XIV. PLANNING FOR BUSINESS INTERESTS

Although attorneys commonly are asked to assist clients in striking an appropriate balance between tax and non-tax issues, this balancing is particularly difficult to achieve when dealing with closely held business interests. The reason for this is twofold: (a) the asset is unique in that it typically has substantial value, but often limited marketability; and (b) dealing with the asset frequently is emotionally charged, due to the fact that family relationships are often intertwined with the business interest. Thus, the role of the advisor is to balance these issues, while helping clients achieve an orderly succession of both management and ownership of their businesses.

This Chapter will provide an overview of the following subjects, which often arise when advising clients regarding their business interests:

- Succession planning for business interests;
- S corporation planning;
- Stock redemptions -- Internal Revenue Code ("IRC") § 303; and
- Extension of time for payment of estate tax -- IRC § 6166.

A. Succession Planning for Business Interests

Owners of closely held businesses often are consumed by the demands of running the day-to-day operations of their businesses. This is, in part, reflected by the fact that less than one- third of family-owned businesses survive the succession from one generation to the next. The fact that so many businesses fail to survive the transfer to the next generation illustrates the challenges that planners face when advising clients regarding succession planning. As noted above, planning for the disposition of a client's closely held business interest is complicated by the fact that other family members often are intricately involved in the business. While these family relationships may provide a foundation on which a successful business can be built, these same relationships can splinter when family members confront the emotionally charged issue of succession planning. The attorney can help reduce the potential for family discord by adequately addressing business and estate planning issues that must be confronted by their clients in order to adopt a successful succession plan.

1. Factors to Consider

In order to develop a successful succession plan, the advisor should, at a minimum, ensure that his client address the following issues:

a. **<u>Sell or Continue the Business</u>**. A threshold issue that must be addressed is whether the client intends to sell the business during his or her lifetime or intends for the business to continue after his or her death.

b. **<u>Ownership and Control of the Business</u>**. If the client intends for the business to continue, the client must determine who or whom should own the business. A related issue is who or whom the client wants to control the business, and whether some owners should hold voting stock, while others hold only non-voting stock. Similarly, the client must determine whether descendants who do not participate in the business should hold equity interests in the business (generally, this is not a good idea, as those who do not actively participate in the business typically want to siphon cash out of the business, while those who participate want to reinvest cash in order to grow the business).

c. **Transition**. The client must determine when transition should occur and how he or she intends to effectuate the transition.

d. **Spouse**. If there is a spouse who does not have a significant ownership interest in the business, the client must determine what the spouse's role will be if he or she survives the owner. If the client intends for the children to own the business, the client must determine whether the spouse is adequately provided for.

e. **Provisions for Owner**. If the client intends to transfer control of the business during his or her lifetime, the client must determine whether he or she wants to remain involved in the business in a diminished capacity (*e.g.*, the client could be retained as a consultant).

2. Alternatives for Transferring Ownership

There are essentially three ways to transfer ownership in business interests to the next generation. You can sell it to them, you can give it to them or you can effectuate a transfer of ownership via a combination of gifts and sales. The attorney has no shortage of techniques that can be used to effectively transfer ownership in a business. The following is a brief overview of some of the more common techniques used by attorneys to transfer ownership of business interests.

a. **Buy-Sell Agreements**. A buy-sell agreement is an agreement among the owners of an entity or among the owners and the entity itself to purchase and sell interests in the entity at a price set under the agreement upon the occurrence of a specified triggering event (*e.g.*, death, disability, an offer to purchase an owner's interest from an outside party or termination of employment).

There are numerous reasons, both tax and non-tax motivated, for owners of a business to establish a buy-sell agreement. One of the primary benefits of a well drafted buy-sell agreement is that it may alleviate disputes among the owners (a benefit that cannot be overstated in the family context). A buy-sell agreement provides certainty to both the outgoing interest holder and the remaining interest holders regarding a variety of issues, including the determination of a buy-out price, payment terms and funding, triggering events giving rise to a disposition of an interest holder's interest and restrictions against transfers. Additionally, a well drafted buy-sell agreement may establish the value of a deceased owner's interest for estate tax purposes if the agreement satisfies the requirements of IRC § 2703.

There are essentially three types of buy-sell agreements: a cross-purchase agreement, a redemption agreement and a hybrid agreement. The typical cross-purchase agreement provides that upon the occurrence of a triggering event (*e.g.*, death, disability or termination of employment), the continuing interest-holders will acquire the withdrawing interest-holder's interest at a purchase price that is determined under the agreement. Under a redemption agreement, upon the occurrence of the triggering event, the entity redeems the party's interest in the entity at a price specified in the agreement. A hybrid agreement combines aspects of both the cross-purchase agreement and the redemption agreement by giving the entity the primary right to acquire the selling interest holder's interest, and permitting or requiring the remaining interest holders to redeem the withdrawing interest holder to the extent that the primary right is not exercised. The order of priority obviously can be reversed, thereby giving the interest holders the primary right to purchase the interest.

(1) Alternatives for Structuring a Buy-Out. A buy-sell agreement may be structured in a number of different ways depending upon the preferences of the business and the interest holders and the level of flexibility desired. For instance, a buy-out can be structured to be mandatory upon the occurrence of certain triggering events (e.g., death, disability, voluntary withdrawal or termination of employment) or at the option of the outgoing interest holder, the business or the remaining interest holders. There are advantages and disadvantages associated with each type of structure that must be considered.

(a) Mandatory Buy-Out. A buy-sell agreement can be drafted to require either the business or the remaining interest holders to purchase the shares of an outgoing interest holder in certain circumstances, such as his or her death or disability. Similarly, a mandatory buy-out can be included in the form of a "put" right, which would require the business to purchase the outgoing interest holder's interest whenever that person wishes to withdraw from the business. Obviously, a mandatory buy-out provides more certainty as to the disposition of the shares; however, it imposes more of a financial obligation on the business or remaining interest holders. Accordingly, if a buy-sell agreement is structured in this fashion for some or all triggering events, it is imperative that a mechanism be in place to provide a source of liquidity to fund the buy-out, such as life insurance on the interest holder, which is discussed below.

(b) Optional Buy-Out. More flexibility, although less certainty, is provided by including an option to purchase upon the occurrence of certain triggering events. For instance, a buy-sell agreement may provide that, upon the death or disability of an interest holder, the business or the remaining interest holders have the option, but not the legal obligation, to purchase the shares of the outgoing interest holder. While this approach provides greater flexibility to the business or remaining interest holders, it can put the outgoing interest holder or his or her estate in a difficult position because there is no certainty that the shares will be purchased. This may be problematic, particularly if an estate may have liquidity concerns. In such an arrangement, a provision is often included allowing the outgoing interest holder or his or her estate to offer the subject shares to a third party. This right is often subject to a right of first refusal, which gives the business and/or the remaining interest holders the right to buy the shares at the same price and terms as any third party.

(2) Determination of Buy-Out Price. One of the most important features of a buy-sell agreement is that it either establishes a buy-out price in the event of a triggering event or provides a mechanism for determining the buy-out price. The following discusses some of the common alternatives for determining a buy-out price.

(a) Certificate of Agreed Value. A fairly common approach is one where the interest holders determine on a periodic basis (e.g., annually) the buy-out price in the event of a triggering event by executing a certificate agreeing to the value of the entity or the shares. This approach, if kept current by the parties, may be a good way to determine the value of the entity or its shares because it is reflective of all of the parties' negotiations of the buy-out price when no one knows whether he, she or it will be the one selling the shares or purchasing them. To address the possibility that the parties will not keep the certificate current, a stale certificate adjustment provision may be incorporated into the buy-sell agreement to provide for an increase in the agreed value based upon a flat percentage increase, the prior year's performance of the business or other factors. Alternatively, a provision could be included to provide for a grace period for the stale certificate to be effective and for it to expire and have no legal effect after such period. In such case, a default provision should be included, such as an appraisal provision (see below).

(b) Formula. Another alternative is to determine the buy-out price through the use of a formula written into the buy-sell agreement. For instance, the buy-out formula could be based upon a multiple of earnings for prior periods that is consistent with the standard in the specific industry involved. A formula provision will provide less certainty regarding the buy-out price than the certificate of agreed value approach.

(c) Appraisal. A buy-sell agreement could also provide that the buy-out price will be determined based upon an appraisal to be obtained by the parties following the occurrence of a triggering event. The agreement could provide for a specific appraiser or the business's regularly engaged certified public accountant to perform the appraisal, for the parties mutually to select an appraiser or for each of the parties to obtain separate appraisals and to take the average of the two values determined. Additional issues that might be addressed in the buy-sell agreement in connection with the appraisal are whether the appraiser should take into account factors such as minority and marketability discounts, control premiums and goodwill. In addition, the buy-sell agreement could specify the type of valuation methodology that the parties believe to be most reflective of the industry and should be applied in preparing the appraisal (e.g., discounted cash-flow method, net asset value method or capitalization of earnings method). As with the formula approach, the appraisal approach will provide less certainty than the certificate of agreed value approach.

(d) Adjustments to Reflect Estate Tax Value. Because of IRC § 2703, the purchase price under a buy-sell agreement is not necessarily determinative of estate tax value. Therefore, another issue to consider in connection with the purchase price is whether any adjustment will be made to the purchase price in the event that the Internal Revenue Service ("IRS") conducts an estate tax audit and determines that the value of the subject shares is higher than reflected in the buy-sell agreement. For instance, if a buy-sell agreement establishes a buy-out price of $1,000,000 and that value is disregarded under IRC § 2703, and the stock is ultimately valued at $3,000,000, will the entity or the other interest holders be required to pay an extra $2,000,000 in respect of the deceased owner's interest? The parties should consider including in the buy-sell agreement a provision that in all events requires the purchase price at the death of an owner to be no less than the value of the shares "as finally determined for federal estate tax purposes." Such a provision will ensure that the estate of the deceased owner (i.e., the surviving spouse and family) will not be stuck selling the business interest for a certain price and owing the entire amount or possibly more to the government for estate taxes.

(3) Payment Terms. It is also critical in structuring a buy-sell agreement to set forth clearly how payment will be rendered for the purchased shares.

(a) Lump Sum Payment. A buy-sell agreement will often provide for a lump sum buy-out in the event of the death of an interest holder, which will be funded by the business or the other interest holders with life insurance proceeds. Under this arrangement, the business (in the event of a redemption) or the other interest holders (in the event of a cross-purchase) will obtain a policy (or policies) of insurance on the life of the insured interest holder naming the business or the interest holders, as the case may be, as both the owner(s) and the beneficiary(ies) of the policy. Upon the death of the insured interest holder, the business or other interest holders will receive the life insurance proceeds that will be used to fund the buy-out of the decedent's shares from his or her estate or post-death revocable trust.

> **EXAMPLE:** A and B own a corporation and enter into a buy-sell agreement, which provides, in part, that, upon the death of one of the shareholders, the surviving shareholder may purchase the deceased shareholder's stock at fair market value, which is to be determined by an appraiser. In order to ensure that each shareholder will have sufficient liquidity to purchase the other shareholder's interest in the corporation, A takes out an insurance policy on B's life, while B takes out an insurance policy on A's life.

In the preceding example, because neither A nor B has an ownership interest in the policy on his or her own life, the proceeds will not be includible in the estate of either of them, even though the policies were purchased pursuant to a reciprocal agreement. See Rev. Rul. 56-397, 1956 C.B. 599. Even if the decedent was the controlling shareholder of a corporation owning a policy of insurance on his or her life, the value of the policy proceeds payable to the corporation will not be attributed to the decedent to the extent payable for a valid business purpose so that the net worth of the corporation is increased by the amount of such proceeds. Consequently, the insurance will be reflected in the value of the decedent's stock interest when it is valued for estate tax purposes. Treas. Reg. § 20.2042-1(c)(6). The same result should be reached in the partnership context. See *Knipp Est. v. Comm'r*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4.

➔ **Planning Point:** If your client is the insured as well as the owner of the insurance policy, you may be able to prevent the insurance proceeds from being included in the insured's gross estate if you can establish that the insured's retention of incidents of ownership was due to a mistake by the agent who sold the policy. See *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950); *Watson v. Comm'r*, T.C. Memo. 1977-268 (1977). Alternatively, if the proceeds are included in the insured's estate, the value of the decedent's interest in the entity should not include the amount of the insurance proceeds. See *Mitchell Est. v. Comm'r*, 37 B.T.A. 1 (1938); *Tompkins Est. v. Comm'r*, 13 T.C. 1054 (1949).

An issue that should be clearly addressed in the buy-sell agreement is how the balance of the buy-out price is to be paid in the event that the life insurance proceeds are insufficient to fund the purchase entirely (e.g., in the event that the interest holders updated the Certificate of Agreed Value to reflect a higher value but never increased the amount of life insurance to fund the buy-out). In such a case, a buy-sell agreement might provide for deferral of payment of the balance over a specified period of time.

(b) **Deferred Payment.** Another alternative is to provide for the purchase price to be paid over a term of months or a cash down payment and payment of the balance over a term of months (e.g., 60 months). This type of arrangement might be included in a buy-sell agreement for certain types of triggering events, such as a voluntary withdrawal or termination of employment, where there are no readily available sources of funds such as life insurance proceeds to provide the necessary liquidity to fund the buy-out. In such a case, the business or the other interest holders would typically provide a promissory note to the outgoing interest holder in exchange for the purchased shares. To provide security to the outgoing interest holder or his or her estate, the purchased shares might be pledged pursuant to a stock pledge agreement that would provide that if the business or remaining interest holders default on the promissory note, the outgoing interest holder or his or her estate can take back the pledged shares.

b. The Use of an FLP or Family LLC to Transfer Business Interest. Generally, by transferring assets to either a family limited partnership or an LLC in return for interests in the entity, significant tax savings can be achieved. This results from the fact that the interests in the entity are cloaked with transfer restrictions that reduce the value of the interest for transfer tax purposes (*i.e.*, a willing buyer would not pay as much for an interest in the entity as he would for the entity's underlying assets). As a result, a transferor can transfer a significantly larger percentage interest in the entity via annual exclusion gifts (or, if a taxable gift occurs, at a significantly reduced tax cost). Similarly, the owner of the interest simply could sell an interest in the entity to a family member at a significantly reduced sale price.

c. Grantor Retained Annuity Trusts. A Grantor Retained Annuity Trust ("GRAT") is an irrevocable trust that pays the creator an annuity, typically annually, for a fixed term of years. The annuity interest is described as a percentage of the initial value of the assets transferred to the GRAT. If the creator survives the trust term, any property remaining in the GRAT at the end of the term (which will be the case if the total return on the trust assets is greater than the actuarial discount rate in effect when the GRAT is created) will pass to the remainder beneficiaries free of all transfer taxes.

d. Sale to a Grantor Trust. A sale to a grantor trust involves the creation of an irrevocable trust that is a "grantor trust" for income tax purposes. A "grantor trust" is a trust that is structured so that all items of income, deduction and credit generated by the trust are taxed to the creator of the trust (*i.e.,* the "grantor") for income tax purposes. The result of grantor trust status is that the trust is ignored for income tax purposes and, as a result, the trust's income, deductions, and credits are passed through the trust to the grantor and reported on the grantor's individual income tax return rather than being reported by the trust as a separate entity. Although the trust is a "grantor trust" for income tax purposes, the trust is structured so that the trust assets are not includible in the grantor's gross estate for federal estate tax purposes. After creating the trust, the grantor sells assets to the trust at their fair market value in return for a promissory note that bears interest at the applicable federal rate sanctioned by the Code. At the end of the note term, any income from and appreciation on the trust assets that exceed the payments required to satisfy the promissory note passes to the beneficiaries of the trust (usually the grantor's children and/or grandchildren) free of estate, gift and, if appropriately structured, generation-skipping transfer taxes.

B. S Corporation Planning

Many closely held businesses are formed as corporations. In order to avoid the negative income tax aspects of corporations (*i.e.*, corporate profits distributed to shareholders in the form of dividends generally are subject to income tax at both the corporate and shareholder levels), the shareholders typically elect for the corporation to be taxed under subchapter S of the Code. Corporations electing to be taxed under subchapter S have become known as "S corporations." S corporations receive favorable tax status under subchapter S, which allows the corporation to be treated as a conduit, much like a partnership, through which the corporation's income and losses flow to the shareholders on a current basis (thereby avoiding the corporate level tax that applies to regular corporations). Nevertheless, to achieve this tax benefit, there are a number of requirements that the corporation and its shareholders must satisfy.

The American Jobs Creation Act of 2004 ("AJCA"), P.L. 108-357 (Oct. 22, 2004), created a number of changes to subchapter S. Most of these changes broaden the availability of S status, while others minimize problems that can occur in electing and preserving the S election. The changes are effective for tax years beginning after 2004. Some of the more pertinent changes have been incorporated into the following discussion.

1. Eligibility for S Corporation Status

In general, to qualify for S corporation status, the corporation must not be an "ineligible corporation" as defined in IRC § 1361(b)(2) and must satisfy the following criteria provided in IRC § 1361(b)(1):

a. **<u>Domestic Corporation</u>**. First, the corporation must be a domestic corporation that is incorporated in the United States.

b. **<u>Limit on the Number of Shareholders</u>**. Second, the corporation may not have more than 100 shareholders. IRC § 1361(b)(1)(a). For purposes of the shareholder limit, a husband and wife (and their estates) are considered as one shareholder (see IRC § 1361(c)(1)), while individuals (other than a husband and wife) who hold stock as tenants in common or as joint tenants are each considered a separate shareholder for purposes of applying this rule (see Treas. Reg. § 1.1361-1(e)(2)).

For tax years beginning after 2004, Section 1361(c) is amended to allow a family to elect to be treated as one shareholder. Members of a family are defined as the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor. The amended provision also incorporates the expansive definition of a family member in Section 152(b)(2). A family member includes a legally adopted child, a child who is a member of an individual's household, if placed with such individual by an authorized placement agency for legal adoption, or a foster child. The provision does not limit the number of families that can each elect to be treated as one shareholder. Thus, it is possible for an S corporation to have far in excess of 100 shareholders.

An individual will not be considered a common ancestor if, as of the later of December 31, 2004 or the time that the S election is made, that individual is more than six generations removed from the youngest generation of shareholders who would, but for this restriction, be a member of the family. Spouses and former spouses are considered to be in the same generation as the individual to whom the spouse is or was married.

The election can be made by any member of the family. Once the election is made, it remains in effect until terminated, as will be provided in regulations to be issued. There is no requirement that any minimum number of family members consent this election.

In conjunction with this election, Section 1362(f) is amended to qualify family elections for relief for inadvertent or invalid elections or terminations. This Section gives specific authority to the Treasury to provide relief where a family election is invalid and results in an invalid S election, or a family election is inadvertently terminated, thereby terminating the S election.

The family election applies only for purposes of determining the number of shareholders - each family member must be otherwise eligible to be an S corporation shareholder. The IRS has announced that it will issue future guidance regarding the S Corporation family shareholder election. Notice 2005-91, 2005-51 I.R.B. 1164.

c. <u>Shareholder Restrictions</u>. Third, all shareholders must be individuals and either U.S. citizens or resident aliens. There are, however, a number of important exceptions to the "individual" rule that allow the following entities to hold S corporation stock: (1) a deceased shareholder's estate; (2) a bankrupt shareholder's estate; (3) a qualified subchapter S trust ("QSST"); (4) an electing small business trust ("ESBT"); (5) voting trusts; and (6) specified tax-exempt organizations. The exceptions for estates, QSSTs and ESBTs are extremely important from an estate planning perspective and are, therefore, discussed in greater detail below.

For purposes of applying the "all individual rule," stock that is held by a nominee, guardian, custodian or agent is considered to be held by the beneficial owner of the stock (*see* Treas. Reg. § 1.1361-1(e)(1)).

> **<u>EXAMPLE</u>:** A partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of S corporation stock (because, as nominee, the partnership is not deemed an S corporation shareholder). However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as an S corporation.

d. <u>One Class of Stock</u>. Fourth, an S corporation may not have more than one class of stock outstanding. Nevertheless, for purposes of this rule, voting rights are disregarded. Thus, an S corporation may issue both voting and non-voting stock (*see* Treas. Reg. § 1.1361-1(l)(1)).

2. Estates and Trusts as S Corporation Shareholders

Although, generally, all shareholders of an S corporation must be individuals, there is an important exception for an estate and certain types of trusts.

a. **A Decedent's Estate as an S Corporation Shareholder**. Although a deceased shareholder's estate is a permitted shareholder (see IRC § 1361(b)(1)(B)), prolonging the administration of an estate may cause the estate to terminate and become a trust that may not be a permitted shareholder (*see Old Va. Brick Co. v. Comm'r*, 44 T.C. 724 (1965), *aff'd*, 367 F.2d 276 (4th Cir. 1966)). For purposes of applying the S corporation rules, the estate, rather than the beneficiaries of the estate, is considered to be the S corporation shareholder.

> **EXAMPLE:** X Corporation, an S corporation, has 100 shareholders, including P. P dies and, at P's death, P's stock is then held by P's estate. P's estate has five beneficiaries. Because the estate, rather than the beneficiaries, is deemed to be X Corporation's shareholder, X Corporation will not violate the 100 shareholder limit under the S corporation rules.

b. **Trusts as S Corporation Shareholders**. IRC § 1361(c)(2) authorizes the following types of trusts to be S corporation shareholders:

(1) **Grantor Trusts**. A trust, all of which is treated under IRC §§ 671 through 678 as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States, is permitted to hold S corporation stock. In addition, after the death of the deemed owner, the trust may continue as a permitted S corporation shareholder for up to two years after the date of the deemed owner's death.

➔ **Planning Point:** The grantor trust must be treated as owned by one individual to satisfy this rule and he or she must be treated as owning both the income and principal of the trust under the grantor trust rules (*see* Treas. Reg. § 1.1361-1(h)(1)(i)).

For purposes of applying the S corporation rules, (i) the individual who is the deemed owner for income tax purposes is considered to be the S corporation shareholder (rather than the trust), and, upon his or her death, if the trust continues to hold the S corporation stock, his or her estate will be considered the shareholder (for up to two years after the decedent's death).

> **EXAMPLE:** X Corporation, an S corporation, has 100 shareholders, including Trust. Trust is a grantor trust for income tax purposes and P is Trust's deemed owner. P is X Corporation's shareholder for purposes of applying the S corporation rules. At P's death, if Trust continues to hold X Corporation stock, P's estate will be X Corporation's shareholder for purposes of applying the S corporation rules. Nevertheless, two years and one day after P's death, Trust will no longer be a permitted shareholder, unless Trust is either a grantor trust, a QSST or an ESBT (in which case the Trust will have a new deemed shareholder for purposes of applying the S corporation rules).

(2) **Testamentary Trusts**. A trust that receives S corporation stock pursuant to the terms of a will may hold such stock for up to two years, beginning on the day of the deemed owner's death. For purposes of applying the S corporation rules, the estate of the testator is regarded as the shareholder. On the first day after the expiration of the two-year period, the general prohibition against trusts as shareholders of S corporation stock applies.

> **EXAMPLE:** X Corporation, an S corporation, has 100 shareholders, including P. P dies and pursuant to P's will, X Corporation stock is transferred to Trust. Trust has six beneficiaries. Because P's estate, rather than the beneficiaries of Trust, is deemed to be X Corporation's shareholder, X Corporation will not violate the 100 shareholder limit under the S corporation rules. Nevertheless, two years and one day after P's death, Trust will no longer be a permitted shareholder, unless Trust is either a grantor trust, a QSST or an ESBT (in which case the Trust will have a new deemed shareholder for purposes of applying the S corporation rules).

(3) **Voting Trusts**. A trust created to exercise the voting power of S corporation stock transferred to it will be permitted to hold S corporation stock if several conditions are satisfied. First, the beneficial owners of the stock must be regarded as the owners of their respective portions of the trust under the grantor trust rules of IRC §§ 671 through 678. Second, the trust must have been created pursuant to a written trust agreement entered into by the shareholders that (1) delegates to one or more trustees the right to vote, (2) requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock, (3) requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust, and (4) terminates, under its terms or by state law, on or before a specific date or event.

When a voting trust satisfies the above conditions, each beneficiary of the voting trust is regarded as a shareholder. Accordingly, each member of the voting trust will count in identifying the number of shareholders of the S corporation, and each member must be a permitted S corporation shareholder (*e.g.*, a U.S. citizen or resident alien).

(4) **Electing Small Business Trusts**. A trust that qualifies as an ESBT may hold stock in an S corporation. In the case of an ESBT, each potential current beneficiary of the trust is regarded as a shareholder for purposes of applying the S corporation rules, unless for any period no potential current beneficiary exists, in which case the trust will be treated as the shareholder. Current beneficiaries include every person that may or will receive a distribution of principal or income from the trust (*see* IRC § 1361(e)(2)). Thus, each potential current beneficiary (i) will be counted toward the 100 shareholder limit and (ii) must be a permitted S corporation shareholder.

(5) **Qualified Subchapter S Trusts**. A QSST is regarded as a grantor trust for purposes of IRC § 1361(c)(2)(A)(i) and, thus, is an eligible S corporation shareholder, provided the beneficiary makes a proper election (*see* IRC § 1361(d)). Only the current income beneficiary is treated as an S corporation shareholder, which, in comparison to the ESBT, simplifies the determination as to whether the shareholder is a permitted S corporation shareholder and in determining if the corporation satisfies the 100 shareholder limit.

3. Qualifying as an ESBT and the Income Tax Ramifications of ESBT Status

The ESBT provisions are designed to create a vehicle through which gifts of S corporation stock in trust may be made, while avoiding the "one beneficiary" rule applicable to grantor trusts and the "all income distribution" requirement of QSSTs.

a. **ESBT Requirements**. A trust will qualify as an ESBT if the following requirements are satisfied (*see* IRC § 1361(e)(1)(A) and (B)):

(1) **Limitation on Beneficiaries**. The only permitted beneficiaries of an ESBT are individuals, estates or certain charitable organizations. For purposes of applying this first requirement, the term "beneficiary" does not include a distributee trust (other than a trust described in paragraphs (2) or (3) of IRC § 170(c)), and, instead, looks through the distributee trust to include those persons who have a beneficial interest in the property held by the distributee trust. Thus, a distributee trust is ignored as long as the beneficiaries of the distributee trust are permitted S corporation shareholders.

> **EXAMPLE:** Trust intends to make an ESBT election. The terms of the Trust provide that the trustee may make discretionary distributions of income or principal to C for life and, upon C's death, Trust is to divide into separate trusts for the benefit of C's children. For purposes of IRC § 1361(e)(1)(A)(i), the beneficiaries of the intended ESBT are C and C's children, and not the separate trusts for the benefit of C's children. Thus, all of the beneficiaries of the intended ESBT are individuals. Nevertheless, once C's children are entitled to receive distributions from the separate trusts (*i.e.*, upon C's death), the S corporation election will terminate unless (1) the distributee trusts are either grantor trusts, QSSTs or ESBTs and (2) C's children are permitted S corporation shareholders.

Section 1361(e)(2) provides that with respect to any period, any person to whom distributions of income or principal could be made under a power of appointment will be considered a potential income beneficiary and, therefore, treated as a shareholder. For tax years beginning after 2004, 1361(e)(2) is amended to provide that in determining the potential current income beneficiaries of an ESBT, any power of appointment will be disregarded if the power remains unexercised at the end of such period. Thus, the fact that a person has a power to make distributions to a large number of persons or to ineligible persons will not result in those persons being treated as potential income beneficiaries if the power remains unexercised.

This provision is further amended to provide that, for tax years beginning after 2004, the ESBT now has one year, instead of 60 days, to sell stock following the date a disqualified person becomes a potential income beneficiary.

(2) **No Interest Acquired by Purchase**. No interest in the ESBT may be acquired by purchase (*i.e.*, although the ESBT may acquire S corporation stock by purchase, the beneficiaries must acquire their interest as a result of a gratuitous transfer).

(3) **<u>Election is Made</u>**. An election must be made to be classified as an ESBT.

(4) **<u>No QSST Election Made</u>**. The trust must not have made a QSST election with respect to any stock held by the trust to qualify as an ESBT.

(5) **<u>Not Tax-Exempt</u>**. The trust may not be a tax-exempt trust, including a charitable remainder annuity trust or charitable remainder unitrust.

b. **<u>Mechanics of the ESBT Election</u>**. The ESBT election must be made within the sixteen-day-and-two-month period beginning on the day that the S corporation stock is transferred to the trust. The *trustee* (as opposed to the beneficiaries) must make the election and file it with the IRS Service Center at which the S corporation files its income tax return. Once made, the election is irrevocable. *See* Treas. Reg. § 1.1361-1(m)(2).

c. **<u>ESBT Income Tax Ramifications</u>**. The flexibility offered by ESBTs comes at a cost from an income tax perspective. Once the election is made, the portion of the trust that consists of S corporation stock is treated as a separate trust for federal income tax purposes (*see* IRC § 641(c)(1)). The income generated by this deemed separate trust is subject to tax at the highest income tax rate applicable to estates and trusts (35% for 2010), except to the extent the capital gains rate applies (*see* IRC § 641(c)(2)(A)). Moreover, the trust's alternative minimum tax exemption amount under IRC § 55(d) is zero (*see* IRC § 641(c)(2)(B)). The taxable income generated by the separate trust is not included in distributable net income of the trust (*see* IRC § 641(c)(3)). Thus, there is no deduction available for distributions to beneficiaries, and no taxable income is passed through to beneficiaries (*see* IRC § 641(c)(2)(C)). Upon termination of all or any part of the separate portion of the ESBT, any loss carryovers or excess deductions under IRC § 642(h) are taken into account by the entire trust, subject to the usual rules (*see* IRC § 641(c)(4)).

If the trust has assets other than S corporation stock, that portion of the trust is treated as a separate trust and is subject to the normal income tax rules for trusts and estates.

> **<u>EXAMPLE</u>:** Trust makes an ESBT election. During the year, Trust has \$200 attributable to S corporation ordinary income and \$150 of other distributable net income. Trust distributed \$160 to beneficiaries during the year. Trust has taxable income of \$200 that is taxed at the 35% rate. The trust also has a distribution deduction of \$150. Thus, of the amount distributed to the beneficiaries, \$150 will be taxed as part of the beneficiaries' income and \$10 will be distributed to them free of further tax (as it was already taxed as part of the ESBT).

Thus, in summary, ESBTs offer increased flexibility in that the trust can accumulate income and spray distributions among multiple beneficiaries; nevertheless, all of the income attributable to the S corporation is taxed at the maximum income tax rate, and the impact of this high rate cannot be minimized by making distributions to beneficiaries.

➔ **<u>Planning Point</u>:** Although ESBTs are subject to a higher income tax rate, they are particularly beneficial in connection with generation-skipping trusts, where the ability to accumulate income and sprinkle income and principal among multiple beneficiaries is a particularly attractive attribute. If you have an existing QSST and determine that it would be beneficial to convert to an ESBT, Treas. Reg. § 1.1361-1(j)(12) specifies the method for converting a QSST to an ESBT or an ESBT to a QSST.

4. Qualifying as a QSST and the Income Tax Ramifications of QSST Status

Although QSSTs are not as flexible as ESBTs, a QSST generally will be preferable from an income tax perspective, because the beneficiaries typically will be taxed at a lower rate and the administration is less complicated (*i.e.*, the administration of an ESBT tends to be more complicated because the S portion of an ESBT is treated as a separate trust for purposes of computing the ESBT's tax liability during the year).

a. **QSST Requirements**. In order to qualify as a QSST, the following requirements under IRC § 1361(d)(3) must be satisfied:

(1) **Terms of Trust**. The terms of the trust must require that:

- During the life of the current income beneficiary, there will be only one income beneficiary of the trust;
- Any trust corpus that is distributed during the life of the current income beneficiary may be distributed only to that beneficiary;
- The income interest of the current income beneficiary will terminate upon the first to occur of that beneficiary's death and the termination of the trust; and
- Upon termination of the trust during the life of the income beneficiary, the trust must distribute all of its assets to that beneficiary.

The terms of the trust must satisfy these requirements from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period during which the current income beneficiary and any successor income beneficiary is the income beneficiary of the trust.

(2) **Income Required to be Distributed or Must Actually be Distributed**. All the trust income (as defined in IRC § 643(b)) must be required to be distributed or must actually be distributed currently to one individual who is a U.S. citizen or resident. The 65-day rule applies to QSSTs, so that a trustee may elect to treat any amount distributed to a trust beneficiary within the first 65 days after the end of the trust's taxable year as if that distribution had been made on the last day of that taxable year (*see* Treas. Reg. § 1.1361-1(j)(1)(i)).

➔ **Planning Point:** If (i) a husband and wife are income beneficiaries of the same trust, (ii) the husband and wife file a joint return and (iii) each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of applying the QSST rules (see Treas. Reg. § 1.1361-1(e)(2)).

➔ **Planning Point:** Because only one individual may receive distributions from a QSST, the income beneficiary cannot be given a lifetime limited power of appointment over any part of the trust (*see* Treas. Reg. § 1.1361-1(j)(1)(i)). Similarly, for the same reason a trust that permits income or principal distributions among a class of beneficiaries cannot qualify as a QSST. Thus, the trust must be drafted to preclude the *possibility* that distributions will be made to someone other than the current income beneficiary.

EXAMPLE: The terms of the trust are silent with respect to principal distributions, however, under state law principal may be distributed to a person other than the current income beneficiary during the current income beneficiary's life. Because the trust's terms do not preclude the possibility that principal may be distributed to a person other than the current income beneficiary, the trust does not qualify as a QSST.

b. **Mechanics of the QSST Election**. An election to treat the trust as a QSST and to treat the income beneficiary as the owner of the trust's S corporation stock must be made by the income beneficiary (not the trustee) within two months and 16 days after the trust's receipt of the S corporation stock (*see* IRC § 1361(d)(1) and (2) and Treas. Reg. § 1.1361- 4(j)(6)(iii)(C)). Once made, the election is irrevocable. Treas. Reg. § 1.1361-1(j)(6)(ii) sets forth the procedure for making the QSST election.

c. **QSST Income Tax Ramifications**. The QSST's income beneficiary is treated as the S corporation shareholder for most income tax purposes (*see* IRC § 1361(d)(1)(B)). Accordingly, the trust's *share of the S corporation's income tax items* will be reported by the income beneficiary for tax purposes, even if he or she does not receive any distributions. The income beneficiary will not, however, report and pay the capital gains tax resulting from the sale of S corporation stock held by the QSST (*see* Treas. Reg. § 1.1361-1(j)(8)); instead the QSST will report and pay capital gains tax with respect to such sale. The QSST itself also will report any other income tax items (*i.e.*, non-S corporation income tax items). Thus, with respect to any non-S corporation income tax items, the QSST is taxed according to traditional trust taxation rules. Accordingly, because the QSST is required to distribute all of its income currently, the income beneficiary will be taxed on the fiduciary income of the trust up to the amount of the trust's distributable net income, while the QSST will be taxed on items of income that constitute principal for fiduciary accounting purposes.

5. Death of an S Corporation Shareholder

Upon the death of an S corporation shareholder, an advisor must be aware of the resulting tax ramifications, including the following:

a. **Effect on S Corporation Status**. In situations where a trust is permitted to hold S corporation stock, the death of a deemed S corporation shareholder could result in the inadvertent termination of the S corporation election. As we have seen, where a trust is permitted to hold S corporation stock under IRC § 1361(c)(2), IRC § 1361(c)(2)(B) deems certain individuals or their estates as the S corporation shareholder (*e.g.*, where a trust is a grantor trust for income tax purposes, the deemed income tax owner (rather than the trust) is treated as the S corporation shareholder; similarly, where a trust receives S corporation stock pursuant to a decedent's will, the trust is a permitted shareholder under IRC § 1361(c)(2)(iii); however, the decedent's estate is treated as the S corporation shareholder). Accordingly, upon the death of a deemed shareholder, advisors must carefully monitor the disposition of the S corporation stock to determine whether or not the successors in interest qualify as permitted S corporation shareholders.

> **EXAMPLE:** P, a U.S. citizen, creates a revocable trust and transfers S corporation stock to the trust. The trust is a grantor trust for income tax purposes and, thus, may hold S corporation stock (*see* IRC §1361(c)(2)(A)(i)). P is the deemed shareholder during his life. Upon P's death, the stock of the S corporation remains in the trust. P's estate is an eligible S corporation shareholder for 2 years after P's death (*see* IRC § 1361(c)(2)(A)(ii) and (B)(ii)).

> **EXAMPLE:** Same facts as above, except one year after P's death, his revocable trust is terminated and the S corporation stock is distributed in equal shares to A, B and C. Neither P's estate nor his trust is thereafter deemed the S corporation shareholder. Instead, A, B, and C are treated as the new shareholders and the factual situation must be reanalyzed to determine if each of them is a permitted S corporation shareholder and to verify that the S corporation does not exceed the 100 shareholder limit.

> **EXAMPLE:** P created a trust for the benefit of C and C's children. The trust qualifies as an ESBT and makes the appropriate election. The terms of the trust provide that the trustee may make discretionary distributions of income or principal to C for life and upon C's death the trust is divided into separate trusts for the benefit of C's children. Upon C's death, the S corporation election will terminate unless (1) the distributee trusts are either grantor trusts, QSSTs or ESBTs and (2) C's children are permitted S corporation shareholders.

b. Impact on Basis. A disadvantage of an S corporation, when compared to an entity that is taxed as a partnership (including a limited liability company), is that an entity taxed as a partnership has the ability to step-up the inside basis (*i.e.*, the assets owned by the entity) of its assets to fair market value in the event of a sale or exchange of an interest or on the death of an owner (*see* IRC §§ 743(a) and 754). There is no similar election available to a corporation. Thus, although an S corporation shareholder's basis in his or her S corporation stock will be "stepped-up" to its fair market value on the date of the deceased shareholder's death, the underlying assets in the S corporation will not receive a similar step-up in basis.

C. Stock Redemptions -- IRC § 303

Under current law, IRC § 303 offers an unparalleled opportunity to receive tax-free corporate distributions of cash. IRC § 303 provides that a redemption of stock the value of which has been included in the gross estate of a decedent for federal estate tax purposes is, if certain requirements are met, treated as a sale of stock even though the redemption would, but for IRC § 303, be taxed as a dividend under IRC § 301. Because stock included in a decedent's estate ordinarily receives a basis step-up under IRC § 1014, a redemption that qualifies under IRC § 303 usually results in recognition of little or no gain or loss. The policy reason behind IRC § 303 is to provide a mechanism that facilitates the tax-free withdrawal of funds from a closely held business in order to provide a source of funds from which estate taxes and administration expenses incurred by the decedent's estate can be paid.

In order to qualify for the tax-favored treatment under IRC § 303, the stock redemption must satisfy, or fall within, the following requirements and restrictions:

1. The Stock is Included in Decedent's Estate

First, in order to qualify under IRC § 303, the redeemed stock must have been included in the decedent's gross estate (see IRC § 303(a)) for estate tax purposes, or the stock must take its basis from stock that was included in the decedent's gross estate and the "old stock" would have qualified for exchange treatment under IRC § 303(a).

2. 35% Requirement

Second, the value of the stock at issue must exceed 35% of the value of the decedent's gross estate, less the amount of deductions allowable under IRC §§ 2053 and 2054 (*i.e.*, debts, claims, administrative expenses and casualty losses).

> **EXAMPLE:** A's gross estate is $2,000,000, which included stock in X Corporation that was valued at $680,000 for estate tax purposes. $120,000 was allowable as estate tax deductions under IRC § 2053. A's estate satisfies the 35% requirement ($680,000 ÷ ($2,000,000 - $120,000) = 36.17%).

➔ **Planning Point:** For purposes of the computation under IRC § 303(b)(2)(a)(ii), the amounts deductible under IRC §§ 2053 and 2054 are taken into account whether or not they are claimed as deductions for federal estate tax purposes. Also, one should note that the amount of charitable and marital deductions are not included as part of the computation.

➔ **Planning Point:** A redemption which qualifies under IRC § 303 is almost always desirable for an estate, because it provides large amounts of cash on a tax-free or low-tax basis (by avoiding dividend treatment). Thus, in planning the administration of the estate, the estate's advisors must be cognizant of the fact that the valuation of the corporate stock and other assets will affect whether or not the 35% rule is satisfied.

➔ **Planning Point:** Advisors should monitor a shareholder's lifetime gift-giving program to make sure that the shareholder does not, unintentionally, reduce his or her stake in the corporation, thereby causing the value of the closely-held stock in his or her estate to fall below 35% of the value of his or her gross estate. If a decedent inadvertently transfers shares that drop him or her below the 35% threshold, he or she could contribute additional property to the corporation in return for additional shares of stock in an amount sufficient to raise his or her interest in the corporation above 35%.

If a decedent's estate has an interest in two or more corporations, the interests may be aggregated for purposes of satisfying the 35% rule if certain requirements are met. Specifically, under IRC § 303(b)(2)(B), the stock of two or more corporations may be aggregated for purposes of the 35% rule if 20% or more in value of each corporation's total outstanding stock is included in the decedent's gross estate. For purposes of the 20% requirement, stock held by the decedent and the decedent's surviving spouse as community property, or held by the decedent and the decedent's surviving spouse as joint tenants, tenants-by-the-entirety or tenants-in-common shall be treated as if it were included in determining the value of the decedent's gross estate (see IRC § 303(b)(2)(B)).

EXAMPLE: D died with a gross estate of $1,200,000. IRC §§ 2053 and 2054 expenses were $200,000. D owned, as his separate property, X Corporation stock valued at $250,000 (X Corporation's total value was $1,000,000). D also owned jointly with his wife stock in Y Corporation. D's one-half interest in Y Corporation was valued at $150,000 (Y Corporation's total value was $1,000,000). By including D's wife's interest ($150,000) in Y Corporation as if it were included as part of D's estate for purposes of the 20% requirement, both X Corporation and Y Corporation will satisfy the 20% requirement. In addition, the combined value of D's interests in X Corporation and Y Corporation (*i.e.*, $400,000) will satisfy the 35% requirement ($400,000 ÷ ($1,200,000 - $200,000) = 40%).

A further complication to satisfying the 35% rule is that IRC § 2035(c)(1) includes in the decedent's estate, for purposes of the 35% requirement, all property transferred by the decedent within three years of death. Thus, stock transferred within three years of the decedent's death is included for purposes of determining whether the 35% rule is satisfied, even though the stock is not included in the decedent's estate and is not eligible for redemption.

EXAMPLE: D transferred $500,000 of X Corporation stock to C in 2000. D died in 2001. His estate was valued at $2,000,000, which included $600,000 in X Corporation stock. Deductions allowable under IRC §§ 2053 and 2054 were $250,000. For purposes of determining whether the 35% rule is satisfied, D's estate includes the stock transferred to C in 2000. Thus, for purposes of the 35% rule, D's estate is valued at $2,500,000, including X Corporation stock of $1,100,000. Thus, D's estate satisfies the 35% rule ($1,100,000 ÷ ($2,500,000 - $250,000) = 48.89%). Nevertheless, only the X Corporation stock actually included in D's estate (*i.e.*, the stock valued at $600,000) may be redeemed under IRC § 303.

<u>EXAMPLE</u>: D transferred $900,000 of real estate to C in 2000. D died in 2001. His estate was valued at $3,000,000, which included $1,200,000 in X Corporation stock. Deductions available under IRC §§ 2053 and 2054 were $300,000. Although D's estate would have satisfied the 35% rule if the transferred real estate was not taken into account ($1,200,000 ÷ ($3,000,000 - $300,000) = 44.44%), it will not satisfy the 35% rule once the $900,000 of real estate transferred in 2000 is taken into account ($1,200,000 ÷ ($3,900,000 - $300,000) = 33.33%).

3. Maximum Redemption Amount

Under IRC § 303(a), the maximum amount that can be received in redemption of the decedent's stock is the sum of (1) state and federal death taxes imposed because of the decedent's death, and (2) funeral and administration expenses allowed as an estate tax deduction under IRC § 2053. The redemption, however, will qualify only to the extent the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of death taxes and funeral and administration expenses. Thus, stock that passes to a beneficiary will not be eligible for redemption treatment under IRC § 303 if the obligation to pay expenses and administration expenses is borne by another party (<u>see</u> IRC § 303(b)(3)).

4. Time Period During which Redemption Must Occur

An IRC § 303 redemption generally must occur within 90 days after the expiration of the statute of limitations for assessment of federal estate taxes, typically three years (<u>see</u> IRC § 303(b)(1)(A)). If a petition for redetermination of estate tax is filed in the Tax Court, the time period is extended to include the 60-day period after the Tax Court's decision becomes final. Also, if an IRC § 6166 election is made to defer estate tax, the period for redemption is extended to include the period during which installment payments will be made.

If a redemption is made more than four years after the decedent's death, the redemption will qualify under IRC § 303 only to the extent it does not exceed the lesser of (1) the amount of death taxes and funeral and administration expenses that remained unpaid immediately before the distribution and (2) the amount paid toward those expenses within one year following the date of the distribution (<u>see</u> IRC § 303(b)(4)).

➔ **<u>Planning Point</u>:** If an IRC § 6166 election has been made to defer estate taxes, any redemption made more than four years after the decedent's death must be carefully coordinated with payment of the estate tax under IRC § 6166 to ensure that the estate does not trigger the acceleration provisions contained in IRC § 6166(g).

D. Extension of Time for Payment of Estate Tax -- IRC § 6166

IRC § 6166 provides that the portion of the estate tax attributable to an interest in a closely held business may be deferred if the value of the closely held business interest exceeds 35% of the decedent's adjusted gross estate (and if the decedent is a U.S. citizen or a resident alien). The purpose behind the statute is to prevent the estate from having to sell the business in order to obtain the necessary liquidity to pay the estate tax. In general, IRC § 6166 permits the estate to elect to defer paying the tax attributable to a closely held business for five years, followed by installment payments over a period not to exceed ten years. Because year one of the installment period overlaps with year five of the deferral period, the maximum extension period is fourteen years.

1. The 35% Requirement

The 35% requirement under IRC § 6166 is calculated in the same manner as the 35% requirement under IRC § 303, and generally is subject to the same rules and restrictions. Accordingly, in calculating the decedent's "adjusted gross estate," the decedent's gross estate is reduced only by the deductions allowable under IRC §§ 2053 and 2054 (see IRC § 6166(b)(6)). In addition, if a decedent's estate has an interest in two or more corporations, the interests may be aggregated for purposes of satisfying the 35% rule if 20% or more in value of each business is included in the decedent's gross estate (see IRC § 6166(c)). For purposes of the 20% requirement, stock held by the decedent and the decedent's surviving spouse as community property, or as joint tenants, tenants-by-the-entirety or tenants-in-common is treated as if it were included in determining the value of the decedent's gross estate (see IRC § 6166(c)). Although the 35% requirement for IRC § 6166 generally is calculated in the same manner as the 35% requirement under IRC § 303, there are two important distinctions: (a) under IRC § 2035(c)(2), the estate will satisfy the 35% requirement only if the estate meets such requirement both with and without the application of IRC § 2035(a); and (b) IRC § 6166(b)(9) specifically disregards the value of passive assets owned by a business in determining whether the 35% requirement is satisfied under IRC § 6166.

2. Interest in a Closely Held Business

For purposes of IRC § 6166 an "interest in a closely held business" includes: (a) a sole proprietorship; (b) an interest in a partnership if 20% or more of the capital interest in the partnership is included in the decedent's gross estate or the partnership had 45 or fewer partners; or (c) stock in a corporation engaged in a trade or business if 20% or more of the voting interest in the corporation is included in the decedent's gross estate or there are 45 or fewer shareholders (see IRC § 6166(b)(1)). The determination as to whether the decedent's interest constitutes an "interest in a closely held business" is made as of the time immediately before the decedent's death (see IRC § 6166(b)(2)(A)).

a. Interests Held by Husband and Wife. For purposes of determining whether the decedent's interest is an "interest in a closely held business," the stock or partnership interests held by a husband and wife as community property or as joint tenants, tenants-in- common or tenants-by-the-entirety is considered to be owned by one person (see IRC § 6166(b)(2)(B)).

b. Indirect Ownership. Similarly, in determining whether the decedent's interest is an "interest in a closely held business," property owned, directly or indirectly, by or for a corporation, partnership, estate or trust is considered to be owned proportionately by the persons who hold an interest in such entity; however, a person is treated as having an interest in a trust only if such person has a present interest in the trust.

> **EXAMPLE:** H and W own stock in X Corporation as joint tenants. There are 43 other shareholders. In addition, a trust, in which there are two beneficiaries with present interests, owns stock in X Corporation. Although H and W are considered one shareholder, each of the beneficiaries of the trust is considered a shareholder. Thus, X Corporation has 46 shareholders and, thus, is not an "interest in a closely held business."

c. **Family Attribution**. For purposes of determining the number of partners or shareholders (*i.e.*, in determining whether an interest is an "interest in a closely held business"), a decedent is treated as owning all of the partnership interests or stock held by the decedent's spouse, siblings, ancestors or descendants (see IRC § 6166(b)(2)(D)).

d. **Trade or Business Requirement**. Even though a business seemingly may fall within the definition of an "interest in a closely held business," the business also must constitute a "trade or business." Thus, only businesses that produce income from active involvement, rather than solely from property ownership, are eligible for estate tax deferral under IRC § 6166.

3. Nature of the IRC § 6166 Relief

Once it is determined that the decedent's interest is an "interest in a closely held business" that satisfies the 35% requirement, the estate may elect to pay all or a portion of the estate tax in two but not more than 10 installments and may take advantage of the reduced interests rates under IRC § 6601(j).

a. **Limitation on the Amount That May be Paid in Installments**. IRC § 6166(a)(2) places a cap on the amount of estate tax that can be paid in installments. The cap is equal to an amount which bears the same ratio to the estate tax as (a) the value of the closely- held business bears to (b) the value of the adjusted gross estate.

> **EXAMPLE:** H died with a gross estate of $2,200,000. His estate had allowable deductions under IRC §§ 2053 and 2054 of $200,000 (thus, H's adjusted gross estate for purposes of IRC § 6166 was $2,000,000 (*i.e.*, $2,200,000 - $200,000). His estate consisted of an 80% interest in a closely held business, which was valued at $900,000. H's estate incurred estate tax of $1,000,000. Accordingly, the maximum amount qualifying for IRC § 6166 treatment is calculated as follows: ($900,000 ÷ $2,000,000) x $1,000,000 = $450,000.

b. **Number of and Due Dates for Installments**. The tax may be paid in two to ten equal annual installments, the first of which is due not more than five years after the date on which the federal estate tax was due to be paid (see IRC § 6166(a)(3)). The date chosen for payment of the first installment of tax does not have to be the anniversary of the original due date of the return, but must be the same date within any month corresponding to the day of the month on which the return was due (see Treas. Reg. § 20.6166-1(e)(2)).

> **EXAMPLE:** If D died on April 2, 2004, the tax would be due on January 2, 2005 (*i.e.*, nine months later). If an IRC § 6166 election is made, the first installment of the deferred estate tax is due on the 2nd of any month through January 2010.

c. **Rate and Due Date for Interest**. If the executor elects to take advantage of the maximum deferral, only interest is paid for a maximum of four years following the date on which the estate tax was due (see IRC § 6166(f)). IRC § 6601(j) establishes a 2% rate for interest payable on the deferred tax attributable to the first $1,000,000 (for decedents dying after 1998, this amount is adjusted annually for inflation -- the amount for 2010 is $1,340,000) in taxable value of a closely held business (this amount is referred to as the "2% portion"). Interest on the deferred tax that exceeds the 2% portion is payable at a rate equal to 45% of the annual underpayment rate established under IRC § 6621 (see IRC § 6601(j)(1)(B)).

> **EXAMPLE:** D dies in 2011 owning a closely held business, which is valued at $4,000,000 for estate tax purposes. The first $1,000,000 is not subject to tax by reason of the applicable exclusion amount. D's executor makes the IRC § 6166 election to pay the estate tax. Interest on the tax attributable to the inclusion of $1,340,000 of value in D's estate is payable at the 2% rate. The interest attributable to the remaining $1,660,000 is payable at 45% of the underpayment rate.

4. Making the IRC § 6166 election

The election must be made no later than the date on which the estate tax return is required to be filed, taking into account any extensions of time that are granted for filing the return (see IRC § 6166(d)). Treas. Reg. § 20.6166-1(a) provides that if the election is made when the estate tax return is filed, the election is applicable both to the tax originally determined to be due and to certain deficiencies. If, on the other hand, no election is made when the return is filed, up to the full amount of certain later deficiencies (but not the tax originally determined to be due) may be paid in installments.

An estate may make a protective election, even if the estate does not appear to satisfy the requirements of IRC § 6166. The protective election will defer payment of so much of the tax as remains unpaid when the estate tax values are finally determined (see Treas. Reg. § 20.6166- 1(d)).
Acceleration of Estate Tax Payment

IRC § 6166(g) provides a number of circumstances which will trigger the acceleration of the due date for payment of estate tax, including the following:

a. **Withdrawal of Money or Disposition of Interest**. The estate tax is accelerated if withdrawals of money or other property from the business equal or exceed 50% of the value of the closely held business. A redemption that qualifies under IRC § 303, however, is not counted for purposes of the 50% withdrawal rule if an amount equal to the redemption distribution is paid on the remaining balance of the estate tax no later than one year after the distribution is made (see IRC § 6166(g)(1)(B)).

b. **Undistributed Income of Estate**. If an electing estate has undistributed net income for a taxable year ending on or after the due date for the first installment, the estate must pay an amount equal to the undistributed income toward the unpaid estate tax on or before the date the income tax return must be filed for the year (see IRC § 6166(g)(2)).

c. **Failure to Pay Principal or Interest on Time**. If there is a failure to pay any principal or interest on time, the unpaid portion of the tax must be paid upon notice and demand from the IRS (see IRC § 6166(g)(3)(A)). Nevertheless, if the unpaid balance is paid within six months of the due date, acceleration does not occur and, instead, the preferential 2% interest rate will not apply to the payment and a penalty is imposed in an amount equal to the product of (a) 5% of the unpaid payment and (b) the number of months or fractions of months after the payment date and before payment is actually made (see IRC § 6166(g)(3)(B)).

E. *Graegin* Loans

Another attractive alternative for estates holding a large and illiquid interest in a closely-held business is the *Graegin* loan, named after *Graegin v. Comm'r*, T.C. Memo. 1988-477. In *Graegin*, a revocable trust included in the decedent's estate owned stock in Graegin Industries, Inc. Graegin Corporation, a wholly-owned subsidiary of Graegin Industries, Inc., lent to the decedent's estate an amount of money equal to the federal estate tax due. The loan was made in exchange for an unsecured promissory note bearing interest at 15% per annum, which was the prime rate at the time of the loan. Under the terms of the promissory note, principal and interest were due in a single balloon payment 15 years after the note was executed by the executors. The promissory note was issued nine months from the date of the decedent's death. The terms of the note prohibited prepayment.

IRC § 2053(a)(2) allows a deduction from the value of the gross estate for estate administration expenses which are allowable by the laws of the jurisdiction in which the estate is being administered. To be deductible, the projected interest expense must be actually and necessarily incurred. Expenses actually and necessarily incurred are expenses in the collection of assets, payment of debts, and distribution of property to the persons entitled to it. Treas. Reg. § 20.2053-3(a).

Treas. Reg. § 20.2053-1(b)(3) provides that a deduction for an administration expense may be claimed even though its exact amount is not then known, provided it is ascertainable with reasonable certainty and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. *Estate of Bailly v. Comm'r*, 81 T.C. 246 (1983).

In general, the courts and the IRS have concluded that interest expenses incurred by an estate on funds borrowed by the estate can be a deductible administration expense provided the loan was reasonably and necessarily incurred in the administration of the estate. For example, in Rev. Rul. 84-75, 1984-1 C. B. 193, the IRS stated that, "because the loan was obtained to avoid a forced sale of assets, the loan was reasonably and necessarily incurred in administering [the decedent's] estate." In *Estate of Todd v. Comm'r*, 57 T.C. 288 (1971), the court stated that "the estate did not own any liquid assets at the time; and that if the estate liquidated some of its nonliquid assets, these would have been sold at reduced prices." Also, in *Estate of Thompson v. Comm'r*, T.C. Memo. 1998-325, the court stated that "[w]e are convinced that the financial position of the estate at the time of the borrowing was insufficient to make the required tax payments and provide for the maintenance of Cane Mill [the business property owned by the estate]"). See also, *McKee v. Comm'r*, T.C. Memo. 1996-362 ("the executors determined that it was preferable to preserve all of decedent's [closely-held] stock and to borrow funds . . . in order to better ensure the estate's ability to pay its obligations."); *Estate of Huntington v. Comm'r*, 36 B.T.A. 698 (1937) ("[t]he issuance of the notes avoided the necessity of sacrificing the assets of the estate by immediate or forced sale"); *Hibernia Bank v. United States*, 581 F.2d 741 (9th Cir. 1978).

The *Graegin* court allowed the immediate deduction of interest for the entire 15-year period as an administrative expense under IRC § 2053. The court reasoned that the note was a genuine indebtedness and, in view of the terms of the note, the amount of the interest to be paid was ascertainable with reasonable certainty and would be paid. See also *Rupert ex rel. Estate of Knepp v. United States*, 358 F.Supp.2d 421 (M.D. Pa. 2004).

Thus, following *Graegin*, an estate may borrow from a related party or from a third party and deduct the sum of the future interest payments over the term of the loan as a cost of administration under IRC § 2053, without having to calculate the present value of such payments. This approach not only avoids the estate's having to sell business assets, but the loan proceeds can be used to pay the estate taxes without altering any valuation discounts claimed on the estate tax return. If the business is sold, the discounts may be lower or eliminated.

To help ensure deductibility under IRC § 2053, the estate must ensure that it has sufficient evidence to prove to the IRS that the loan is necessary to the administration of the estate due to the estate's illiquidity. If the loan is obtained by a related party, the estate must be able to prove that the loan is substantially similar to a loan that would have been obtained from an independent third party lender.

➔ **Planning Point:** Before obtaining a *Graegin* loan, the parties involved must ensure that there will be enough post-death cash flow to service the loan. In addition, the parties must realize that the agreement between the lender and the estate may restrict the estate's ability to make distributions to the beneficiaries during the life of the loan.