2d ed. 1966) (stock which can be used for prohibited purpose is not "common stock").
life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust.” Treasury Regulation section 25.2523-1(f)(5) provides further that an interest transferred in trust does not qualify for the deduction “if the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment.” In view of the foregoing regulations, there may be grave doubt whether the testator’s wife will have the requisite beneficial enjoyment since the gifts consist of stock over which the donor controls the flow of dividends and where it is his intention to declare no dividends or only nominal dividends until his retirement. Although there is no direct authority on this issue, Treasury regulations provide that a power in the spouse to require the trustee to exchange the trust res if it is unproductive will safeguard the deduction. But giving the spouse such a power would probably be opposed by the testator. Also, if the testator dies before initiating the second phase of the plan, restrictions of any kind on the trustee’s power to dispose of the trust res will cause it to be included in testator's gross estate. Nonetheless, even if the Commissioner should challenge the deduction, testator can still make substantial gifts to his spouse over a period of time within the limits of his $3,000

73. Ironically, testator’s ability to declare large dividends as well as to restrict them may create a problem. Where the owner of controlling interest in a close corporation made a gift of preferred stock to his spouse, with restrictions as to voting, liquidation, and alienation rights, and then declared large dividends on that stock, the Second Circuit held such gift was an assignment of taxpayer’s future dividends. Overton v. Commissioner, 162 F.2d 155 (2d Cir. 1947). Cf. Babson v. Delany, 56-2 U.S. Tax Cas. 19828 (D. Mass. 1956).

74. See generally Reeves’ Estate v. Commissioner, 180 F.2d 829 (2d Cir. 1950) (counterpart of § 2035 under 1939 Code); Lewis W. Welch, 8 T.C. 1139 (1947) (corporate control in income tax context); In re Shupack's Will, 1 N.Y.2d 482, 136 N.E.2d 513 (1956) (corporate control in statutory forced share context); Treas. Reg. § 25.2522(a)-2(b) (1954); Rev. Rul. 67-54, 1967 INT. REV. BULL. No. 8, at 10 (corporate control in § 2036 context).


76. Rev. Rul. 67-54, 1967 INT. REV. BULL. No. 8, at 10, construing § 2036, provides that the value of a gift of corporate nonvoting common stock placed in an inter vivos trust shall be included in the grantor's gross estate where grantor controls the dividend policy of the corporation, if the grantor is trustee at his death, or the trustee's power to dispose of the transferred property is restricted in any way and the trustee holds the property at grantor's death. Hence, the nonvoting common will be included in testator's gross estate if he dies prematurely and the trust provisions restrict the trustee from disposing of the res. Strong consideration might therefore be given to outright gifts to the wife and daughter.
annual exclusion and $30,000 lifetime exemption.

B. DISPOSING OF TESTATOR'S CONTROL OVER THE CORPORATION

The second phase of the proposed plan is designed to pass corporate control to the son when testator retires and also provide testator and his wife with a retirement income. Prior to retirement testator amends the articles of incorporation to allow the holders of both voting and nonvoting common to exchange their stock for high yield, cumulative, nonvoting preferred stock. The wife and daughter exchange all the nonvoting common they have acquired from testator, while he exchanges all his voting common except for that which he intends to give to his son. Although testator only needs to withhold one share of voting common in order to pass corporate control to his son, he will probably want to give the son a sufficient number of shares to equalize the son’s equitable ownership of the corporation with that of his sister. While this exchange will decrease the family’s margin of voting control, it will not lower it below a majority, and the family’s claim against corporate assets does not diminish. The testator is now provided with a retirement income from the preferred stock dividends. Furthermore, the corporate earnings available for expansion are not seriously impaired, because testator’s former salary can now be channeled into dividends.

At death testator bequeaths his preferred stock to his wife and daughter, in trust 77 or outright, thereby providing them with an additional source of income. He can dispose of his remaining common stock to the son inter vivos to the extent of the annual exclusion, or to the extent that he can afford the gift taxes, and any remaining at his death can be bequeathed to the son. In any event, control will have been transferred to the son. If the testator should die prematurely before effecting this recapitalization, he can direct his executor to effect the same by will. 78

With regard to the tax incidents of the retirement trans-

77. If the bequest is made in trust, care should be taken that the trust qualifies under § 2056(b)(5) in order to ensure that testator’s estate receives the state tax marital deduction with respect to such bequest. Testator can bequeath the stock to a trust created during his life in favor of his wife, and his device will probably complete the transaction without subjecting the trust to continuing administration by a probate court. See J. Ritchie, N. Alford & R. Effland, DECEDENTS’ ESTATES AND TRUSTS 552-53 (2d ed. 1961) and cases cited therein.

78. See note 4 supra.
action, the exchange of common for preferred most likely falls within the scope of a section 368(a)(1)(E) recapitalization and is therefore tax-free under section 354(a)(1). The fact that the son and X do not make the exchange will not prevent characterization of the transaction as a recapitalization. In Muchnic v. Commissioner a corporation offered to exchange new preferred for old common at a rate of one for six. Only two stockholders made the exchange, and the court held that the exchange constituted a tax-free recapitalization. Furthermore, although treasury regulations provide that a corporate transaction does not come within the purview of section 368(a)(1) unless it has a business or corporate purpose, the exchange

79. The fact that a transaction falls within the scope of § 354 does not foreclose the existence of a gift from one shareholder to another or of compensation from the corporation to a shareholder-employee. Section 356(f) expressly recognizes such a possibility in a § 354 exchange. See McDowell, Gift Tax Problems in Organization and Reorganization of Family Corporations, N.Y.U. 20th Inst. on Fed. Tax. 213, 222 (1962). Care should therefore be taken that the rate of exchange does not result in preferred stock being received which greatly exceeds in value the nonvoting common given up. See Treas. Reg. § 25.2512-8 (1955).

80. 29 B.T.A. 163 (1933).


82. Treas. Reg. § 1.368-1(c) (1955) provides in pertinent part:

A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) . . . . Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise . . . . [A transaction] that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consumption of a preconceived plan having no business or corporate purpose, is not a plan or reorganization.

At least one case has held that the absence of a formal business purpose in a corporate transaction does not necessarily mean that income tax avoidance is the purpose. Parsheysky's Estate v. Commissioner, 303 F.2d 14 (2d Cir. 1962). In that case the controlling stockholder of a close corporation caused a spin-off as a part of his estate plan. The court said:

[S]ince most spin-offs . . . concern closely-held corporations, it is not only difficult but often purely formalistic to distinguish between corporate and personal benefit. The separate legal entity of corporations cannot obscure the fact that they are operated by their shareholders in the manner most likely to benefit themselves . . . . The benefits to the corporation and to the shareholders are virtually indistinguishable. Consequently, the courts have uniformly held transactions such as reallocation of ownership interests between different groups of shareholders to be tax-free reorganizations.

Id. at 19. (The court's footnotes and citations are omitted).
Section 306 poses little threat to the plan because of an exception contained in section 306(b) (4) (B). This exception provides that ordinary income treatment shall not apply upon the disposition or redemption of section 306 stock where there has been a prior or simultaneous disposition of the stock with respect to which the section 306 stock was issued, if such disposition is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. In addition, Treasury Regulation section 1.306-2(b) (3) provides that it is not necessary to establish to the satisfaction of the Commissioner that the redemption does not have as one of its principal purposes the avoidance of federal income tax where there is a prior disposition of the stock with respect to which the section 306 stock was issued. Since in this case the wife and daughter will have exchanged all of their common stock for the preferred, the preferred received by the wife and daughter should not encounter section 306 difficulties if subsequently redeemed or sold.

83. See Marjorie N. Dean, 10 T.C. 19 (1948); Elmer W. Hartzel, 40 B.T.A. 492 (1939).

84. The family and entity attribution rules do not apply under § 306(b) (4) (B) in determining whether there has been a prior or simultaneous disposition. Section 318(a) provides that the attribution rules shall apply only where they are "expressly made applicable." While § 318(b) (3) makes § 318 expressly applicable to § 306(a) (1) (A), it does not mention § 306(b) (4) (B).

85. Section 306(b) (4) (A) provides that any disposition of § 306 stock, regardless of whether there has been a prior disposition of the stock with respect to which it was issued, shall not receive ordinary income treatment if it is established to the satisfaction of the Secretary that it was not made in pursuance of a plan of tax avoidance. Theoretically, at least, this would seem to open a route of eliminating the 306 taint problem. However, the "nonavoidance purpose" test must be established by the taxpayer and treasury regulations provide only scanty guidelines. See Treas. Reg. § 1.306-2(b) (3) (1955). Moreover, the Service will not ordinarily issue rulings in the § 306(b) (4) area. Rev. Proc. 31, 1984–2 Cum. Bull. 947. Hence, from a planning point of view, § 306(b) (4) (A) offers little aid.

86. Rev. Rul. 84, 1959–1 Cum. Bull. 71 provides:

For bona fide business reasons a corporation issued new common and new non-voting, non-participating, cumulative preferred stock for all its old common stock in a recapitalization. . . . [After the exchange, stockholder A owned only preferred stock; other stockholders owned both common and preferred.] The preferred stock received by A is not section 306 stock since after the exchange he owns no common stock, no voting stock and no participating stock. On the other hand, after the trans-
the son inter vivos, testator's preferred will also fall within
this exception. In any event, preferred stock held by the
testator will lose its taint upon his death, since Treasury Regulation section 1.306-3(e) provides that section 306 stock "ceases
to be so classified if the basis of such stock is determined by
reference to its fair market value on the date of the decedent-
stockholder's death . . . under section 1014."

A primary advantage of the above plan is that it allows
testator to achieve the estate tax marital deduction. Testator
can bequeath stock to his spouse either outright or in a qualified
marital deduction trust. A drawback to the plan may be pre-
seated, however, by section 302 in conjunction with the attri-
bution rules of section 318 if the widow attempts to redeem a
portion of her holdings following testator's death. The son's
voting common will be attributed to her directly if she owns
the bequeathed stock outright, or, if her interest is in trust,
the son's stock will be attributed to the trust through he widow
because she is a beneficiary. Hence, the termination of
interest and substantially disproportionate tests of section 302
may be difficult to meet, and therefore any proceeds the
widow receives from a partial redemption might be treated as
ordinary income. However, the not essentially equivalent to
a dividend provision of section 302 may preclude this undesir-
action each of the other shareholders . . . who received preferred
stock owns a percentage interest in the common stock equity
which is greater or not substantially less than his percentage
interest in such equity before the transaction. In these circum-
stances the transaction is substantially the same as the receipt of
a stock dividend under section 306 (c) (1) (B) of the 1954 Code.

If testator gives all the common stock to his son upon retire-
ment, the preferred will lose its taint at that time. Treas. Reg.
§ 1.306-2(b) (3) (1955) illustrates this point with the following example.

[I]f a shareholder received a distribution of 100 shares of sec-
tion 306 stock on his holdings of 100 shares of voting common
stock in a corporation and sells his voting common stock before
he disposes of his section 306 stock, the subsequent disposition
of his section 306 stock would not ordinarily be considered a
disposition, one of the principal purposes of which is the avoid-
ance of Federal income tax.

See note 77 supra.

Section 302(c) (2) sets forth the conditions upon which the
Bull. 106, enunciates, however, that the waiver of the family attribution
rules applies only to the last link of an attribution chain which ends in
the distributee. Since the last step of attribution where the widow's
interest is held in trust is the entity attribution of the stock owned
constructively by her to the trust, the attribution of the son's stock to
the mother cannot be waived.

See notes 15-19 supra and accompanying text.

See notes 20-25 supra and accompanying text.
able result. In *Davis v. United States*, the redemption of preferred stock did not terminate the shareholder's interest in a close corporation and was pro rata after application of the attribution rules. The court held the redemption to be not essentially equivalent to a dividend because a strong business purpose had been demonstrated.

Applying this holding to the present situation, a partial redemption of the widow's stock following testator's death might well result in capital gain treatment of the corporate distribution by a showing that the corporation redeemed the stock in order to induce new investors or to plow preferred stock dividends into expansion. However, the uncertain judicial construction of a proposed plan under the not essentially equivalent test makes the test a very limited and dangerous planning tool.

A partial redemption by the daughter would incur less risk because the son's stock would not be attributed to her. Section 318(a) does not provide for direct attribution among siblings, and section 318(a)(5)(B) proscribes the indirect achievement of such attribution. The mother's stock will be attributed to her daughter, but Treasury Regulation section 1.302-2(a) states that

> if a shareholder owns only non-voting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) . . . .

There is consequently little probability of section 302 dangers if the daughter makes a partial redemption of her stock.

Deciding whether the preferred stock should be participating may be a problem. Because the son will not have income-producing stock, he will want his efforts on behalf of the corporation to be reflected in appreciated common stock. If the preferred is made participating, this appreciation will be greatly diluted. On the other hand, the testator's desire to treat his

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92. 274 F. Supp. 466 (M.D. Tenn. 1967).
93. Also, in *Estate of Arthur F. Hinrichsen*, CCH Tax Ct. Mem. 271 (1966), the Tax Court gave great weight to the fact that a close corporation could obtain loans at an interest rate less than that being paid on preferred stock in finding a preferred stock redemption not equivalent to a dividend. See Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir. 1966), rev'd 24 CCH Tax Ct. Mem. 147 (1966) (preferred stock redemption held essentially equivalent to a dividend); *Estate of Joseph L. Antrim, Jr.*, 26 CCH Tax Ct. Mem. 60 (1967) (redemption of nonvoting preferred held not essentially equivalent to a dividend).
children equally will be made more difficult if his daughter does not participate in the corporate growth. A graduated or limited participation by the preferred stock may provide a partial solution to this problem.94

Another potential difficulty with the proposed plan is that X will probably oppose the creation of preferred stock. He will not want to convert any of his common shares to preferred because he would thereby reduce his voting interest in the corporation. If he were to do so, and at the same time retain some of his common, the preferred received by him would be tainted by section 306. Moreover, the preferred stock dividends will divert corporate income away from expansion thus lessening the appreciation of his common stock. On the other hand, there is realistically little that X can do to prevent execution of the plan.95

Finally, the greatest practical complication with this or any other recapitalization is that it does not provide liquidity for the testator's estate. If testator has no other source of liquid assets, stock will have to be sold to pay the death taxes, and because close corporation stock has at best an uncertain market, drastic losses might have to be taken.

There are, however, several possible solutions to the liquidity problem. Where a section 302 redemption of a portion of testator's stock might result in ordinary income treatment of the distribution, a section 303 redemption will not.96 That section provides that a redemption of testator's stock, to the extent of his death taxes and funeral and administrative expenses, shall be treated as a distribution by the corporation in full payment in exchange for the stock so redeemed. If this approach is used, care must be taken so that inter vivos gifts do not reduce the father's holdings below the section 303 qualification requirements. Section 303 is available only if the value of the stock included in

94. There is also a danger if the preferred is made participating that it will be considered § 306 stock because the exchange of common for preferred has not substantially reduced the widow's or daughter's interest in the equity of the corporation. See note 86 supra.

95. At least under Minnesota law and the Model Business Corporation Act a dissenting shareholder can do little to prevent a reorganization. See note 60 supra.

96. Provided funds for the redemption may cause the corporation to incur tax penalties if it accumulates excessive earnings. See note 3 supra. See generally Horwich, Stock Redemptions Under Section 303 and the Accumulated Earnings Tax, 10 TAX COUNSEL Q. 117 (1966); Washington, Can Earnings Still Be Accumulated To Finance Section 303 Redemptions?, 44 TAXES 43 (1966).
testator's gross estate is: (1) more than 35 per cent of the value of his gross estate, or (2) more than 50 per cent of his taxable estate.

Clearly, section 303 is a limited solution. It will not provide liquidity for nonstock bequests and legacies which the testator might wish to make. A hybrid buy out and recapitalization scheme might be beneficial in this respect. The testator could recapitalize as described above, but instead of bequeathing the common to his son, he would initiate an entity or cross purchase buy out of this interest. Since the recapitalization can be designed to lower both the number of common shares and their fair market value, the premiums on a life insurance funded buy out would be substantially reduced, and the insurance proceeds would provide testator's estate with the desired liquidity.

IV. CONCLUSION

While entity buy outs are often used to transfer corporate control in close corporations, they are not well suited for transferring control from father to son in family corporations. The risk is too great that the tax attribution rules operating upon the corporate redemption of the father's stock will cause disastrous tax consequences. An insurance funded cross purchase buy out avoids the redemption problem and can be used to advantage where the family shareholders can afford the annual premium payments. In addition, such a buy out scheme provides liquidity for the testator's estate. Where the family shareholders are unable to purchase sufficient insurance to fund a buy out, or where the testator is uninsurable, a recapitalization will achieve transfer of corporate control without causing a drain on the income of either the corporation or its shareholders. However, a recapitalization provides no liquidity for testator's estate and for that reason works best if testator has a source of liquid funds apart from the corporation or does not wish to make cash gifts at death.