Chapter 19

Planning for the Owner of the Closely Held Corporation

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¶1901 Overview

Every owner of a substantial interest in a closely held corporation is a prime candidate for financial planning services. The founder of a closely held corporation is a candidate for such services from the inception of the corporation. A financial planner can do a great deal in the initial planning of the business structure and throughout the life cycle of the business that will yield good short- and long-term financial planning results.

This chapter addresses the financial planning aspects of closely-held businesses, some of which may qualify as a small business. The Small Business Association relief programs are beyond the scope of this guide, but visit the AICPA’s Payroll Protection Program page for more resources to help your clients (www.aicpa.org/sba). For COVID-19 planning strategies and client facing resources from the PFP Section, visit www.aicpa.org/pfp/COVID19.

.01 Value of the Stock

Stock in the business is usually the principal asset of an owner of a close corporation. Thus, the stock is often the key element in financial planning.
Although the stock in the close corporation can be quite valuable, it is an illiquid asset. For estate and gift tax purposes, it can present difficult valuation problems. The real value of the stock might depend on the founder’s talent and drive, which are qualities that valuation experts do not necessarily consider. The value attributable to the founder’s work might not be apparent until years after the founder’s death. The heirs might become aware of the value of the founder to the close corporation when its earnings begin to decline, and the heirs try to sell their shares.

Special rules that apply for valuing intergenerational transfers of family businesses are discussed in chapter 23, “Impact of Estate Freeze Rules on Intrafamily Transfers.”

.02 Key Areas the Financial Planner and Owner Must Address

**Successor management.** If the real value of the business derives from the current owner’s talents, knowledge, contacts, and drive, the owner must plan to develop successor management. If successor management is not available within the family, then the owner must search outside the company or develop an employee within the company to assume management responsibilities. In any case, the financial planner must be prepared to assist in developing incentive compensation programs designed to recruit or retain talent. If the owner cannot find a suitable successor, then the owner and financial planner must formulate a plan to dispose of the business.

**Building a second estate.** Having virtually everything invested in a business is generally not a good idea. The financial planner and the owner should seek to build a second estate to provide a cushion if the unexpected happens, and the business fails or suffers a downturn. The financial planner must help the owner create plans to take money out of the business. Diversification of asset holdings and investments should be a central message of the financial planner to the business owner. Techniques to take money out of the business include investment in alternative assets not directly connected with the business; dividing the business into distinct enterprises; profit-sharing plans; a stock bonus plan; an employee stock ownership plan (ESOP), with sales of stock to the ESOP trust; or stock redemptions. Another possibility is to give stock to charities to generate income tax deductions. The owner could then invest the tax savings. The business owner should also consider the benefits of life insurance, especially as a source of needed liquidity.

**Reserve fund for business.** The financial planner should calculate how much extra cash the business may require when the owner dies, in terms of possible loss of key customers, tougher bank financing, and the need for more working capital to allow for successor management’s inexperience. Accumulated earnings of a C corporation should be looked at with an eye to IRC Sections 531–537, with particular attention paid to the accumulated earnings credit of IRC Section 535(c)(2), which sets the minimum credit at $250,000 ($150,000 for certain personal service corporations), and IRC Section 537(b) before the tax on excess accumulations may be considered. The latter section permits accumulations for the purpose of IRC Section 303 redemptions in the amount of administration expenses, federal estate taxes, and state death taxes. However, it allows this accumulation only in the year in which the shareholder dies and the years thereafter. The corporation must have other reasonable business needs to justify prior accumulations.

**Outside market.** Does a market exist for the business? Where is the market? What can the business owner do to enhance marketability? Successor management and building funds within the business will help. What are the possibilities of a merger? Is there a possibility of going public? Should the business owner take steps to prepare the business for a possible public offering, even though only a private offering appears likely?
Sale to insiders. The corporation can use an ESOP to dispose of a major stock interest with highly favorable income tax results ([¶1920]). Other possibilities include buy-sell agreements between shareholders or business associates or with key employees capable of running the business. If a sale to associates is a possibility, and the associates are in a common age bracket with the owner-client, the financial planner should consider whether to arrange a buy-sell at a moderate bargain price or to seek a higher price. If all associates agree, a bargain price could be to the client’s advantage if co-owners and associates predecease the client. The buy-sell price will aid, if not control, the valuation for estate tax purposes, provided special valuation rules contained in IRC Section 2703 and discussed in [¶2310] are satisfied. When the potential buyers and sellers are related persons, any buy-sell agreement price is viewed with permitted statutory skepticism by the IRS. If the parties are unrelated persons, the price used in a buy-sell agreement is given a presumption of fairness — neither party can be sure of being the buyer or the seller, hence, the suggestion that a “fair” price will be arrived at to protect each party’s interests.

Estate taxes. What will the owner’s estate tax be under the present plan? To what extent is the owner-client relying on the marital deduction[1] to reduce estate tax liabilities? What will happen if the spouse predeceases the client? What if the spouse survives and retains a significant stock interest until death? How much unified credit[2] is expected to be available? What steps are open to reduce the estate tax impact? Lifetime gifts? Charitable giving? Lifetime sale of the business? Life insurance? Fixing valuation? Is there a deceased spouse’s unused exclusion available through the portability rules? What may be the impact of state estate and inheritance taxes in addition to the federal estate tax? What will the transfer tax exclusion be in the year of death? These are some of the questions that the financial planner should ask before addressing planning techniques to deal with the answers to these questions.

Estate liquidity. After determining the potential federal and state estate tax impact, the financial planner should calculate how much money the estate will need to pay debts, funeral expenses, administration expenses, federal and state death taxes, and cash bequests. How will the estate obtain the money required? What liquid assets will the estate likely have? What outside resources are available? Will individual heirs or trusts be in a position to lend funds to the estate or purchase illiquid assets? To what extent can the estate rely on stock redemptions under IRC Sections 302 or 303 to meet liquidity needs? Will the business be in a position to accomplish the redemptions? If not, what steps can the business owner take to enable it to do so? Can the estate qualify for installment payments of the federal estate tax ([¶1925])?

Stepped-up basis. Stock retained until death will receive, as a general rule under current law, a basis equal to its fair market value (FMV) for estate tax purposes.[3] All income tax liability for prior appreciation will be eliminated, leaving more money for the estate or heirs on a sale or redemption. This factor affects the choice between lifetime gifts of stock (when the basis carries over from the donor to the donee) and testamentary dispositions. With the 20% capital gains rate for wealthy taxpayers in 2020 and beyond, and subjecting capital gains to the 3.8% tax on net investment income, planning for increases in income tax basis takes on greater importance.

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1 IRC Section 2056.
2 IRC Section 2010.
3 IRC Section 1014(a).
Valuation. What steps can the business owner take to fix the value of the stock for sale or estate tax purposes? Is discounting appropriate? The financial planner should encourage clients to use bona fide appraisals when needed to satisfy the adequate disclosure rules of the IRS.

Recapitalization and restructuring. Recapitalizing to a mix of common and preferred stock offers a number of financial and estate planning advantages. This technique is only available to a C corporation because an S corporation may not issue preferred stock. An S corporation may have voting and nonvoting stock without violating the single class of stock rule for S corporations, as long as the preferences attributable to each category of stock are identical. Some of those strategies are discussed in ¶1910.

Executive benefits. To the extent that the client occupies the position of an executive in a closely held corporation, all the planning considerations discussed in chapter 16, “Planning for the Executive,” apply.

The concept of “personal goodwill” — a way to avoid double taxation in a C corporation. A decision of the Tax Court addressing the concept of “personal goodwill” suggests a strategy to avoid the double taxation to which C corporations and their shareholders are subject when the assets of a C corporation are sold.

C corporation sellers may try to avoid the double tax by suggesting a stock sale, but sophisticated buyers who agree to a stock sale will typically try to discount the purchase price because there will not be a stepped-up basis in assets.

A possible solution to the C corporation asset sale is to have the shareholders sell their personal goodwill in the business. If this planning is successful, the sellers of the goodwill pay a single level of tax at long-term capital gain rates, and the buyer obtains the same amortizable asset it would have received if it had purchased an intangible asset from the corporation.

The leading cases that support a personal goodwill argument are Martin Ice Cream v. Commissioner, 110 T.C. 189 (1998) (distributor relationships belonged to the seller, not to the corporation, so the buyer purchased a capital asset from the seller, rather than receiving an appreciated corporate asset) and Norwalk v. Commissioner, 76 TCM 208 (1998) (client relationships were the individual property of the selling accountants and shareholders, rather than the property of the corporation).

The IRS opposes this concept, and has successfully challenged it in Muskat v. Commissioner, 554 F.3d 183 (1st Cir. 2009) (there were no negotiations for personal goodwill, and payments for a noncompetition agreement did not qualify); Howard v. Commissioner, No. 10-35768 (9th Cir. 8/29/11) (a dentist had an employment agreement with his corporation, and the court concluded his services and practice were conveyed to the corporation via the employment contract, and were corporate assets); and H & M, Inc. v. Commissioner, T.C. Memo 2012-290 (a leading life insurance salesman sold his corporation and claimed personal goodwill based on his reputation). This was denied because there was no purchase price allocation to personal goodwill and the taxpayer entered into a covenant not to compete.

To be successful in the personal goodwill argument, it appears necessary to raise the issue early in the negotiations and allocate something valuable to it; possibly supported by an independent appraisal and avoid having employment or noncompete agreements with the corporation that convert personal goodwill to a corporate asset.

The personal goodwill issue again surfaced in the U.S. Tax Court in the case of Bross Trucking, Inc. v. Commissioner, T.C. Memo, 2014-107. The Tax Court determined that the goodwill of a trucking business was not corporate goodwill, but personal to its owner and sole shareholder. Because the goodwill
was not considered part of the assets of the corporation, the corporation did not distribute appreciated intangible assets in the form of goodwill to the owner and therefore did not recognize gain.

The court distinguished two different goodwill situations. It recognized personal goodwill developed and owned by shareholders and corporate goodwill, developed and owned by the company. In this case, the court found that the trucking business of the taxpayer may have lost its goodwill due to an investigation, so that any remaining goodwill was owned by the taxpayer personally.

Importantly, the court found that taxpayer had not transferred his goodwill to the trucking business. There was no employment contract or noncompete agreement. The taxpayer was free to leave the business and take his personal assets with him.

In another case, the taxpayer was successful in reducing the value of stock included in a decedent’s estate by asserting that the personal goodwill of a valuable employee should not be attributed to the value of the corporation. In Estate of Adell, TCM 2014-155, the Tax Court noted the importance of a key employee to the value of a decedent’s business and stated:

A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. Although employees may transfer that goodwill by a noncompete clause or other type of contract, absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation.

Expect the IRS to challenge a claim of personal goodwill when it is involved in a transaction involving a C corporation where the IRS can assert a double tax claim, as well as in a disputed valuation situation where the taxpayer seeks to reduce a business valuation by the personal goodwill of the key employees. However, the cases indicate that where the shareholder (or key employee) does have a reputation or special relationships (often seen, for example, in the sale of a medical practice) and significantly there is no employment agreement or noncompete agreement restricting the asset to the corporation, the shareholder (or key employee) may then be free to treat the goodwill as his or her own personal asset.

¶1905 Initially Planning the Business Structure

Placing all business operations in one corporation is not always necessary or appropriate. The financial planner should not overlook the possibility of combining the corporate form with individual, LLC, or partnership ownership of the elements of the business enterprise. The financial planner should also consider the use of multiple corporations. Multiple entities can open the door to many attractive financial planning possibilities.

For example, assume a business is engaged in the manufacture and sale of widgets. The business owner might set the business operations up as follows. The business owner uses a corporation for the operating part of the business — to do the manufacturing and selling and to carry inventory and accounts receivable. The corporation receives a certain amount of working capital. The real estate and the plant in which the corporation operates, however, are owned by the shareholders preferably in limited partnership or LLC form and are leased to the corporation. The corporation does not own the machinery and equipment it uses to manufacture the widgets. A limited partnership, in which the corporation is the general partner, owns the machinery and equipment. The shareholders are limited partners, along with one or more trusts for the children of shareholders. The partnership leases the machinery to the corporation. If the business owner has extensive office equipment, computers, and fax machines, these too might be owned by the
partnership or individual family members and leased to the corporation. Of course, the leasing arrangements must be fair and reasonable based on terms that might have been obtained in truly arm’s-length transactions.

What has been accomplished by using this structure? The shareholders, as owners of the real estate, might incur losses in the early years to offset their other income. However, the losses are losses from passive activities, which include business activities in which the taxpayer does not materially participate and the rental of any tangible property (irrespective of material participation). A taxpayer may generally only use passive losses to offset income from passive activities until the taxpayer disposes of the property in a taxable transaction to an unrelated party. The taxpayer carries the disallowed passive activity losses forward to the next tax year.  

Passive income does not include portfolio income (interest, dividends, and capital gains). However, under a special exception for rental real estate in which an individual actively participates, the taxpayer may deduct annually up to $25,000 of losses against nonpassive income. The $25,000 loss allowance is phased out ratably between $100,000 and $150,000 of adjusted gross income (AGI). Another exception to the prohibition on the deduction of passive losses permits certain closely held corporations (but not including personal service corporations) to use passive losses to offset business income, but not portfolio income. A special “self-rental rule” treats as active income the rental income received when a taxpayer rents property to a related entity to avoid the taxpayer manipulating positive rental income to take advantage of offsetting passive losses from other activities. Self-rental income is also treated as active for purposes of the net investment income tax, so it is not subject to that tax. 

Assuming that the shareholders have deducted the losses from the real estate, when the real estate begins to generate a net income, the shareholders can make gifts of the real estate to trusts for their children. These gifts may produce income tax savings by moving the taxable income to persons in lower tax brackets (if the children are not subject to the kiddie tax) while removing the real estate from the shareholders’ gross estates. In addition, the gifts may provide the children with income to be used or accumulated for worthwhile purposes.

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4 IRC Section 469(c).
5 IRC Section 469(d)(1).
6 IRC Section 469(g).
7 IRC Section 469(b).
8 IRC Section 469(e)(1).
9 IRC Section 469(i).
10 IRC Section 469(e)(2).
11 Regulation Section 1.469-2(f)(6).
12 Regulation Section 1.1411-4(g)(6).

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The rental income going to the limited partnership that owns the machinery and equipment could be offset, in part, by depreciation deductions. If the partnership shows losses, the benefit of the depreciation deductions would be limited under the passive activity loss rules discussed previously.

One or more of the suggested entities may be eligible for the 20% qualified business income deduction from taxable income available for owners of pass-through entities under new IRC Section 199A as introduced by the 2017 Tax Cuts and Jobs Act (TCJA).

The fact that the corporation does not own the real estate, the machinery, or equipment might not have a material effect on the price obtainable on an eventual sale of the corporate stock. Earnings from the business operations are more likely to be the controlling factor when determining the value of the corporation.

Planning opportunities are available when structuring the corporation itself. This chapter will not examine issues such as taxable or tax-free incorporation and other income tax factors. However, income tax factors are often related to financial planning.

Rather, this chapter will concentrate on the capital structure of the corporation. If the corporation has more than one class of stock, it cannot be an S corporation. Differences in voting rights alone, however, will not create a second class of stock for S corporation purposes. Under Subchapter S, corporate profits and losses are generally passed through to shareholders. Therefore, using an S corporation avoids the double taxation otherwise inherent in the C corporation form. The S corporation election is discussed in detail in ¶1945.

Also, the financial planner should give some thought to the use of multiple corporations to multiply accumulated earnings credits and split income between separate entities. C corporations will be given greater consideration with the 21% flat tax rate arising under the TCJA.

¶1910 Recapitalization and Post-Organizational Planning

At one time, recapitalizing a corporation with a mix of common and preferred stock offered financial and estate planning advantages with respect to intrafamily transfers. Congress enacted IRC Section 2036(c) in 1987 largely to eliminate these advantages, but Congress repealed this provision in 1990 and replaced it with new rules for valuing transfers of interests in family businesses. These rules are contained in IRC Sections 2701 through 2704 and discussed in chapter 23, “Impact of Estate Freeze Rules on Intrafamily Transfers.” The following discussion is a theoretical analysis related to recapitalizations

13 IRC Section 1361(b)(1).
14 Regulation Section 1.1361-1(l)(1).
15 IRC Section 1366.
16 IRC Section 535(c).
of both family-owned companies and companies owned by unrelated parties. However, family companies must apply the IRC Section 2701 rules to determine whether a recapitalization results in a gift. If a gift results, the family companies must determine the amount of the gift.

.01 Reasons for Recapitalization

**Raising capital.** When raising capital, one of the concerns of management is to retain control of the company. Raising capital from venture capitalists or other investors usually requires issuance of securities convertible into common stock, such as convertible debentures or convertible preferred stock. Depending on the negotiating power of each party, one possibility is to convert the common stock into separate class A voting stock and class B nonvoting stock. Management would retain the class A stock, while reserving the class B stock for issuance to the investors on conversion. A variation, when allowed under applicable state law, might be some form of weighted voting stock with each class A share having 10 votes and each class B share having one vote.

**Successor management.** Hiring younger management is important to the continuity of any business. Senior management is concerned about maintaining control and having minority shareholders in the event a junior executive leaves the company. These concerns may be addressed by issuing nonvoting stock to junior executives, which they may convert to voting stock over time, with a buy-back agreement for the stock in the event of termination of employment. Another alternative is to issue voting stock to junior management but restrict the voting rights of junior management for a specified period.

**Retirement planning for senior management.** A business owner might have a substantial portion of his or her assets invested in a closely held company. When approaching retirement, the business owner is concerned with converting the investment into a retirement fund to ensure sufficient liquidity during retirement and possibly for estate tax purposes. Advance planning is important. Such planning should include an agreement among the shareholders addressing the sale of the stock, including guidelines for computing the price of the stock, indicating how it is to be paid, and providing security for the payment. The shareholders may consider converting the common stock into preferred stock or debt, with put and call options exercisable at various times.

**Dissension among the owners.** A solution to any dissension among the owners can take several forms, such as a buyout, a division of the company, or a complete liquidation. Sometimes, the shareholders can provide for consequences of dissension in a buy-sell agreement. The agreement might provide a mechanism for triggering a put or call of the shares or for conversion into a nonvoting security.

Recapitalizations can take on many forms depending on the circumstances involved in each situation. A recapitalization provides management with flexibility.

.02 Sale-Leasebacks

In the initial structuring of a business, keeping the real estate and machinery out of the corporation can be desirable from a financial planning point of view. Instead of having all the assets held in the corporation, individuals through an LLC or a partnership of the shareholders or members of their families can own the real estate and machinery and lease them to the corporation. If the corporation owns the real estate and machinery from the outset, later, the corporation might be able to enter a sale-leaseback arrangement with a shareholder, partnership, or outside family members or trusts. The IRS watches such sale-leaseback transactions closely. The IRS might challenge the sale-leaseback on the grounds that it is a sham transaction. However, if the arrangement is not a sham because it has the elements of an arm’s-
length transaction, and makes economic sense (for example, by providing additional financing for the corporation) it may withstand an IRS challenge.

¶1915 Obtaining Money From the Corporation Via Stock Redemptions

Converting stock of a closely held corporation into cash without undue sacrifice of the stock’s real value can be one of the prime problems of the estate of a substantial shareholder. If the corporation has sufficient money, redemption of all or part of the stock held by the estate or its beneficiaries is a way of extracting the cash from the corporation. If the estate is not careful, however, a redemption might be at the price of a deeper discount than if the estate had sold the stock to an existing shareholder or a stranger. The tax law may treat the stock redemption as a dividend,\(^\text{17}\) instead of as a sale qualifying for capital gain taxation, unless certain strict corporate redemption requirements of IRC Section 302 are satisfied. Although qualified dividends are taxed at the same maximum 20\% rate as long-term capital gains in 2020, qualifying the redemption as a sale is still far preferable to dividend treatment. That is because a sale will allow the basis of the stock redeemed to be offset against the redemption proceeds, so that only the net difference is taxable. With dividend treatment, the entire redemption proceeds are taxable (to the extent of the corporation’s earnings and profits). Also, if the stock passes from a decedent, its tax basis would be its FMV at the date of death or six months later at the alternate valuation date if the alternate valuation date is available.\(^\text{18}\)

Thus, qualifying the redemption to be taxed as a sale or exchange and not as a dividend is important. The IRC provides two routes by which a shareholder may achieve this objective. One is IRC Section 302, which deals with distributions in redemption of stock. The other is IRC Section 303, which deals with distributions in redemption of stock to pay death taxes and funeral and administration expenses. Neither route is free from difficulty. However, IRC Section 303 is usually the easier route, assuming, of course, that there has been a death of a shareholder with a substantial interest in the corporation.

If a redemption following the death of a shareholder qualifies for sale or exchange treatment under IRC Sections 302 or 303, the amount distributed in excess of basis will be taxed as a long-term capital gain. The law deems capital assets acquired from a decedent to have been held long term, regardless of the actual holding period.\(^\text{19}\) If a redemption does not qualify for sale or exchange treatment under either provision, the full amount received is taxed as a dividend if the corporation has sufficient earnings and profits.\(^\text{20}\)

Qualified dividends are taxed at a maximum rate of 20\% for 2020 and thereafter. A net capital gain is the excess of net capital gains over any net capital losses.\(^\text{21}\) The tax rate for a net capital gain is the

\(^{17}\) IRC Section 302(d).

\(^{18}\) IRC Section 1014(a).

\(^{19}\) IRC Section 1223(11).

\(^{20}\) IRC Sections 301(c)(1) and 316(a).

\(^{21}\) IRC Section 1222(11).
lower of the regular tax rate or the alternative tax rate. The alternative tax rate for net capital gains consists of various layers, depending on a number of factors, including the nature of the property sold and the overall tax bracket of the seller. These layers can cause all, or part, of a net capital gain to be taxed at rates ranging from zero to 37%, depending upon the nature of the asset sold, holding period, and the income tax bracket of the seller. In 2020, the maximum long-term capital gain rate and the tax rate on qualified dividends is 20% for persons with taxable income of more than $496,600 (married filing jointly) or $441,450 (single). The thresholds for these taxes are indexed annually for inflation. The additional 3.8% tax on net investment income applies for single filers with AGI over $200,000 and married joint return filers with AGI over $250,000. The thresholds for the net investment income tax are not indexed for inflation. (See ¶3330 in chapter 33, “Year-End and New Year Tax Planning,” and chapter 38, “Planning for the Net Investment Income Tax,” for more information on the net investment income tax). The 25% and 28% rates continue to apply to specialized types of gain.

To take advantage of IRC Section 303, the value of the closely held business stock in the decedent’s gross estate must be more than 35% of the value of the decedent’s adjusted gross estate (the gross value of the estate reduced by allowable expenses, losses, and debts). The redeeming shareholder will receive capital gains treatment only to the extent that the shareholder’s interest is reduced directly (or through a binding obligation to contribute) by payment of the deceased shareholder’s death taxes or funeral or administration expenses. Special rules apply if two or more separate corporations are involved, as noted in the text that follows.

The amount that the corporation may distribute in accordance with IRC Section 303 without the distribution being taxed as a dividend is limited by the amount of estate taxes and interest thereon and the amount of funeral and administration expenses allowable as deductions for federal estate tax purposes. If the corporation’s distribution in redemption of stock exceeds the limits, the excess will be taxed as dividend income to the extent of the corporation’s earnings and profits, unless the distribution qualifies for capital gains treatment under the general corporate redemption provisions of IRC Section 302.

To qualify under IRC Section 303, the redemption must take place after the decedent’s death and generally within the three-year period allowed for the assessment of estate tax. This period begins when the estate tax return is filed (normally within nine months of death), plus 90 days, or, if the estate files a petition with the U.S. Tax Court to challenge an IRS determination of estate tax, within 60 days of the court’s final decision, whichever period is longer. However, if the executor has made an election to pay the federal estate tax in installments under IRC Section 6166 (¶1925), the time for redemption under

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22 IRC Section 1(h).
23 IRC Section 1(h).
24 IRC Section 303(b)(2).
25 IRC Section 303(b)(3).
26 IRC Section 303(b)(2)(B).
27 IRC Section 303(a).
28 IRC Sections 301(c) and 316(a).
IRC Section 303 extends to the due date of the last installment.\(^\text{29}\) In the case of redemptions made more than four years after death absent the election to pay the federal estate tax in installments, capital gains treatment is limited to the lesser of (1) the aggregate amount of death taxes, funeral, and administration expenses remaining unpaid immediately before the redemption or (2) the total amount of such taxes and expenses paid within one year of the redemption.\(^\text{30}\)

.01 Two or More Separate Corporations and IRC Section 303

Often, a decedent owns stock in two or more closely held corporations. For example, a decedent might own an interest in a real estate corporation that leases property to an operating corporation in which the decedent holds an interest. In such case, if the decedent’s gross estate includes 20\% or more in value of the stock of each of two or more corporations, then the estate may aggregate the values of the combined shares when determining whether the estate satisfies the 35\% test of IRC Section 303.\(^\text{31}\)

.02 Important Considerations Affecting Use of IRC Section 303

IRC Section 303, despite its restrictions, is a way of extracting cash (and property) from a closely held corporation in a tax-favored way. The estate can use the cash to satisfy its liquidity needs. However, the executor should consider the following negative factors.

**Control of the business.** If the stock to be redeemed represents the swing vote in the control of the business, the executor should weigh the loss of control against the benefits to be obtained. Revenue Ruling 87-132\(^\text{32}\) offers a way of maintaining relative voting strength. In the case that gave rise to this ruling, a company had outstanding 300 shares of voting common stock owned equally by an estate and an individual who had no interest in the estate. The estate wanted to accomplish an IRC Section 303 redemption but did not want to lose relative voting power. A proposed solution was to issue a stock dividend of 1,500 shares of new nonvoting common to each of the two shareholders and then have the estate immediately redeem 1,000 of the new nonvoting shares in an IRC Section 303 redemption. The problem with the proposed solution was that under existing IRS rulings, a stock distribution that is immediately redeemable is taxable, rather than being tax-free under IRC Section 305. The IRS, recognizing that IRC Section 303 is remedial and the time factors involved, carved out an exception for IRC Section 303 redemptions. In such a case, the stock dividend is tax-free notwithstanding the immediate redemption.

To implement this type of solution, the redeeming shareholder might need to persuade the other shareholders to consent to the stock dividend and redemption. This consent may be necessary, even when the party seeking the solution is in control under applicable state law or corporate charter provisions. This plan, depending on state law, may require a greater-than-majority vote to effect such corporate action.

A corporation can use a recapitalization to achieve similar results. If the stock dividend and recapitalization solutions are not feasible, the shareholders should consider limiting the amount redeemed so that

\(^{29}\) IRC Section 303(b)(1).

\(^{30}\) IRC Section 303(b)(4).

\(^{31}\) IRC Section 303(b)(2)(B).

\(^{32}\) 1987-2 CB 82.
control will not be lost or relative voting strength will not be drastically weakened. Again, the shareholders must consider the effect of state law and corporate charter provisions.

Notwithstanding the favorable result of Revenue Ruling 87-132, note that this result was only possible due to the willingness of the surviving shareholder to allow the stock dividend to avoid having the decedent’s family’s interest being diluted by an IRC Section 303 redemption. Not every surviving shareholder can be counted on to be as generous. The financial planner should assess the situation in which an IRC Section 303 may be likely and recommend a corporate recapitalization or stock dividend before any shareholder dies. At that time, because no shareholder will know which will be the first to die, it is likely that there will be greater cooperation in bringing about the desired corporate action.

**Effect on business operations.** How will taking cash or property for redemption purposes affect the operation of the business? Will working capital be depleted to an unreasonable degree? Will plans for replacement or expansion of plant and equipment be affected? What will the redemption do to the value of the shares, if any, retained? The shareholders should address these and similar questions. The IRC Section 303 redemption opportunity should not be viewed as the “Plan A” succession plan for a closely held corporate business. It is a helpful fallback if no other appropriate planning has taken place but should be viewed cautiously as a likely drain on the corporation’s available assets or borrowing power, or both.

**Loss of deferred payment benefits.** IRC Section 6166 provides for deferred payment of estate taxes over 14 years when the estate includes a qualifying closely held business, as discussed in ¶1925. However, the estate might lose the benefits of installment payment of estate taxes and face an accelerated liability if the estate or heirs divest themselves of 50% or more of the value of their interest in the business before all of the decedent’s estate taxes have been paid. The shareholders must exercise caution to keep any sales or redemptions within the percentage limit, or the redemption proceeds will have to be used to pay the accelerated liability for the deferred federal estate taxes.

Nevertheless, if the distributions in redemption of stock to pay taxes to comply with IRC Section 6166 result from compliance with the provisions of an IRC Section 303 election, the redemption of stock and the withdrawal of money and other property distributed in the redemption will not be treated as a distribution or withdrawal that will cause an acceleration of the balance of the deferred tax to become due.33

**Redemptions by different parties.** Redemptions by different parties might pose some problems. As noted previously, capital gain treatment is available to a redeeming shareholder only to the extent that the shareholder’s interest is reduced directly (or through a binding obligation to contribute) by any payment of death taxes or funeral or administration expenses. This requirement obviously limits the number of shareholders able to take advantage of IRC Section 303. A corporation might have two or more shareholders who qualify for redemption under IRC Section 303, when the decedent’s will bequeaths the stock to two or more persons. If two or more redemptions occur, the regulations take a first-come, first-served approach, regardless of whether the particular redemption might have qualified as an exchange under IRC Section 302.

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33 IRC Section 6166(g)(1)(B)(i).
If multiple redemptions occur, the corporation and the redeeming shareholders should attempt to qualify the redemptions under IRC Section 302 in order not to waste the IRC Section 303 limits. The following discussion addresses additional planning issues regarding IRC Section 303 redemptions.

**Valuation of stock.** The redemption price will not necessarily be the same as the value that the IRS puts on the stock for estate tax purposes. If the redemption price exceeds the value finally determined for estate tax purposes, the redeeming shareholder will realize a capital gain.

.03 Planning for IRC Section 303 Redemptions

Advance planning is often required to take advantage of IRC Section 303 in order to avoid any adverse side effects. Some of the key factors to consider are as follows.

**Meeting the 35% test.** In some cases, the shareholders will have no problem meeting the requirement that the stock includible in the decedent’s gross estate is more than 35% of the value of the adjusted gross estate. However, if the client anticipates difficulty satisfying this test, the financial planner might consider the following strategies:

- **Lifetime gifts.** Gifts of property other than the business stock made more than three years before death will reduce the estate and help the stock interest to meet the 35% test. Gifts within the $15,000 annual exclusion limit (for 2020 and indexed annually for inflation) made within three years of death can also help in meeting the 35% test. However, other gifts made within three years of death in excess of the annual exclusion amount will be includible in the gross estate calculation for the purpose of testing availability of IRC Section 303 with respect to the 35% test.\(^\text{34}\)

- **Transfer of property to a corporation.** A shareholder may transfer property to a corporation tax-free under IRC Section 351 in exchange for more stock. The shareholder might transfer property to the corporation that he or she has been leasing to the corporation in exchange for more corporate stock. The exchange increases the percentage of stock in the shareholder’s estate.

- **Sale of nonbusiness assets.** A sale of nonbusiness assets and investment of the proceeds in the business will reduce the percentage of nonbusiness assets in the gross estate. The investment in the business will increase the value of the family member’s stock.

- **Gift tax marital deduction planning.** Use of the estate tax marital deduction\(^\text{35}\) will help in meeting the 35% test. In addition, the use of the gift tax marital deduction\(^\text{36}\) will help if the shareholder makes the gifts more than three years before death. Although gifts within three years of death are generally not includible in the gross estate of the donor, such gifts (other than those

\(^\text{34}\) IRC Section 2035(c)(1).

\(^\text{35}\) IRC Section 2056.

\(^\text{36}\) IRC Section 2523.
qualifying for the annual gift tax exclusion) are includible only for the purpose of determining IRC Section 303 eligibility.\textsuperscript{37}

- **Creation of spousal joint tenancies.** An individual who is not prepared to make an outright gift to a spouse to help meet the 35\% test should consider creating a joint tenancy with the spouse. An individual may create a joint tenancy with a spouse with no gift tax consequences because of the unlimited marital deduction.\textsuperscript{38} Only one half of the property that a decedent holds in joint tenancy with a spouse is includible in the decedent’s gross estate.\textsuperscript{39} Generally, only the half that is includible in the decedent’s gross estate receives a stepped-up basis at the decedent’s death. However, both halves of community property receive a tax-free step-up in basis if the decedent’s gross estate includes at least half the value of the property.\textsuperscript{40} The step-up in basis to FMV for property acquired from a decedent that passed away in 2010 whose estate elected to opt out of the federal estate tax system is generally limited to $1.3 million of appreciation to all beneficiaries, plus $3 million of appreciation for property received by a surviving spouse.

- **Multiple corporations.** If the client holds stock in two or more corporations and is still unable to meet the 35\% rule even with the multiple corporation 20\% aggregation rule, a merger or consolidation of the corporations might serve to meet the qualifying tests. The client could also set up a holding company to hold the stock of the separate corporations. The stock of the holding company might then meet the IRC Section 303 tests. Establishing an independent business purpose for the holding company is important to avoid the requirement to make dividend distributions to avoid personal holding company tax under IRC Section 541. However, despite possible difficulties, the personal holding company merits consideration if other means of satisfying the IRC Section 303 tests are not feasible.

**Preparing the corporation for redemptions.** The corporation must have the money to redeem the stock. If the client is counting on the IRC Section 303 redemption to satisfy the estate’s liquidity needs, the corporation must have cash or cash equivalents on hand. If the estate’s liquidity is not a major concern, then the corporation can distribute illiquid property in redemption of the stock. The corporation could distribute property that is used in the business and plan a lease-back arrangement that permits the corporation to continue to use the property and provides liquidity to the estate through the rent payments. Note that if appreciated property is used in a redemption here, it may trigger a gain to the distributing corporation upon the distribution of such appreciated property.

In lieu of cash, the corporation may give a shareholder its note. The redemption will then be deemed to have been made when the corporation gives the note, not when it pays the note.\textsuperscript{41} This option gives the

\begin{itemize}
\item \textsuperscript{37} IRC Section 2035(c)(1).
\item \textsuperscript{38} IRC Section 2523.
\item \textsuperscript{39} IRC Section 2040(b).
\item \textsuperscript{40} IRC Sections 1014(a) and 1014(b)(6).
\item \textsuperscript{41} Revenue Ruling 65-289, 1965-2 CB 86.
\end{itemize}
corporation additional time to pay for the stock. If the stock is not publicly traded, the shareholder may recognize gain, if any, realized on the redemption using the installment method.\(^{42}\)

Life insurance owned by the corporation on the life of the shareholder-executive may also finance the redemption. The corporation will receive the insurance proceeds income tax-free.\(^{43}\) The proceeds will be included in the decedent’s gross estate if the decedent had any incidents of ownership in the policy.\(^{44}\) However, incidents of ownership are not attributed to the insured solely because the proceeds are payable to a corporation that he or she controls.\(^{45}\) Nevertheless, life insurance proceeds payable to the corporation will be a factor in determining the value of the stock for estate tax purposes.\(^{46}\) For these reasons, allowing a member of the decedent’s family or an irrevocable life insurance trust to own the policy to keep the proceeds out of the decedent’s gross estate might be better. The policy owner could then lend the proceeds to the corporation in order to accomplish the IRC Section 303 redemption.

A C corporation’s accumulation of earnings to meet redemption needs exposes the corporation to the risk of the accumulated earnings tax.\(^{47}\) However, accumulations to meet “the reasonable needs of the business” are permissible. IRC Section 537(a) defines the quoted phrase to include IRC Section 303 needs of the business, which in IRC Section 537(b) are defined as to permit accumulation in the tax year of the corporation in which a shareholder dies, or any taxable year thereafter, of an amount needed, or reasonably anticipated to be needed, to redeem stock under and within the limits of IRC Section 303. If the corporation starts accumulating funds for an eventual redemption under IRC Section 303 in years before death occurs, it may be hit with an accumulated earnings tax (with a tax rate of 20% for 2020 and thereafter) when more than $250,000 has been accumulated ($150,000 in the case of certain personal service corporations). The corporation can reduce the risk of the accumulated earnings tax by documenting other reasonable business needs for accumulating earnings. S corporations and their shareholders are not subject to the accumulated earnings tax.

**Maintaining control.** When there are ownership interests in the corporation outside of the decedent’s family, redemptions can shift the balance of control unless the shareholders do something about it. Be careful if a family with a 50% ownership interest transfers any of the decedent’s voting shares in an IRC Section 303 redemption. Control (or “stand-off control”) may be lost to the other 50% owners. If the corporation has only common stock, one of the things to consider is a recapitalization. In the recapitalization, the corporation would issue common stock and nonvoting preferred (or nonvoting common) stock. The corporation could then redeem the preferred or nonvoting common stock without affecting control. A 50% ownership family can maintain its voting power. The common stock and preferred stock are combined when applying the 35% test. If preferred stock is authorized but unissued, a simple approach would be to issue preferred stock as a stock dividend (before death). Note that preferred stock

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\(^{42}\) IRC Section 453.

\(^{43}\) IRC Section 101(a)(1).

\(^{44}\) IRC Section 2042(2).

\(^{45}\) Regulation Section 20.2042-1(c)(6).

\(^{46}\) Regulation Section 20.2031-2(f).

\(^{47}\) IRC Section 531.
can only be issued by a C corporation, not by an S corporation. An S corporation may, however, issue voting and nonvoting common stock in a recapitalization and avoid the prohibition on S corporations having two classes of stock as long as the preferences of the voting and nonvoting shares are identical.

A dividend of preferred stock on a C corporation’s common stock would constitute IRC Section 306 stock. A shareholder usually realizes ordinary income on the sale of IRC Section 306 stock to the extent of the stock’s ratable share of the corporation’s earnings and profits at the time the corporation distributed the IRC Section 306 stock. The stock is also IRC Section 306 stock in the hands of a transferee if the transferee determines his or her basis in the stock by reference to the basis of any other person in the IRC Section 306 stock. Thus, IRC Section 306 stock received as a gift retains its character as IRC Section 306 stock.

Nevertheless, IRC Section 306 stock received from a decedent that has a basis equal to its FMV at the date of the decedent’s death or at the alternate valuation date will no longer be IRC Section 306 stock. Therefore, the C corporation could redeem preferred stock that a taxpayer received from a decedent, and IRC Section 306 would not apply. If IRC Section 306 is applicable, any excess of the amount realized over the stock’s ratable share of the corporation’s earnings and profits first reduces the basis of the IRC Section 306 stock and then is treated as gain on the sale of the stock. A shareholder may not recognize a loss on the sale of IRC Section 306 stock. If the shareholder transfers the IRC Section 306 stock to the corporation as a redemption, the amount received in the redemption is treated as a dividend to the extent of the corporation’s earnings and profits at the time of the redemption. Any amount received in excess of the earnings and profits first reduces the basis in the stock and then is treated as a gain on the sale or exchange of the stock.

An exception to the usual rules of IRC Section 306 applies if the shareholder disposes of the IRC Section 306 stock in a sale to an unrelated party that completely terminates the shareholder’s entire stock interest in the corporation. If the shareholder disposes of his or her IRC Section 306 stock in a redemption, the usual IRC Section 306 rules will not apply if the redemption qualifies as an exchange under IRC Section 302(b)(3) as a complete termination of interest, or an exchange under IRC Section 302(b)(4) as a partial liquidation or an exchange under IRC Section 331 in complete liquidation of the

48 IRC Section 306(a)(1)(A).
49 IRC Section 306(c)(1)(C).
50 IRC Section 306(c)(1)(C).
51 IRC Section 306(a)(1)(B).
52 IRC Section 306(a)(1)(C).
53 IRC Sections 306(a)(2), 301(c)(1), and 316(a).
54 IRC Section 301(c)(2).
55 IRC Section 301(c)(3)(A).
56 IRC Section 306(b)(1)(A).
In addition, the usual IRC Section 306 rules will not apply when gain or loss is not recognized to the shareholder or when the transactions do not have a principal purpose of avoiding federal income tax.

**Limiting redemption.** All redemptions qualifying under IRC Section 303 count against the IRC Section 303 limit on redemptions, including those that would qualify as exchanges under IRC Section 302. The corporation needs a plan to avoid wasting IRC Section 302 redemptions on IRC Section 303 and avoid redemptions under IRC Section 303 in excess of its limits. One approach might be a contract between the shareholders and the corporation under the terms of which the corporation is bound to redeem only as much of a shareholder’s stock as the decedent’s executor deems necessary, appropriate, and fair to all concerned.

**.04 Redemptions under IRC Section 302**

Apart from IRC Section 303, the general rule is that a corporate distribution to a shareholder out of earnings and profits, including a redemption, is to be treated as a dividend and not as a payment in exchange for stock. However, four important exceptions under IRC Section 302(b) apply to redemptions that permit them to be treated as sales, not dividends:

1. A redemption not essentially equivalent to a dividend
2. A substantially disproportionate redemption
3. A complete termination of the shareholder’s interest
4. Redemptions from non-corporate shareholders in partial liquidation

A redemption is not essentially equivalent to a dividend if it results in a “meaningful” reduction of the shareholder’s “interest” in the corporation. Under the regulations, a determination of this issue must be made on a case-by-case basis. For this reason, the focus is usually on the second and third exceptions where there are more definitive rules. However, Revenue Rulings 75-502, 75-512, and 78-401 provide some specific guidance on the availability of the first exception.

The first ruling indicated that the factors to be considered focus on the shareholder’s right to vote and exercise control, to participate in current earnings and accumulated surplus, and to share in the net assets.

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57 IRC Sections 306(b)(1)(B) and 306(b)(2).
58 IRC Section 306(b)(3) and (4).
59 IRC Sections 301(c)(1) and 302(d).
60 1975-2 CB 111.
61 1975-2 CB 112.
62 1978-2 CB 127.
on liquidation. Where these rights are significantly reduced, the redemption may not be essentially equivalent to a dividend.

In the second ruling, the IRS held that a reduction of a shareholder’s interest from 57% to 50%, with the remaining 50% interest being held by an unrelated party, was meaningful. Revenue Ruling 78-401 held that a reduction of a shareholder’s interest from 90% to 60% was not meaningful because the shareholder retained the power to control the day-to-day operations of the company. This factor, rather than the shareholder’s reduced interest in earnings and surplus or liquidation proceeds, was given controlling weight. The fact that some corporate actions might require more than a 60% vote was deemed to be of no consequence when the corporation did not show such actions to be imminent.

A **substantially disproportionate redemption** is one that reduces the shareholder’s percentage of voting stock interest below 80% of what it was before the redemption and leaves the shareholder with less than 50% of the corporation’s outstanding stock. The required application of the attribution or constructive ownership rules set out in IRC Section 318 complicate the matter considerably.

The thrust of these rules is that the redeeming shareholder is treated as owning not only the shares registered in his or her own name but also those owned by his or her spouse, children, grandchildren, parents, estates or trusts of which the shareholder is the beneficiary, partnerships of which he or she is a member, and corporations in which he or she owns a majority of the stock interest. Furthermore, stock owned directly or indirectly by a beneficiary of an estate is considered owned by the estate.

Because of these attribution rules, satisfying the substantially disproportionate redemption exception is often difficult before or after the death of the shareholder of a closely held family corporation.

One possible way of getting around the attribution rules after death would be if a beneficiary of the estate that holds the decedent’s stock has ceased to be a beneficiary at the time of the redemption. Regulation Section 1.318-3(a) says that an individual is no longer a beneficiary when he or she has received all the property he or she is entitled to, no longer has a claim against the estate, and only a remote possibility exists that the estate will seek a return of the property or payment to satisfy claims against the estate or expenses of administration. The IRS has ruled that the interest of a residuary legatee is not terminated until the estate is closed.⁶³ Even with a special legatee, as long as the valuation of the closely held stock remains open, the IRS might consider the special legatee as a beneficiary.

If a shareholder completely terminates the shareholder’s interest in the corporation, the redemption may qualify for sale or exchange treatment. A complete termination may also meet the disproportionate redemption rules discussed previously. In a complete termination, the constructive ownership rules of IRC Section 318(a)(1) do not apply, provided that the redeeming shareholder (1) has no interest in the corporation other than as a creditor for at least 10 years after the redemption; (2) agrees to notify the IRS of any acquisition of an interest in the corporation within the 10-year period; and (3) retains all records of the redemption for 10 years. The prohibited interests include a position as an officer, director, or employee of the corporation.⁶⁴ This provision allows the corporation to redeem all of the shareholder’s

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⁶³ Revenue Ruling 60-18, 1960-1 CB 145.

⁶⁴ IRC Section 302(c)(2)(A).
stock using an installment note. If the stock is not publicly traded, the shareholder may defer the recognition of any gain realized using the installment method.\textsuperscript{65} Redeeming the stock with an installment note might be an attractive option to corporations that lack sufficient cash to pay for the stock immediately.

The shareholder will lose the benefit of the waiver of the constructive ownership rules in certain circumstances beyond those involved in the reacquisition of an interest within the 10-year period. This waiver does not apply if (1) any part of the stock redeemed was acquired from a related person within 10 years or (2) any related person owns stock at the time of the redemption, the ownership of which is attributable to the redeeming shareholder, and such person acquired any stock in the corporation from the redeeming shareholder within 10 years, and the stock so acquired is not redeemed in the same transaction. However, these limitations do not apply if the acquisition or disposition of stock does not have as one of its principal purposes the avoidance of federal income tax.\textsuperscript{66} Thus, the IRS might not consider gifts of stock to children as part of an ongoing gift program to have tax avoidance as a principal purpose.\textsuperscript{67}

IRC Section 302(c)(2)(C) specifically provides that entities may waive the family attribution rules. However, beneficiaries must join in the waiver and must agree to be jointly and severally liable with the entity for any deficiency resulting from an acquisition by any of them within the 10-year period discussed previously. The term \textit{entity} includes trusts, estates, partnerships, and corporations. No provision exists for a waiver of attribution to and from entities and their beneficiaries. To the extent that these attribution rules apply, essentially the same problems and solutions exist under this exception that exist under the disproportionate exception, that is, when these rules apply, qualifying for capital gain treatment in an otherwise compliant redemption transaction is very difficult.

\textbf{.05 Partial Liquidation}

Under the safe harbor rule of IRC Section 302(e), a distribution is a partial liquidation for the purposes of the fourth exception to dividend treatment in these cases:

- It is not essentially equivalent to a dividend (determined at the corporate level) and occurs in the year in which the corporation adopts a plan of partial liquidation (or in the following year).
- The distribution occurs under a plan to cease conducting a business that has been actively conducted for at least five years.
- The corporation did not acquire the business in a taxable transaction within the last five years.
- The corporation is actively engaged in another trade or business.

\textsuperscript{65} IRC Section 453.

\textsuperscript{66} IRC Section 302(c)(2)(B).

\textsuperscript{67} IRS Letter Ruling 8236023, June 8, 1982.
.06 Distributions of Property

The corporation recognizes gain, but not loss, on a distribution of appreciated property as if the corporation sold the property in exchange for the redeemed stock in a corporate redemption for its FMV. However, the FMV of the property will be treated as not less than the amount of a liability on the property to which the property is subject or which the shareholder assumed. Whether the redemption is treated as a dividend or an exchange to the shareholder has no effect on the recognition of gain or loss by the corporation on a distribution of property.

.07 Dividend Distributions

If a distribution does not qualify as a stock redemption under IRC Section 302 or 303, then it is treated as a dividend paid to the shareholder. Qualified dividends are generally taxed at the same zero to 20% rates that apply to net long-term capital gains. Dividends are taxable only to the extent of the corporation’s current and accumulated earnings and profits. Dividends may also be subject to the 3.8% net investment income tax, depending on the recipient’s AGI.

A distribution that exceeds earnings and profits is treated first as a tax-free recovery of the shareholder’s basis for the stock. Basis can only be reduced to zero. Any distribution that exceeds both earnings and profits and the shareholder’s basis in the stock is treated as capital gain.

**Stock redemptions treated as dividends.** A stock redemption that is treated as a dividend differs from other types of dividend distributions because the shareholder has actually surrendered stock to the corporation for which he or she had a basis. Because the redemption is treated as a dividend, the shareholder cannot use the basis to offset the redemption proceeds. Instead, the basis of the shareholder’s remaining stock is adjusted to account for the basis of the stock redeemed. When the redeeming shareholder owns no remaining stock, the basis is allocated to other shareholders whose stock ownership is attributed to the redeeming shareholder under IRC Section 318.

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68 IRC Section 311(b).
69 IRC Section 311(a).
70 IRC Section 311 (b)(2) and IRC Section 336(b).
71 IRC Section 316(a).
72 IRC Section 301(c)(2).
73 IRC Section 301(c)(3)(A).
74 Regulation Section 1.302-2(c).
ESOPs offer advantages for small business employers and their employees. ESOPs as employee benefits were discussed in ¶910. This chapter discusses ESOPs from the standpoint of their use for post-organizational planning for business interests.

In ¶1915, this publication discusses the problems faced by the shareholder in a closely held corporation who undertakes to have the corporation redeem the shareholder’s stock before death, as well as the problems confronting the owner’s estate. The corporation itself faces a major problem. It must accumulate the funds for a redemption, and it can accumulate those funds only out of after-tax dollars. The corporation can carry life insurance on a key shareholder-executive, and the collection of the proceeds will not be taxable to the corporation. However, the corporation may not deduct the premiums. Insurance can help with redemptions after a shareholder’s death only if the shareholder is insurable at the time of applying for life insurance.

A dramatic change takes place when a corporation uses an ESOP. The annual cash contributions a company makes to an ESOP are tax deductible. If a shareholder dies and the ESOP has sufficient cash, it purchases the shareholder’s stock from his or her estate. Thus, the ESOP has acquired the stock with pretax, not after-tax dollars, because each dollar the company contributed to the ESOP was tax deductible.

.01 Tax-Free Rollover on Sale of Qualified Securities to ESOPs

When one of the founders of an ESOP-sponsoring business is ready to retire and surrender control, the founder might be concerned about lack of diversification because a disproportionate amount of the founder’s net worth may be concentrated in the company stock. IRC Section 1042 permits such an individual, or his or her estate, to sell employer securities to the ESOP and defer recognition of gain by reinvesting the proceeds in securities of domestic corporations meeting certain tests. However, such deferral is available only if the holder of the company securities has held them for at least three years before the sale to the ESOP. In order to qualify for this deferral opportunity, the ESOP must hold at least 30% of the outstanding stock of each class of stock of the corporation after the sale of the owner’s interest has been concluded.

The basis of the stock in the domestic corporations acquired by the shareholder is reduced by the amount of the deferred gain so that if the shareholder sells the securities acquired, the shareholder will recognize the deferred gain. If the shareholder holds the securities until death and they have appreciated in value, the shareholder will save taxes on the appreciation.

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75 IRC Section 101(a)(1).
76 IRC Section 264(a).
77 IRC Section 1042(b)(2).
78 IRC Section 1042(e).
the shares receive a step-up in basis\textsuperscript{79} and all income tax liability for pre-death appreciation is eliminated.\textsuperscript{80}

\textbf{.02 Financing}

Formerly, there was an exclusion from income for 50\% of interest income received on loans made to an ESOP or to an employer-corporation, the proceeds of which are used by the ESOP to acquire employer securities (so-called “leveraged ESOPs”). The exclusion, available to banks, insurance companies, other commercial lenders, and regulated investment companies, was generally repealed for loans made after August 20, 1996.\textsuperscript{81} However, the exclusion continues to apply to such loans made under a written binding contract in effect before June 10, 1996.\textsuperscript{82} The exclusion also continues to apply to certain loans made after August 20, 1996, to refinance loans made before August 21, 1996. Qualified refinancing loans must meet the requirements of IRC Section 133 before repeal and not increase the outstanding principal amount of the prior loan and not extend the term of the original loan.

\textbf{.03 Dividends}

Dividends paid in accordance with the ESOP plan provisions on securities held by an ESOP on the record date are deductible by the corporation if paid (1) in cash to the participants in the plan or to their beneficiaries; (2) to the plan and distributed in cash to the participants in the plan or their beneficiaries; or (3) if used to make payments to repay stock acquisition loans but only if the dividends involved are on the stock acquired by the loan.\textsuperscript{83}

\textbf{¶1925 Qualifying for Installment Payment of the Estate Tax}

The federal estate tax is due and payable nine months after death.\textsuperscript{84} If the value of an interest in a closely held business exceeds 35\% of the value of the adjusted gross estate (gross value of the estate reduced by allowable expenses, losses, and debts),\textsuperscript{85} the executor may elect to pay the estate taxes attributable to the business interest (but not the estate taxes attributable to nonbusiness assets) in two or more, but not more than 10, annual installments, with interest only on the unpaid tax due for four years, and the actual installment payments of the unpaid tax due beginning in the fifth year following the decedent’s date of death. A closely held business means an interest owned as

\begin{itemize}
  \item a sole proprietorship or
\end{itemize}

\begin{itemize}
\item \textsuperscript{79} IRC Section 1014(a).
\item \textsuperscript{80} IRC Section 1042(e)(3).
\item \textsuperscript{81} IRC Section 133, repealed by the Small Business Job Protection Act of 1996 (P.L. 104-188).
\item \textsuperscript{82} Small Business Job Protection Act of 1996 (P.L. 104-188, Act Sec. 1602(c)(3)).
\item \textsuperscript{83} IRC Section 404(k).
\item \textsuperscript{84} IRC Sections 6075(a) and 6151(a).
\item \textsuperscript{85} IRC Section 6166(b)(6).
\end{itemize}

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• a partner in a partnership
  — having 45 or fewer partners or
  — in which the decedent owned 20% or more of the capital.
• an owner of stock in a corporation
  — having 45 or fewer shareholders or
  — in which the decedent owned 20% or more of the voting stock.

.01 Installment Requirements

The installment payments must be equal. If the executor makes the election to pay such estate taxes in installments, the first installment payment is due no more than five years after the prescribed date for paying the federal estate taxes. The maximum payment period is 14 years, rather than 15 years, because the due date for the last interest-only payment is the same date as the due date for the first installment payment of the tax. This provision allows the estate to defer the estate taxes attributable to the business interest for up to 14 years, with a special 2% interest rate applicable to the estate taxes on the first $1 million (indexed for inflation under IRC Section 6601(j)(3)) in taxable value of the closely held business. The inflation-adjusted amount for the estate of a 2020 decedent is $1,570,000.

For the purpose of meeting the 20% ownership requirement, shares of corporate voting stock held by members of the decedent’s family, as well as the decedent’s own voting stock, are to be counted. Family members are spouse, children and grandchildren, parents, brothers, and sisters. These attribution rules are not applied when determining the number of partners or shareholders.

If the estate obtains this 14-year extension for payment of taxes, the estate must pay only interest annually during the first four years. The estate may pay the tax owed in annual installments with interest over the next 10 years. As indicated previously, the inflation-adjusted amount for the estate of a 2020 is $1,570,000. If the amount of the estate tax extended under IRC Section 6166 is less than this amount, only the lower amount qualifies for the special 2% rate. Any amounts of deferred estate tax that are in excess of the amount that qualifies for the 2% rate (called the “2% amount”) are taxed at a rate equal to 45% of the rate, determined by the IRS, that applies to underpayments of tax. The interest paid on the

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86 IRC Section 6166(b)(1).
87 IRC Sections 6166(a)(3) and 6166(f)(1).
88 IRC Section 6601(j)(1)(A).
89 IRC Section 6166(b)(2)(D).
90 IRC Sections 6166(b)(2)(D) and 267 (c)(4).
91 IRC Section 6601(j)(2).
92 IRC Section 6601(j)(1)(B).
estate tax deferred under IRC Section 6166 is not deductible on the decedent’s estate tax return (Form 706) or on the estate’s income tax return (Form 1041) filed for the decedent’s estate.

Example 19.1. Brenda died in 2009, when the applicable exclusion amount was $3.5 million. The estate tax value of her closely held corporate interest was $5 million and her executor elected, pursuant to IRC Section 6166, to extend the time for payment of the federal estate taxes. The amount of estate tax attributable to the value of the corporation between $3.5 million and $4,830,000 (the number for 2009 decedents) is eligible for the 2% interest rate. The 2% portion is $618,500, computed as follows: a $2,074,300 tentative estate tax on $4,830,000 minus $1,455,800 (the applicable credit amount for 2009). An interest rate of 45% of the rate applicable to underpayments of tax is assessed against the portion of the estate tax exceeding the $618,500 amount.

If the estate has undistributed net income for any taxable year after its fourth taxable year, the executor must apply it to the unpaid estate taxes.

The 14-year extension can help overcome a cash squeeze, at the small price of low interest rates. In situations in which an extension of time to pay the estate tax appears to be of possible use but there is some question about whether the estate can meet the more than 35% of the adjusted gross estate attributable to closely held businesses test for installment tax payment, the financial planner should give some thought to strategies that will help satisfy the test. The client could either increase the size of the closely held corporate interest, reduce the size of the other parts of the estate through gifting, or both.

The number of shareholders for purposes of the 45-shareholder limitation is to be determined immediately before the decedent’s death. Spouses holding stock in any form are counted as one shareholder. If a partnership, other corporation, or trust is a shareholder, the partners, other shareholders, and beneficiaries of the trust are all counted as shareholders. The latter provision is designed to prevent circumvention of the 45-shareholder limitation through the use of these other entities.

The maximum amount of estate tax deferrable is the amount of estate tax attributable to the closely held business interest. This amount is determined by the ratio of the value of the closely held business interest to the adjusted gross estate. In addition, if during the installment payment period, one half or more in value of the corporate voting stock (or other qualifying business interest) is sold, or if aggregate with-
drawals (distributions) are made that equal one half of the value of the corporate interest (or other qualifying business interest), there is an immediate acceleration of the unpaid balance of the estate tax. This rule suggests that the deferral provision has practical long-term value only in situations in which the executor or heirs will continue to hold the voting stock in the closely held corporation (or other qualifying business interest).

The executor or personal representative may make the deferral election with respect to certain qualified holding companies, provided that the indirectly owned interest would meet the requirements of IRC Section 6166 had the decedent owned it directly. But the 2% interest rate and five-year deferral of principal are not available to holding companies. Also, any portion of the value of the decedent’s businesses attributable to clearly passive assets does not qualify. When the business involves the management of passive investment assets, it may not qualify as a closely held business for purposes of IRC Section 6166. If additional services are performed, converting the activity to a service enterprise, a qualifying business interest will be found. Revenue Ruling 2006-34 liberalized the availability of IRC Section 6166 deferral for persons holding real estate investments and engaging in some active management of those investments.

This 14-year extension for paying the estate tax is a good planning tool if the estate can meet the 35% test. The 14-year extension is not subject to a means test or a need test. Large estates with ample liquidity may qualify for the 14-year extension for paying the estate tax attributable to a closely held business.

To meet the 35% test in borderline situations, the business owner should consider making lifetime gifts of nonbusiness assets more than three years before death. The unlimited marital deduction for lifetime gifts offers one possibility of reducing the size of the business owner’s estate. Lifetime gifts to nonspouse beneficiaries taking advantage of the $15,000 annual exclusion (for 2020), which is indexed annually for inflation under IRC Section 2503(b)(2), is another way to reduce the adjusted gross estate. Gift splitting with one’s spouse would be another way to make gifts with favorable tax consequences to help the estate qualify for the installment payment of the estate tax. The sale of nonbusiness assets and the acquisition of additional business assets with the proceeds might be another way to help the estate qualify for the installment payment of estate taxes. Administration expenses will also help meet the qualification requirements.

The amount of estate tax eligible for installment payments is reduced by the amounts distributed in an IRC Section 303 redemption in accordance with IRC Section 6166(g)(1)(B) (¶1915). This reduction is a

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100 IRC Section 6166(g)(1)(A).
101 IRC Section 6166(b)(8).
102 IRC Section 6166(b)(9).
103 PLR 199929025.
104 IRC Section 2523(a).
105 IRC Section 2503(b)(1).
106 IRC Section 2513.
factor in determining whether to use an IRC Section 303 stock redemption or the tax deferral offered by IRC Section 6166.

To take advantage of the installment payment of estate taxes, the executor must make the election on or before the due date of the estate tax return or any extensions. The executor should make the decision well in advance of the deadline to allow time to resolve any questions. To make the IRC Section 6166 election, check the applicable box on Form 706 and attach the required statement (described in the instructions for Form 706) and calculation to Form 706 when it is filed.

When measuring the federal estate tax attributable to the closely held voting stock or other qualifying business interest, one multiplies the estate tax by a fraction. The numerator is the value of the closely held voting stock or other qualifying business interest, and the denominator is the decedent’s adjusted gross estate.

.02 Reasonable Cause Extension

An estate may obtain a discretionary extension of the time for payment of estate tax from the IRS for up to 10 years for reasonable cause. Regulation Section 20.6161-1(a)(1) contains four examples of reasonable cause, including situations in which an estate cannot readily sell its illiquid assets to pay estate taxes, or the estate consists, in large part, of valuable rights to receive payments in the future.

¶1930 Keeping the Business in the Family

Is the business worth keeping in the family? That is an initial question to be addressed by the financial planner in the course of advising the business owner while living and ultimately by the surviving family members. The shareholders must weigh not only current earnings but also potential future earnings in the light of possible changes in the market, technology, capital requirements, competition, supplies, and labor. If patents, copyrights, licenses, leases, or other assets that can be classified as wasting assets are involved, the shareholders must also take their future expiration into account.

If the business is worth retaining, the next question is: Who will manage the business? The first place to look for management is within the family. A business owner must realize that the process of choosing and implementing a succession plan can be difficult. The owner may face issues of control, sibling rivalries, equality of treatment, love, money, and taxes, not to mention the owner’s own mortality.

The overlap of family and business relationships can make the task of grooming a successor from within the family much more difficult than grooming an outsider to take over. Ideally, the business owner can take various steps to make the transition run smoothly.

The business owner might want to establish an outside board of directors or advisers who would help select and train a successor. The business owner should establish specific rules for hiring family members. The owner should go so far as to develop qualifications for positions. Anyone, even a family member, would have to meet the qualifications to be hired.

Creating a development plan for potential successors is essential. The business owner’s unexpected death or sudden disability could leave the company without needed leadership in the absence of a plan.

\footnote{IRC Section 6161(a)(2).}
The plan must address how the successor will acquire the technical expertise and skills needed to take control. In addition, a mechanism should exist for an ongoing evaluation of the successor’s performance during the transition phase.

The business owner must teach every aspect of the business to the successor. Before turning over the reins completely, the owner can let the successor manage a department and evaluate the successor’s performance.

Sometimes, personality conflicts make grooming a child to take over for a parent extremely difficult. In such a case, the parent should consider bringing in an outside mentor. The parent would need to consider cost factors.

The family can use counseling if an absolute stalemate develops. Alternatively, the business owner can establish a family council to resolve conflicts.

To recruit and retain competent management, the corporation must arrange special compensation. Executive compensation arrangements are discussed in ¶1605. Recapitalization is one route that offers outside management an equity interest while preserving family control. On the other hand, if vesting control in management seems wiser, the corporation can give the new management voting common stock and give the family preferred stock, which can provide a steady income.

If broad-based employee participation in the ownership of the enterprise appears to afford a sounder basis for successful operation of the business, then the shareholders should consider an ESOP.

Depending on the circumstances of the particular case, efforts aimed at keeping the business in the family might be aided by the use of the special use valuation election (¶2210.01) and the election to defer payment of estate taxes (¶1925).

¶1935 Buy-Sell Agreements — Questions and Answers

The owner of a closely held corporation is naturally concerned about what will happen to the corporation upon the owner’s death. Although a corporation may exist in perpetuity, many practical problems must be solved to ensure the continuity of a business. A buy-sell agreement deals with some of the problems.

A buy-sell agreement is a contract providing for the sale of the corporate stock upon the happening of a specified event. Generally, this event is the death of one of the stockholders. However, the agreement can also provide for a sale upon the disability, retirement, or withdrawal of one of the parties. Buy-sell agreements may establish value for transfer tax purposes if they meet the rules contained in IRC Section 2703 (discussed in ¶2310).

The following questions and answers offer guidance in the practical lifetime structuring of buy-sell agreements. Where estate tax will be due, planning before death can help avert two serious tax problems: determining the value of the stock for estate tax purposes and identifying the source of funds to pay the estate tax (this problem is particularly important because of the limited market for the stock of a closely held corporation).
Q. What are the key advantages of a buy-sell agreement?

A. In the absence of a buy-sell agreement, the corporate stock might be unmarketable. The agreement avoids a forced sale or the unwilling or unwelcome participation in the business of the decedent’s surviving spouse or heirs. If the decedent’s estate receives cash in exchange for the corporation’s stock, funds are available for payment of federal and state estate taxes, payment of estate administration expenses, ongoing family support, and other necessary purposes.

The buy-sell agreement provides for corporate succession and control of the business according to the parties’ desires. The agreement dispels fears that the business will terminate on the death of one of the stockholders. It is also a morale booster for key employees who otherwise might fear loss of their jobs. The agreement eliminates the risk of the corporation being barred from an S corporation election by reason of a nonqualifying or non-consenting stockholder.

Q. How does a buy-sell agreement work?

A. There are three types of buy-sell agreements:

1. The cross-purchase agreement is a buy-sell agreement that exists among stockholders. Example: A corporation has two stockholders, A and B. A and B both agree that, upon either’s death, the decedent’s estate must sell, and the survivor must purchase the decedent’s stock.

2. The stock redemption agreement is an agreement to which the corporation and the shareholders are parties. The corporation agrees to buy (redeem) the decedent’s stock. Example: A corporation has two shareholders, A and B. Both agree that their estates will sell or tender for redemption the shares they owned to the corporation (see ¶1915 for a discussion of stock redemptions generally).

3. In a hybrid or combination agreement, the corporation and the stockholders agree to buy the decedent’s stock. Such an agreement consists of both a cross-purchase and a redemption agreement. Example: A corporation has two shareholders; each owns 100 shares of stock. There is a cross-purchase agreement for 50 shares of stock (or an option for a stockholder to purchase 50 shares of stock and a corporate stock redemption agreement for the remaining 50, or 100 if the option is not exercised). Unless the surviving stockholders buy their agreed portion before the redemption by the corporation, the redemption proceeds may be taxable as a dividend to the estate. Therefore, the surviving stockholders must take extreme care that the corporate redemption does not occur first.

Q. How can funds be obtained to pay for the stock?

A. Funding a buy-sell agreement with life insurance is generally advised. When the stockholders use the cross-purchase approach, each stockholder owns an insurance policy on the life of every other stockholder. If the agreement provides for redemption of the stock by the corporation, the corporation carries a life insurance policy on each stockholder whose stock is to be purchased. Upon the death of a stockholder, the corporation or the surviving stockholder (depending on the type of agreement) collects the insurance proceeds. The surviving stockholders or the corporation then use the proceeds to purchase the stock of the deceased stockholder. The stockholders can use existing policies if a stockholder becomes uninsurable. Good planning suggests acquiring insurance to fund a buy-sell agreement sooner rather than later, whereas delay suggests that
issues of health and insurability could create problems. When a corporation has only two stockholders, use of a single first-to-die policy covering both stockholders should be less costly than using two separate policies (¶705).

Making periodic contributions to a sinking fund is a method that is particularly valuable when a stockholder is uninsurable. However, if the corporation is a C corporation, it must exercise care to avoid the accumulated earnings tax.108

Q. **What are the tax consequences of a cross-purchase agreement?**

A. Life insurance premiums paid by the stockholders are not deductible.109 Insurance proceeds paid to the surviving stockholder are exempt from income tax if the policy is acquired directly from an insurance company.110 If the policy is acquired from another stockholder, proceeds are excluded from income only to the extent of consideration and premiums and other amounts paid by the transferee of the policy.111 This is the so-called “transfer for value rule,” which can be avoided by having the insurance policies owned by a corporation or a partnership or a grantor-type trust, but not owned by another stockholder.112

Transfer of shares between the stockholders has no tax effect on the corporation.

Sale of the decedent’s stock by his or her heirs or estate will result in taxable gain to the extent that the sale proceeds exceed basis113 (that is, a basis at death equal to the value of the stock for estate tax purposes under IRC Section 1014(a)). Sellers of the decedent’s stock must include in gross income any interest they receive on the deferred portion of the selling price.114 In the typical case, the purchase price is equal to the date-of-death value of the shares sold by the seller, so the selling stockholder’s estate or heirs does not realize any gain, except for the situation of estates of certain decedents that passed away in 2010, whose estates opted out of the federal estate tax system, and must follow the carryover basis rules. See ¶1005 for further details.

The basis of the surviving stockholders in the corporate shares they buy is equal to the shares’ purchase price.115

Q. **What are the tax consequences of a stock redemption agreement?**

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108 IRC Sections 531-537.
109 IRC Section 264(a).
110 IRC Section 101(a)(2).
111 IRC Section 101(a)(2).
113 IRC Section 1001.
114 IRC Section 61(a).
115 IRC Section 1012.
A. Life insurance premiums paid by the corporation to fund the redemption of shares are not deductible. The investment of corporate funds in life insurance policies to fund a buy-sell agreement does not incur the penalty on unreasonable accumulation of earnings if the accumulation serves a valid corporate purpose, rather than an individual shareholder’s purpose.

Insurance proceeds received by the corporation upon the death of a stockholder are not subject to regular income tax and are no longer subject to the corporate AMT which was repealed by the TCJA effective for 2018 and beyond, making a corporate redemption of a shareholder’s stock a more attractive planning alternative than previously when the corporate AMT treated the life insurance proceeds as a tax preference.

The premiums paid on a policy insuring a stockholder are not taxable as dividends to the stockholder if the corporation is the owner and beneficiary and retains the incidents of ownership of the policy.

The premiums paid on an insurance policy covering the life of one stockholder are not taxable as dividends to the other stockholders.

Redemption of the deceased stockholder’s stock generally has no tax consequences to the surviving stockholders; the basis of the survivors’ stock is unchanged. A redemption resulting in a complete termination of the deceased stockholder’s interest generally results in sale or exchange treatment (¶1915).

A corporation realizes no gain from the redemption of a shareholder’s stock unless it distributes property in the redemption with a greater value than its adjusted basis (appreciated property).

A corporation may not recognize any loss on a redemption distribution of property with a value less than its adjusted basis. The decedent’s estate acquires a cost basis in the property distributed to it. However, the estate should generally recognize little, if any, gain because the stock

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116 IRC Section 264(a)(1).
117 IRC Section 533 and Regulation Section 1.533-1(a).
118 IRC Section 101(a).
119 IRC Section 56(g).
120 IRC Section 302(b)(3).
121 IRC Section 311(b).
122 IRC Section 311(a).
123 IRC Section 1012.
Q. Which type of buy-sell agreement should the stockholders select?

A. Each type of agreement has its advantages and disadvantages. Some key factors to consider are as follows:

Cross-purchase agreement:

1. Surviving stockholders must pay for the deceased’s stock with after-tax dollars (if there is not sufficient life insurance to complete the purchase).

2. This type of agreement is relatively simple and quite satisfactory when the number of stockholders is small. It can become burdensome, however, when the corporation has many stockholders. For example, if a corporation has five stockholders at the time they execute a buy-sell agreement, the last survivor would have to purchase the shares of the four predeceased stockholders.

3. The obligation to purchase shares generally falls upon younger, minority-interest stockholders, who often are the least financially able to buy the shares or afford the life insurance premiums on older stockholders, or both.

4. This type of agreement generally results in fewer legal problems and less complicated tax consequences.

5. The purchasing stockholders obtain a basis in the purchased stock equal to what they paid for it.

6. If each stockholder must purchase a life insurance policy on every other stockholder, a large number of stockholders means a large number of life insurance policies. For example, if there are three stockholders, six policies are required. If there are five stockholders, 20 policies are required.

Stock redemption agreement:

1. Such an agreement has the virtue of simplicity when the corporation has several stockholders.

2. The corporation, not the stockholders, pays the life insurance premiums if the agreement is funded. The benefit is that the premiums are paid with money that has been taxed only to the corporation. When the stockholders pay the premiums in a cross-purchase plan, the premiums are paid with money that might have been taxed both to the corporation and

124 IRC Section 1014(a).
the stockholders (as dividends if the corporation is a C corporation). If possible, the premiums should be paid from compensation received by the stockholders as salary or bonus to at least allow the corporation to claim a compensation deduction.

3. Despite the use of the corporation’s earnings and profits for the stockholders’ benefit, no dividend treatment results.

4. If the corporation does not use insurance as a funding device, the corporation might not have sufficient money to redeem the shares when the deceased stockholder’s shares are tendered for redemption.

5. If the corporation lacks sufficient money to redeem the decedent’s shares, it can use installment payments of the purchase price and still waive the family attribution rules. However, the debt creates a problem of security and interest to protect the estate and heirs of the deceased stockholder.

6. There is no basis increase to the remaining stockholders when the corporation is the purchaser of the stock.

**Q. How is valuation of the stock determined?**

**A.** Generally, the parties use one of the following four methods:

1. *Book value at the date of death or at the end of the preceding accounting period.* This method is often unrealistic and not an accurate measure of value. The IRS will generally not accept book value as a proper method of valuation. It should not be used in a buy-sell agreement.

2. *Fixed price provided for in the agreement and agreed upon by the stockholders.* This method is sound only if the stockholders review and update it periodically, and it constitutes an accurate measure of FMV.

3. *Price fixed by appraisal after death.* The disadvantage of this method is the delay in choosing and then obtaining able appraisers. Consequently, the stockholders might not know the price for a significant time. Delay is a normal experience under this method.

4. *Self-adjusting formula set forth in the agreement.* The stockholders can use a variety of formulas, for example, book value at close of the preceding accounting period plus a fixed sum or a formula giving one weight to book value and another to the value indicated by the capitalization of earnings, possibly weighted to emphasize recent years. (See ¶1940 for further details on these methods and other valuation factors.)

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125 IRC Sections 302(b)(3) and 302(c)(2)(A).
Q. Is valuation binding for federal estate taxes?

A. For the valuation to be binding for federal estate tax purposes, the agreement must state that the stockholders cannot freely dispose of or encumber their stock during their lifetimes. In the absence of a restriction on transferability, the government will not be bound even by a bona fide valuation. The IRS generally scrutinizes the valuation provided in a buy-sell agreement. The stockholders should determine the price through arm’s-length bargaining and negotiations. Agreements entered into after October 8, 1990, must meet special requirements under IRC Section 2703 in order to fix value, particularly if they involve family members. These requirements are discussed in ¶2310.

Q. What are disability buy-sell agreements?

A. Although buy-sell agreements generally include death provisions, disability can and does disrupt many businesses. Therefore, these agreements often contain disability buyout provisions. The stockholders can use disability insurance policies for funding and can use the disability definition in the insurance policy as the definition of disability in the buy-sell agreement. The agreement can provide for the acquisition of the stock of the disabled stockholder after a period of six months or one year of disability, for example. Normally, after this period, the stockholders will know whether the disability is permanent.

Q. What are the tax consequences of such an agreement?

A. The disabled stockholder will realize a gain or loss on the sale of stock depending upon the stockholder’s basis in the shares. The corporation may deduct the premiums paid on the disability income insurance policies. However, unless the premiums are included in the gross income of the employee-stockholder, any disability income insurance proceeds will be included in the stockholder’s gross income. However, once the disability insurance proceeds are treated as payment for the redemption of the stock, the corporation may not deduct the premiums, and the stockholder will treat the payments as amounts received for the sale of his or her stock.

¶1940 How Shares in Closely Held Corporations Are Valued

For tax purposes, what are the shares of a closely held corporation worth? Many owners lack knowledge of their value. Yet, the determination of the value of the stock can have substantial tax consequences. Valuation of the shares of a closely held corporation can be especially important in the area of estate and gift taxes, but it can also have relevance for income taxes. Special valuation rules apply when a senior family member transfers common stock to junior family members while retaining preferred stock (¶2305).

How is value determined? A properly drafted buy-sell agreement is intended to provide that a disabled stockholder, or the estate of a deceased stockholder, will receive a fair price for the shares of stock.

126 IRC Section 1001.
127 IRC Section 162(a).
128 IRC Sections 61(a) and 105(a).
Agreements among family members entered into after October 8, 1990, must meet special requirements in order to fix value. These requirements are discussed in ¶2310. If the stockholders do not have a controlling buy-sell agreement, then the IRC, Treasury regulations, revenue rulings, and court decisions offer guidance for determining value for tax purposes.

In practice, if the IRS challenges the values used by the taxpayer, the IRS and the taxpayer arrive at the valuation by a process of negotiation and compromise. In a taxable estate situation, the taxpayer usually tries for a low valuation, whereas the IRS seeks a high valuation. However, this is not always the case. The taxpayer will want a high valuation, for example, if seeking a charitable contribution deduction, a large income tax basis, or other income tax advantages. With the significant increase in the federal transfer tax exclusion ($11,580,000 for 2020, indexed annually for inflation), there may be more estates less concerned with low transfer tax values and more concerned with using higher values to increase basis and avoid future income tax.

**Planning Pointer.** For many years, taxpayers have claimed valuation discounts to reduce the taxable values of their business interests. Minority-interest discounts and discounts for lack of marketability have been the most popular claims. With the increased transfer tax exclusions and the availability of portability, fewer taxpayers will have taxable estates. This suggests there will be fewer discounts claimed so that higher values (and higher income tax basis) will pass to heirs. It will be interesting to see if the IRS will insist in applying these discounts itself to reduce the values of the reported property and the corresponding income tax basis if the taxpayers do not claim the discounts. It is suggested that the IRS will not be taking this position in estates that do not sustain any transfer tax liability. The short-term return to the IRS to be aggressive here will be very limited, and probably not worth their effort.

If the taxpayer is unwilling to accept the valuation determined by the IRS, the taxpayer may challenge it in the U.S. Tax Court or may pay the tax and sue for a refund in a U.S. district court or the U.S. Court of Federal Claims. Generally, in tax litigation, the burden is on the taxpayer to show that the determination by the IRS is incorrect. However, the taxpayer may shift the burden of proof to the IRS by introducing credible evidence with respect to any factual issue. In addition, the taxpayer must prove that he or she has complied with the requirements to substantiate any item, has maintained all records required, and has cooperated with reasonable requests by the IRS.

Corporations and partnerships whose net worth exceeds $7 million or that have more than 500 employees may not shift the burden of proof to the IRS. The net worth of an estate is determined on the date of the decedent’s death. The net worth of a trust is determined on the last day of the tax year, which is the subject of the dispute. In practice, courts are likely to find a compromise value for the stock between

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129 IRC Section 7491(a).
130 IRC Section 7491(b).
131 IRC Sections 7491(a)(2)(C) and 7430(c)(4)(D)(i)(II).
the valuations of IRS experts and those of the taxpayer, assuming the court finds both experts to be credible. Valuation understatements beyond certain limits must be avoided at risk of penalty, as discussed in ¶1005. The IRS has the burden of proof for the imposition of any penalty on an individual.

Estates often litigate disputes concerning valuation issues. Unless the potential estate tax savings exceed the expense of litigation and the executor is reasonably confident of victory, the executor should not rush to the courts. An executor who litigates and loses may be liable for a surcharge unless the executor obtains the consent and approval of the beneficiaries.

A financial planner should consider the possibility of valuation disputes in the planning stage. The financial planner should consider possibly higher valuations than originally reported when computing estate taxes and planning for the estate’s liquidity needs and other related matters.

No single formula applies to all valuation situations. The IRS, however, has issued guidelines to value shares of stock in closely held businesses. (Revenue Ruling 59-60 enumerates factors for valuing such stocks for estate and gift tax purposes. Under Revenue Ruling 65-192, these factors are equally applicable for income tax purposes.) The IRS Valuation Training for Appeals Officers Handbook provides a discussion of Revenue Ruling 59-60 and further insight about how the IRS values closely held securities. Because valuation is not an exact science, the financial planner should consider all relevant factors affecting FMV in the planning stage. The executor should consider these factors when resolving valuation disputes with the IRS. The IRS promulgated draft regulations for discussion under IRC Section 2704 in August 2016 that were designed to severely limit valuation discounts in intrafamily business transfers. The draft regulations were heavily criticized and were withdrawn as “burdensome” in 2017. These same draft regulations are being proposed by some political candidates in 2020.

.01 Factors to Consider

The following discussion is an analysis of the fundamental factors for valuing shares of stock in closely held businesses.

**Factor No. 1 — Nature and History of the Enterprise From Its Inception**

The history of the business is important when establishing its past stability or instability, its growth or lack of growth, and its diversity or lack of diversity. These are some of the facts needed to ascertain the degree of business risk. The history should highlight the nature of the business; its products or services, or both; its operating and investment assets; its capital structure; its plant facilities; and its sales records.

**Factor No. 2 — Economic Outlook and the Condition of the Specific Industry**

Knowledge and consideration of overall economic conditions are essential to appraise closely held stock. The company’s progress in relation to its competitors and the industry’s ability to compete are

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132 IRC Section 6662.

133 IRC Section 7491(c).

134 1959-1 CB 237.

135 1965-2 CB 259.
significant. Although courts will undoubtedly take judicial notice of the current economic situation, information on existing business and economic conditions can be useful.

Factor No. 3 — Book Value of the Stock and Financial Condition of the Business

Balance sheets and necessary supplementary schedules should be obtained for at least two years preceding the appraisal date. This data usually will disclose the liquid position of the enterprise, the book value of the assets (for a discussion of valuation of business real estate, see the end of ¶1940), working capital, long-term indebtedness, capital structure, and net worth. These factors are customarily regarded as significant in evaluating a business. Separate consideration should be given to non-operating investments such as securities and real estate. Book value (assets minus liabilities) might be significant, but book value generally bears no direct relationship to FMV. Even when the IRS or the taxpayer contends that the FMV approximates the book value, the courts seldom rely on book value. However, when the taxpayer made an attempt to show a lower value by using a capitalization-of-earnings method, the Claims Court required use of a book value method.136

Factor No. 4 — Earning Capacity of the Company

Although determining the most significant factor affecting the FMV of stock is often difficult, earnings are generally deemed to be most important. Detailed income statements for a period (at least five years) immediately before the appraisal date are also important. (Of course, if the corporation or other business entity has been in business for less than five years, a shorter period must be used.) The use of prior earnings records is recommended because they are usually the most reliable guide to expected future earning power.

The earnings for a prior period are not merely averaged to predict future earnings. Trends (rate of growth, static earnings, declining earnings) must be taken into account. Perhaps the earnings of more recent years should be weighted more heavily than the earnings of earlier years. Clearly, if past earnings were materially affected by nonrecurring factors (for example, unusual capital gains or losses), adjustments should be made for them. Because of the unique relationship of major shareholders to their closely held corporations (these shareholders are often officers or employees of the corporation, or both), adjustments to reported earnings might have to be made for salaries or other forms of compensation. A determination should be made about whether the same salaries would be paid to non-shareholders with the same ability and performing the same duties. The loss of a key executive can have a depressing effect on value, particularly if the corporation has no trained and capable employees to succeed to the management position. Alternatively, the loss of a key employee might not seriously impair the business because of adequate life insurance coverage or the availability of competent management or the cessation of the payment of an excessive salary. Although the extent of the loss and the consequent reduction in the value of the stock are difficult to establish, the financial planner should consider the type of business and the role of the key executive.

Even when future earning power has been computed, one of the most difficult problems remains: the determination of the proper multiple to apply to these earnings. No standard table of capitalization rates applies to closely held corporations. Perhaps the best guide to finding the appropriate capitalization rate is to ascertain that of comparable companies whose shares are publicly traded, making an appropriate

136 A. Luce, Jr., 4 Cl. Ct. 212 (1984), 84-1 USTC ¶ 13,549.
adjustment downward because the closely held stock is not publicly traded. The following are among the most important factors to consider when deciding on a capitalization rate in a particular case:

- The nature of the business
- The risk involved
- The stability or irregularity of earnings

**Factor No. 5 — Dividend-Paying Capacity**

Another important factor is the dividend-paying capacity of the business, rather than the dividends actually paid in the past. However, the dividend-paying factor is probably a less reliable indication of FMV than are other factors. In a closely held corporation, the controlling stockholder(s) can substitute salaries and bonuses for dividends, thereby reducing net income and understating the capacity of the corporation to pay dividends. In such enterprises, the payment of dividends is often based on the financial and tax needs of the controlling stockholder or group in control. The IRS acknowledges the necessity of retaining a reasonable portion of profits in the business to meet competition; therefore, it recognizes that a publicly held company has more access to credit and at more reasonable terms than does a closely held corporation.

When an actual or effective controlling interest is being valued, the dividend factor is *not* a material factor because the dividend payment is discretionary with controlling stockholders.

**Factor No. 6 — Whether the Enterprise Has Goodwill or Other Intangible Value**

Goodwill is based primarily on earning capacity. The presence and value of goodwill depends on the excess of net earnings over and above a fair return on net tangible assets. Elements of goodwill include the prestige and renown of the business enterprise, the ownership of a brand or trade name, and a record of successful operation over a prolonged period in a particular locality.

No single method exists for valuing goodwill. The previously mentioned factors should be considered, and when all else fails (that is, there is no better basis available), the IRS suggests a formula approach described in Revenue Ruling 68-609.137

**Factor No. 7 — Sales of the Stock and Size of the Block to Be Valued**

Prior sales of stock of closely held corporations are meaningful and useful if they were arm’s-length transactions. Such sales are closely scrutinized. Forced or isolated small sales do not generally reflect FMV. Because prevailing market prices are not available, no adjustment or discount is made for “blockage.” (Under the blockage theory, a blockage discount from the market price is allowable if the block of stock is so large that if it were placed on the market over a reasonable period of time, it would depress the price.) However, the size of the block of stock is relevant and should be considered. Valuing a large block of stock at a discount might be appropriate because of the general difficulty of disposing of it.

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137 1968-2 CB 327.
Factor No. 8 — Market Price of Stocks of Similar Corporations

In valuing unlisted securities, the value of securities of corporations in the same or a similar line of business, listed on an exchange, should be considered with other pertinent factors. However, if sufficient comparable companies whose stocks are so listed are not available, the appraiser might use a comparison with actively traded NASDAQ stocks. Although precise comparability is generally not attainable, some stocks might be reasonably similar.

.02 Weight of Factors

Depending on the circumstances in each case, some factors might carry more weight than others. Earnings might be the most important criterion of value in some situations, whereas asset value will be more significant in others. Generally, the IRS accords primary consideration to earnings when valuing stock of companies selling products or services. Conversely, in an investment or real estate holding company, the IRS might give the greatest weight to the assets underlying the securities being valued.

Other factors considered include condition of plants and equipment; adequacy of accumulated depreciation; effect of legal restrictions and limitations; environmental hazards; contingent liabilities; union relations; employee relations; efficiency of management, employees, and plant; dependence on major customers, suppliers, and products; cash flow projections; and interest rates.

.03 Discount for Lack of Marketability

A substantial discount might be available on the basis that the stock lacks marketability (that is, an absence of a ready or existing market for the sale or purchase of the securities being valued). In its Valuation Training for Appeals Officers Handbook, the IRS recognizes that if owners of closely held stock should try to list a block of securities on a stock exchange for sale to the public, they probably would have to make the offerings through underwriters, incurring costs for registration, distribution, and underwriters’ commissions. The courts have upheld the use of such costs to determine lack of marketability. However, when securities law restrictions on unregistered stock owned by a decedent terminated at death, the shares of stock were valued at their date-of-death value, not subject to a discount relating to the expired restrictions.138

.04 Minority Interests

A minority stock interest in a closely held corporation owned by a person not related to the holders of the majority of the stock will normally be valued for estate and gift tax purposes at a substantial discount from what would otherwise be its FMV.

In 1993, the IRS reversed its position that minority discounts generally are not permitted on intrafamily transfers of stock if the family, in the aggregate, has either voting control or de facto control at the time of the transfer. In Revenue Ruling 93-12,139 the IRS announced its acceptance of court decisions holding that shares owned by family members are not attributed to another family member for determining the

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139 1993-1 CB 202.

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value of that individual’s shares. This position facilitates discounting of family-owned stock and the transfer of greater amounts of stock within a family at low or no gift tax cost.

The U.S. Court of Appeals for the 10th Circuit has held that a minority-interest discount and a special use valuation election (¶1005) are not mutually exclusive, provided that the minority discount is applied first.\(^{140}\)

| Planning Pointer. | For wealthy taxpayers likely to be subject to transfer taxes, given the availability of the significant gift tax lifetime exclusion in 2020 ($11,580,000 per donor), as well as a significant generation-skipping transfer tax exclusion (also $11,580,000 in 2020), planning for family business interests suggests consideration of aggressive gifting plans to limit future appreciation for senior family members, including aggressive discounting while the gift tax lifetime exclusion remains at this level. So far, discounts have not been limited by legislation or regulation. |

.05 Controlling Interests

The courts have recognized that an additional element of value might be present in a block of stock representing a controlling interest for valuation purposes. The taxpayer and the IRS might sometimes be at odds in the application of this rule. The IRS might be disposed to have “premium value” used when it will enhance revenue and might oppose its use when it will reduce revenue. The taxpayer, on the other hand, will favor use of the premium when it will reduce taxes and increase basis, such as when the controlling interest is shielded from tax by the marital deduction, portability, or by the unified credit, and oppose the premium when higher transfer taxes will result.

.06 Key Person Discount

The IRS recognizes the fact that, in many types of businesses, the loss of a key individual can have a depressing effect on value.\(^{141}\) Some courts have accounted for this depressing effect on value by applying a key person discount.

When a taxpayer seeks a key person discount, the taxpayer should present evidence of special expertise and current significant management decisions, as well as demonstrate an actual decline in business revenue or profitability, or both, attributable to the loss of the key person.

.07 Valuation of Business Real Estate

Under IRC Section 2032A, if certain conditions are met, the executor may elect to value real property included in the decedent’s gross estate which is devoted to closely held business use or farming, on the basis of the property’s value in the closely held business or farm, rather than at its FMV determined on the basis of its highest and best use.\(^{142}\)

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\(^{140}\) *C. Hoover Est.*, 69 F.3d 1044 (10th Cir. 1995).

\(^{141}\) Revenue Ruling 59-60, 1959-1 CB 237.

\(^{142}\) IRC Section 2032A.
For the special valuation rule to apply, the deceased owner, while alive, or a member of the owner’s family, or both, must materially participate in the operation of the business or farm, and the heirs of the owner must continue that participation in the years following the decedent’s death.

For a discussion of how the provision is applied when business real estate or a farm is held directly by the decedent and of the conditions attached to the election, see ¶2110.

¶1945 Electing S Corporation Status

Many closely held corporations will want to consider electing exemption from corporate taxes by making the appropriate election under Subchapter S. The S election offers these added advantages:

- Facilitating income-splitting within the family by way of gifts of stock.
- Permitting shareholders to deduct their share of the S corporation’s losses against other types of income. This ability is especially useful in start-up situations in which the shareholders expect losses. However, the shareholder must materially participate in the business and have basis in the corporate stock to deduct losses, and the business must not consist of the rental of property.
- Reducing, but not eliminating, problems of unreasonable compensation.
- Avoiding penalty taxes on accumulated earnings or personal holding companies.

S corporations compute their taxable income in the same manner as individuals, with a few exceptions. The dividends-received deduction does not apply to S corporations. Each shareholder takes into account a pro rata share of the corporation’s income, deductions, and credits. Basis adjustments to stock are made in accordance with a specific set of ordering rules, as specified by statute. Losses that are passed through to the S corporation shareholders and unused because of their lack of basis may be carried over to subsequent tax years until sufficient basis is acquired.

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143 IRC Section 1363(a).
144 IRC Section 1366(a)(1).
145 IRC Sections 469(a) and 469(c)(1).
146 IRC Section 1363(b).
147 IRC Section 1366.
148 IRC Section 1367.
149 IRC Section 1366(d)(1).
150 IRC Section 1366(d)(2).
When considering whether to operate as an S corporation, the corporate and individual tax rates under current law should be considered: The top individual rate is 37% for 2020 and thereafter.\textsuperscript{151} The top individual income tax rate of 37% is greater than the top corporate rate of 21% applicable to regular C corporations.\textsuperscript{152} But the C corporation must address the double taxation issue. If a business is planning to retain earnings to fund growth, the owners might prefer to operate it as a regular corporation as opposed to operating it as an S corporation. The decision may turn on whether the owners generally will be in higher income tax brackets than the business, if the business were operated as a regular corporation.

The TCJA also created the IRC Section 199A 20% qualified business income deduction for taxable income of pass-through entities, including the S corporation. Accordingly, planning must be done on a client-by-client basis. Which clients will be best served as a C corporation with a 21% corporate tax rate, but with a 37% top rate on compensation and a 15% to 23.8% rate on qualified dividends and long-term capital gains? Which clients would be best served as an S corporation with the 20% pass-through deduction, remembering that IRC Section 199A is not available for all business entities over certain taxable income thresholds (specified service trades and businesses) and has complex calculation issues involving W-2 income, income based on real estate asset values and the fact that IRC Section 199A will sunset after 2025 (or sooner if there is political risk) while the 21% C corporation rate is purportedly permanent?

The reasonable compensation required to be paid to S Corporation owner-employees creates W-2 income, which is helpful in claiming a QBI deduction at some levels of income, but is detrimental at other levels of income. The financial planner must look at S corporations and the QBI deduction on a case-by-case basis.

An S corporation may not have more than 100 shareholders.\textsuperscript{153} All members of a family (including multiple generations), as well as their estates and spouses, are treated as one shareholder for purposes of determining the 100-shareholder limit.\textsuperscript{154} There is no need to make an affirmative election to have this rule apply. An S corporation may not have more than one class of stock, but differences in voting rights are permitted, as long as only the voting rights are different, that is, there are no differences involving dividend distributions, liquidation preferences, etc.\textsuperscript{155}

New shareholders are bound by a prior S corporation election unless the holders of more than 50% of the shares of the stock consent to a revocation of the election.\textsuperscript{156} An S corporation must use a calendar year for reporting purposes unless it can show a valid business purpose for the use of a fiscal year to the satisfaction of the IRS or unless it makes a special election under IRC Section 444. Under IRC Section 444, an S corporation that would otherwise have to adopt a calendar year under the preceding rules may

\textsuperscript{151} IRC Section 1.

\textsuperscript{152} IRC Section 11(b).

\textsuperscript{153} IRC Section 1361(b)(1).

\textsuperscript{154} IRC Section 1361(c)(1)(A)(ii), as amended by the Gulf Zone Opportunity Act of 2005 (P.L. 109-135).

\textsuperscript{155} Regulation Section 1.1361-1(l)(1).

\textsuperscript{156} IRC Section 1362(d)(1).

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elect to adopt or change to a tax year with a deferral period no longer than three months (or the deferral period of the year from which the change is made, if that deferral period is shorter than three months).

S corporations that elect fiscal years must make required payments approximating the amount of tax the shareholders would have paid on income during the deferral period if the corporation had been on a calendar year.

Tax-favored fringe benefits of any employee owning more than 2% of the stock of an S corporation are treated in the same manner as those of a partner in a partnership. Thus, such benefits are taxable to the shareholders, but the corporation receives a deduction for the payment of the benefits. This treatment is less favorable than the treatment available to C corporation shareholder-employees to whom such fringe benefit payments are not automatically taxable.

An accrual-method S corporation may not deduct interest or an expense item payable to any shareholder until it makes payment, and the shareholder includes it in income.\(^{157}\) This rule applies to all shareholders;\(^ {158}\) it is not limited to those who own more than 2% of the S corporation’s stock.

.01 Planning Opportunities

Some additional S corporation planning opportunities are discussed in the section that follows. They are not necessarily listed in their order of importance because importance can vary with the circumstances of the individuals involved.

100 shareholders. The 100-shareholder rule allows broad-based equity financing and family income-splitting, without loss of control, through the use of nonvoting common stock.

Nonvoting common. The use of nonvoting common stock enables those holding voting common stock to retain control, while at the same time, moving equity to other family members. At the same time, the use of nonvoting common stock might favorably affect valuation for gift and estate tax purposes by diluting the senior shareholders’ equity interests.

Debt instruments. A debt instrument providing interest geared to an index, such as the prime rate, may be used without necessarily creating a second class of stock.\(^ {159}\)

New shareholders. Although new shareholders cannot terminate S corporation status by refusing to consent to the S election, they may do so by transferring stock to a nonqualified shareholder, such as a nonresident alien, or to certain trusts that do not qualify as S corporation shareholders, unless contractually barred from doing so.

Passive income. Corporations with income that consists largely, if not entirely, of passive income are not disqualified from being S corporations. Corporations that converted to S corporation status from C corporation status with accumulated earnings and profits from regular C corporation years are subject to

\(^{157}\) IRC Section 267(a)(2).

\(^{158}\) IRC Section 267(e).

\(^{159}\) IRC Section 1361(c)(5).
a 25% of gross receipts passive income limitation and possible loss of the S corporation election if the receipt of “excess” passive income persists for more than three years.\[160]\n
**Foreign source income.** Corporations with gross receipts from foreign sources might want to elect S status.

**Election after termination.** In general, a corporation may not make a new S corporation election within five years of a prior terminated or revoked election without the consent of the IRS.\[161]\n
If the termination was inadvertent, the S corporation and its shareholders may take steps to cure the problem and ask the IRS to disregard the inadvertent termination.\[162]\n
It may be necessary for the corporation to go through the private letter ruling process including payment of the user fee to address this problem.

**Gifts of stock.** Shareholders can use gifts of S corporation stock to achieve family income-splitting and tax savings. Income is allocable to shareholders on a per-share, per-day basis.\[163]\n
**TCJA possible dilemma.** Many S corporations are considering converting to C corporations to take advantage of the 21% flat corporate tax rate. Several concerns arise, however. If the S corporation owners have “regrets” about the conversion, they cannot return to S corporation status for five years after the conversion. Assuming they return to S status, they must address the consequences of the built-in-gains tax (having been a C corporation now converting to an S Corporation) which has a five-year lookback to the corporation’s C status years, forcing the activities and assets from the C status years to still be subject to C corporation tax rules during the five-year lookback period. Although the 21% C corporation tax rate is not scheduled to sunset after 2025, like most of the TCJA, “political risk” of changes long before 2026 certainly creates uncertainty for the financial planner in advising clients on these issues.

.02 Trusts as S Shareholders

As a broad general rule, trusts are not eligible S corporation shareholders, with the following exceptions.

**E lecting small business trusts.** Stock in an S corporation may be held by certain electing small business trusts (ESBTs).\[164]\n
Any portion of such a trust that consists of S corporation stock will be treated as a separate trust\[165]\n
and taxed at the highest rate of income tax for estates and trusts. Deductions of S corporation distributions are not allowed. No alternative minimum tax exclusion is allowed. No capital loss carryover or offsetting $3,000 capital loss deduction is allowed.\[166]\n
For an electing small business trust to be an eligible S corporation shareholder, no interest in the trust may be acquired by purchase (that is,

160 IRC Section 1362(d)(3).
161 IRC Section 1362(g).
162 IRC Section 1362(f).
163 IRC Section 1366(a)(1).
164 IRC Section 1361(c)(2)(A)(v).
165 IRC Section 641(c)(1)(A).
166 IRC Sections 641(c)(1)(B) and 641(c)(2).
acquired with a cost basis). Rather, the interests must be acquired by gift, bequest, or other non-purchase acquisition. An electing small business trust is permitted to either distribute or accumulate its income in the discretion of the trustees.

The TCJA allows a nonresident alien individual to be a potential current beneficiary of an ESBT without causing the loss of the S corporation election beginning in 2018. IRC Section 1361(c)(2)(B)(v). The TCJA also provided that charitable contributions from an ESBT are to be tested under the rules of IRC Section 170 rather than under the more limiting rules of IRC Section 642(c) as was the case prior to 2018.

The trustee must file an election where the corporation files its Form 1120S to have the ESBT treated as a permitted S corporation shareholder within 75 days of the ESBT becoming an S corporation shareholder.

The Committee Reports to the Small Business Job Protection Act of 1996 note that these trusts will facilitate family financial planning by allowing an individual to establish a trust to hold S corporation stock to spread equity ownership and income among family members or other trust beneficiaries.

**Grantor trusts.** A trust, the grantor of which is treated as the trust owner under the rules of IRC Sections 671-678, may be an S corporation shareholder. A grantor trust may remain an eligible shareholder for a two-year period following the death of the grantor, provided the entire corpus of the trust is includible in the grantor’s gross estate. A longer period of eligibility may be available if the trust qualifies as a qualified revocable trust and makes an election under IRC Section 645 by filing Form 8855. However, a grantor trust is an eligible S corporation shareholder only if the grantor would be eligible, that is, is a citizen or resident of the United States.

**Voting trusts.** Voting trusts are eligible S shareholders.

**IRC Section 678 trusts.** Trusts in which a person other than the grantor is treated as the trust owner for income tax purposes under IRC Section 678 are eligible S corporation shareholders. IRC Section 678 provides that a person other than the grantor is to be treated as the owner of a trust if such person alone has the exercisable power to vest the trust corpus or the income therefrom in himself or herself.

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167 IRC Section 1361(e)(1)(A)(ii).
168 IRC Section 1361(e)(3).
169 P.L. 104-188.
170 IRC Section 1361(c)(2)(A)(i).
171 IRC Section 1361(c)(2)(A)(ii).
172 IRC Section 1361(c)(2)(A)(i).
173 IRC Section 1361(c)(2)(A)(iv).
174 IRC Section 1361(c)(2)(A)(i).
**Qualified subchapter S trust.** A qualified subchapter S trust (QSST) has the following stipulations:

- It is a trust with only one current income beneficiary, to whom all of the current income of the trust is to be distributed.
- Any corpus to be distributed during the life of the current income beneficiary is to go only to such beneficiary.
- The income interest of the current income beneficiary is to terminate on the earlier of the beneficiary’s death or termination of the trust.
- On the termination of the trust during the life of the current beneficiary, the trust is to distribute all of its assets to such beneficiary.\(^{175}\)

The beneficiary must make an election in order to have the qualified subchapter S trust treated as a permitted S corporation shareholder within 75 days of the QSST becoming an S corporation shareholder.\(^{176}\)

**Certain exempt organizations.** Qualified retirement plan trusts described in IRC Section 401(a) and charitable organizations described in IRC Section 501(c)(3) are allowed to be S corporation shareholders, but not charitable remainder trusts.\(^{177}\) Caution, however, as business-related income received by an otherwise tax exempt trust may be deemed to be unrelated business taxable income and subjected to an unexpected large tax liability.

Many trusts commonly used in financial or estate planning will or can be made to fall within the rules allowing them to be shareholders of an S corporation, if they meet the requirements of a grantor trust, an electing small business trust, or a qualified subchapter S trust. Caution: When a grantor trust holding S corporation shares terminates, be sure the successor beneficiary is a qualified S corporation shareholder.

**.03 Other S Corporation Considerations**

**Time of election.** The S corporation election may be made at any time during the prior tax year (to be effective at the commencement of the next tax year) or on or before the 15\(^{th}\) day of the third month of the current tax year to be effective for the current tax year\(^{178}\)

**S corporations allowed to have subsidiaries.** An S corporation is allowed to own 80\% or more of the stock of a C corporation. However, an S corporation may not elect to file a consolidated return with its

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175 IRC Section 1361(d)(3).

176 IRC Section 1361(d)(1)(B).

177 IRC Section 1361(c)(6).

178 IRC Section 1362(b).
affiliated C corporations. In addition, an S corporation may own a qualified S corporation subsidiary.

Some financial institutions may elect S corporation status. The following types of financial institutions, which do not use the reserve method of accounting for bad debts, may elect S corporation status: domestic building and loan associations, any mutual savings bank, and any cooperative bank without capital stock organized and operated for mutual purposes and without profit.

¶1950 Corporate-Owned Life Insurance and the Estate of a Controlling Shareholder

The Treasury regulations provide that when the economic benefits of a life insurance policy on a decedent’s life are reserved to a corporation in which the decedent is the sole or controlling shareholder, the corporation’s incidents of ownership will not be attributed to the shareholder because of his or her stock ownership if the proceeds are payable to the corporation. Thus, the proceeds would not be included in the decedent’s gross estate. However, if the proceeds of an insurance policy the corporation owns on a sole or controlling shareholder’s life are not payable to the corporation (or to a third party for a valid corporate business purpose), the incidents of ownership will be attributed to the insured through his or her stock ownership. Thus, in such a case, the proceeds would be included in the decedent’s gross estate.

.01 Who Is a Controlling Shareholder?

An insured will not be treated as a controlling shareholder under the regulations unless the insured owns stock possessing more than 50% of the total combined voting power of the corporation at the time of death. However, if an insured individual owns as little as 51% of the outstanding voting stock, 100% of the life insurance proceeds on a policy owned by the corporation and not payable to the corporation will be included in the insured decedent’s gross estate.

One way to avoid this result is for the controlling shareholder to make gifts of enough voting shares to reduce his or her voting power to 50% or less.

180 IRC Section 1361(b)(3).
181 IRC Section 1361(b)(2)(A).
182 Regulation Section 20.2042-1(c)(6).
183 IRC Section 2042(2).
184 IRC Section 2042(2).
185 IRC Section 2042(2).
.02 Weighing the Cost of Inclusion

The controlling shareholder will normally be in a position to control whether the insurance proceeds are payable to the corporation or to another beneficiary, in whole or in part. If the proceeds are payable in their entirety to the corporation, no part of the proceeds will be includible in the controlling shareholder’s gross estate. However, the insurance payable to the corporation increases the value of the insured’s shares and those of all other shareholders. This result might be better for family members than if the insurance proceeds are made payable to them and includible in the controlling shareholder’s gross estate, depending, of course, on the size of the controlling shareholder’s estate and its relationship to the available estate tax exclusion.

If the shareholder decides to retain full control of the corporation but wants the insurance proceeds payable to a named beneficiary other than the corporation or his or her estate, and if the shareholder wants to exclude the insurance proceeds from estate taxation, the corporation must surrender all incidents of ownership in the policy.

If a shareholder wants to retain control of the policy, the shareholder might wish to purchase the policy from the corporation (or have the policy distributed as a dividend) and then transfer it, and all incidents of ownership in it, to a trust or to a family member. If the trust is an irrevocable life insurance trust, and if the insured lives three years after the date of transfer of the policy to the trust, the policy proceeds will be excluded from the gross estate of the insured shareholder.