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IS THE WILL THE WAY?
TRANSMITTING INTERESTS IN A FAMILY CORPORATION

by

GAIL LEVIN RICHMOND

INTRODUCTION

It has been brought to the attention of your committee that the problem of financing the estate tax is acute in the case of estates consisting largely of shares in a family corporation. In many cases the result will be the absorption of a family enterprise by larger competitors, thus tending to accentuate the degree of concentration of industry in this country.

Your committee is of the opinion that remedial action is desirable in order to prevent the enforced sale of the family businesses which are so vital and desirable an element in our system of free private enterprise.\(^1\)

The above explanation of the predecessor to Internal Revenue Code section 303\(^2\) is illustrative of Congressional statements respecting small businesses.\(^3\) Given these sentiments, it is hardly surprising that successive Congresses have enacted income and transfer tax provisions designed to ease the tax burdens of operating such a business and to facilitate its transfer from one generation to the next.\(^4\)

This article examines the effects of recent enactments\(^5\) upon the methods

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\(^1\) Levin Richmond: Transmitting Interests in a Family Corporation

\(^2\) Revenue Act of 1950, ch. 994, § 209, 64 Stat. 932 (1950). The Internal Revenue Code of 1954 will hereinafter be referred to as I.R.C. in the footnotes of this article. Unless otherwise indicated all such references are to the Code as in effect January 1, 1983.

\(^3\) See, e.g., H.R. REP. No. 749, 88th Cong., 1st Sess. 27 (1963) ("Your committee believes that it is important to provide a greater rate reduction for small businesses because of their importance in maintaining competitive prices in our economy, and also because of the greater difficulty small businesses have in finding outside funds to finance their expansion."); H.R. REP. No. 1380, 94th Cong., 2d Sess. 21-22 (1976) ("Your committee believes that, when land is actually used... in other closely held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential 'highest and best use' especially since it is desirable to encourage the continued use of property for... small business purposes.").

\(^4\) E.g., I.R.C. §§ 48(c), 179, 1244 (income tax provisions); §§ 2032A, 6166 (transfer tax provisions).

of transmitting interests in a closely-held corporation. Because the tax consequences will frequently vary depending upon whether the corporation is a C corporation or an S corporation, a brief description of each form precedes the discussion of the relevant tax consequences. The tax consequences, which will be discussed thereafter, involve interrelated questions: which consequences are involved, and who will bear their brunt? Because nontax considerations also influence the timing of stock transfers, the discussion will address them as well.

I. C CORPORATIONS AND S CORPORATIONS

The C corporation was the only major corporate form originally given effect for federal income tax purposes. These corporations are taxpaying entities separate from their shareholders, who report and pay tax on corporate income only as it is actually distributed to them in the form of dividends. Because the corporation is a separate taxable entity, it offers its shareholders significant opportunities for reducing the tax consequences of business profits. A high bracket shareholder with sufficient income from other sources, including his corporate salary, can allow corporate profits to accumulate rather than having them distributed as dividends. In addition, liberal fringe benefits can be used to supplement the earnings of a shareholder-employee without subjecting him to additional income tax consequences. Income retained in the corporation until the shareholder’s retirement can be withdrawn at the lower tax rates anticipated during retirement years. Indeed, if the amounts accumulated translate directly into increases in the value of his stock, he can ultimately extract them at capital gains rates when he sells his shares or has them redeemed by the corporation. Should a post-mortem transaction occur, the income tax consequences, which would involve only post-death appreciation, would be borne by his estate or testamentary donees.


7References in this article to types of corporations will use the nomenclature introduced by Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 2, 96 Stat. 1669 (“S corporation” for those entities governed by I.R.C. §§ 1361-1379; “C corporation” for all other corporations).

8The term “major” is used to exclude other forms, such as insurance companies, which are given special treatment.

9In certain instances shareholders will be taxed under the I.R.C. § 565 consent dividend provisions although no corporate distributions are made. Consent dividends provide a means for avoiding the accumulated earnings tax and personal holding company tax, the corporate level penalty taxes. I.R.C. §§ 531, 541.

10Salaries are deductible only if they are reasonable. I.R.C. § 162(a)(1). However, a salary is not deemed unreasonable merely because the corporation pays inadequate dividends. Rev. Rul. 79-8, 1979-1 C.B. 92.

11These items are also subject to the reasonableness test of I.R.C. § 162(a)(1).

12So long as he intends to keep control within his family, most sales would be made to family members. Indeed, few outsiders would be willing to purchase a minority interest in such an enterprise. Although the focus of this article is gratuitous transfers, there will be many situations in which sales to family members, whether or not coupled with redemptions by the corporation, are the preferred mechanism for shifting ownership to the next generation.
Despite the advantages outlined above, the C corporation is not always the entity of choice. If the corporation suffers losses, its shareholders cannot offset them against their income from other sources. Even if the entity is profitable, shareholders of modest means may require distributions of virtually all its annual profits. Payments which fail to pass muster as a reasonable allowance for salary would be denied deduction by the corporation and taxed as a dividend to the shareholder.13

The S corporation, which originated in the Technical Amendments Act of 1958,14 provides relief in the situations mentioned in the preceding paragraph. Tax is imposed at the corporate level in rare situations.15 Instead, corporate profits and losses are allocated pro rata among the entity’s shareholders.16

S corporation status is not automatically conferred upon every corporation for which it would prove advantageous. The corporation and its shareholders must affirmatively elect such status,17 and they must meet statutory eligibility requirements.18 The first such requirement relates to the number of shareholders. Originally limited to ten shareholders, S corporations are now allowed to have thirty-five shareholders at any one time.19 Indeed, if spouses are included as shareholders, stock could be owned by as many as seventy persons without terminating the election.20

Given the decline in the birthrate in recent years, the increased limits should prove unnecessary so long as the business is held solely by members of the founder’s family. Even if four generations owned stock at any one time, the maximum number of individual owners would rarely exceed twenty-five;21 thirty-five shareholders are possible if the first generation includes siblings or unrelated individuals, but a corporation profitable enough to sustain the financial needs

1I.R.C. § 116 provides minimal relief from double taxation.
3See, e.g., I.R.C. §§ 58(d), 1374, 1375.
4Prior to the Subchapter S Revision Act, only losses were allocated to all persons who were shareholders during the year; gains were allocated only to persons owning stock at year end. Now all items are allocated on a pro rata basis among all persons owning stock during the year; such items keep their character when they pass through to shareholders in the same manner partnership items pass through to partners. I.R.C. § 1366(a)-(c).
5I.R.C. § 1366(a).
6I.R.C. § 1362(a).
7Although the Subchapter S Revision Act conformed S corporation taxation more closely to that of partnerships and their partners, the restrictions discussed in this section may force some entities into partnership status and away from the major benefit a corporation would offer an owner-employee — limited liability.
8I.R.C. § 1361(b)(1)(A). This number conforms to the exemption from registration for private securities offerings.
9I.R.C. § 1361(c)(1).
10This figure is derived from a family unit consisting of husband and wife (generation one), two children and their spouses (generation two), four grandchildren and their spouses (generation three), and eight great-grandchildren. The original shareholders are in their eighties, and a generation is defined with reference to the twenty-five years per generation assumption of I.R.C. § 2611(c)(5)(C). Because spouses do not count as separate shareholders, this corporation would have only fifteen shareholders. Obviously, increased fertility will present little problem in such a setting.
of that large a group may have long since outgrown the other restrictions inherent in an S corporation's structure.

More important than the number of permissible shareholders are the types of permissible shareholders. Rarely will the fourth generation in any family group have reached the age of majority, and founding shareholders often doubt the wisdom or maturity of potential shareholders in the second and third generations as well. Some form of restricted ownership, such as a custodianship arrangement for minors, has always been permitted for S corporations, but few trust arrangements are allowed.

Preferred stock can be used in a C corporation to transfer an income interest without transferring any voting rights. This device is unavailable to the S corporation, which is limited to one class of stock. Since the enactment of the Subchapter S Revision Act, donors have one important mechanism for maintaining their control. The corporate charter can now provide for differences in voting rights among common shares. In addition to reducing the power given the donees of such shares, nonvoting stock may be employed to reduce the transferor's gift tax consequences. Such shares are clearly less valuable than the otherwise identical voting shares the transferor retained.

II. CONSEQUENCES OF THE TRANSFER

Several tax consequences are relevant to the decision between inter vivos and testamentary transfers. The donor's personal tax concerns include the federal income tax consequences of corporate profits and the transfer tax obligations engendered by an inter vivos gift. If he is planning to have his remaining shares redeemed by the corporation immediately after the gift or at his later retire-

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23Grantor trusts, including the I.R.C. § 678 variety, are permitted during the deemed owner's life and for a limited time thereafter. I.R.C. § 1361(c)(2)(A)(i)-(ii). Testamentary trusts may retain stock for up to 60 days. I.R.C. § 1361(c)(2)(A)(iii). Voting trusts are allowed. I.R.C. § 1361(c)(2)(A)(iv). One additional permitted trust, added in 1981 and refined in 1982, is the qualified subchapter S trust. I.R.C. § 1361(d). All trust accounting income must be distributed (or required to be distributed) currently to one individual, and the trust can have but one income beneficiary during the current income beneficiary's lifetime. In addition, the beneficiary must be willing to elect grantor trust treatment with respect to trust income attributable to the S stock. A mandatory dividend policy, under which earnings sufficient to pay the beneficiary's tax on his share of corporate income would be distributed, might be essential to the securing of such election. As will be discussed in a later portion of this article, the tax consequences of trusts as shareholders may extend beyond the loss of S corporation status. See infra text accompanying notes 137-158.


26I.R.C. § 1361(c)(4). Voting limitations contained in the charter are preferable to those occasioned by voting trusts, which have limited terms. Model Business Corp. Act § 34 (1969) (Model Business Corp. Act. has a ten year limitation).

27While a testamentary gift also has transfer tax consequences, the estate tax does not reduce the resources available to the donor during his lifetime. While a net-of-tax gift can be employed to relieve the donor of the gift tax obligation, this technique results in his owing an income tax in situations where the gift tax obligation exceeds his basis for the stock being transferred. Diedrich v. Commissioner, 102 S. Ct. 2414 (1982), aff'd 643 F.2d 499 (8th Cir. 1981).
ment, the income tax consequences of the redemption are also relevant.

The donee may be concerned about the donor's estate tax obligations and other expenses of administering the donor's estate, particularly if these are substantial enough to cause estate liquidity problems and result in a forced sale of inherited stock. In addition, the donee has his own income tax consequences to consider. These involve the income tax consequences to him of current corporate profits and the income tax consequences to him should he later sell his stock. Because the donor generally wishes to maximize the donee's income and assets, he may instruct his attorney to take this into consideration in planning the transfer.

Nontax considerations are also important in the decision between inter vivos and testamentary gifts. The donor may hope to interest his children or grandchildren in the family business by giving them shares of stock. By transferring these shares during his lifetime he will be able to judge the commitment each child displays and, equally important, each child's ability. Although he wants them to become more involved in the business, the donor may resist his children taking over during his lifetime. Obviously, the ability to retain voting control is an important consideration, particularly if it can be accomplished without adverse tax consequences. Probate and the attendant costs, delay, and publicity may influence some individuals towards inter vivos gifts, although the availability of will substitutes should minimize the importance of this factor.

The discussion which follows is based upon a corporation owned entirely by its founder, who is planning transfers to lineal descendants. Initial consideration will be given to outright transfers of voting common stock in a C corporation. Variations on that scheme will be discussed thereafter.

A. Income Tax Consequences

Because the donor is taxed on a C corporation's profits only as they are distributed to him, inter vivos gifts of its stock are rarely important as income

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24In this connection, I.R.C. §§ 303, 2032A, and 6166, discussed infra, are relevant to the donor's planning.
25Sales at appraised value, or in a bargain sale mode, are also possible. However, this article will assume the donor intends totally gratuitous transfers.
26As life expectancies increase along with doubts as to the survival of the social security system, a donor may wish to maintain control over his continued salary or dividend income. Donors who are familiar with the King Lear saga may exhibit particularly strong feelings about retaining control. See generally Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983).
27E.g., joint tenancies and revocable trusts.
28In each case, the results will differ very little if stock is also owned by (or to be transmitted to) spouses at each level. Gift-splitting under I.R.C. § 2513 allows the donor and spouse to use additional § 2503(b) exclusions and two unified credits irrespective of how title is held. The assumption will be made, however, that no transfer of stock will be made by the founder to his spouse. While such an assumption may be totally at odds with reality, particularly if the marital deduction is needed to avoid estate tax at the founder's death, it involves a situation that will occur eventually. Either the founder's spouse will predecease him, or, if she dies later, she will be transmitting the stock to the next generation without benefit of the marital deduction. In this article the further assumption is made that the founder is a male who will predecease his spouse. Obviously, an attorney dealing with an actual client must be prepared for an entirely different outcome.
shifting tools. If the corporation can accumulate its profits at a lower overall tax cost than would be imposed on their distribution to the sole shareholder, it can also do so when there are multiple owners. So long as dividend distributions are nondeductible, engendering immediate double taxation, increased overall taxation results as soon as any shareholder has taxable income in excess of his zero bracket amount. Even if a donee is not presently a taxpayer, distributions to him offer no tax savings compared to the result achieved when the corporation permissibly accumulates earnings and profits.

Income tax savings due to shifting income from donor to donee would occur in situations where the corporation regularly pays dividends. These savings would continue so long as the donor is in a higher tax bracket than the donee. Thus, gifts by a parent in his forties or early fifties to children who are students yield considerable savings; gifts to the same children when they are corporate employees and the founder is approaching retirement could have exactly the opposite effect. While the donee’s future tax bracket is unpredictable, particularly if he or she is quite young, that of the donor may be computed with relative ease. The results of such predictions are clearly relevant to the decision as to whether the gift should occur before the founder’s death.

The donee of C corporation stock will rarely have interests in opposition to those of the donor with respect to income tax consequences. If the stock pays no current dividend, the donee is rarely worse off than he would have been if he had not received the gift. Even if taxes are due on dividend income, he will still have a positive after-tax return on a zero investment.

Corporate tax rates are, in general, lower than those imposed on individuals earning the same amount of income. The top corporate tax rate of 46% is imposed for 1983 taxable years on taxable income in excess of $100,000; a married individual filing a joint return would be in the 48% bracket, and a single individual would be in the 50% bracket, with that taxable income. Compare I.R.C. § 1 with I.R.C. § 11. Obviously, the relative savings has decreased substantially from its pre-ERTA level, when the top individual rate was 70%. See I.R.C. § 1 (1981).

Even though the rate differential has narrowed, there are still substantial savings available if the choice is between dividends (as opposed to salary) and accumulation. If a 46% bracket corporation paid the 54 cents remaining after taxes to a shareholder in the 50% bracket, only 27 cents would remain of the original dollar earned at the corporate level. Thus retained earnings, which could be transformed into potential capital gains, accumulate faster than distributed earnings. Obviously, the accumulated earnings tax is a factor which often results in distribution. I.R.C. §§ 531-537, 561-563, 565.

In fact, increased overall taxes result only if each shareholder’s taxable income exceeds the zero bracket amount, his dividend income exceeds the I.R.C. § 116 exclusion, and the accumulated earnings tax is not an imminent threat.

There are, of course, certain variables that reduce the predictability of the donor’s future income. If he is several years away from retirement, future salary is uncertain. Likewise, future benefits flowing from that salary will also be uncertain. This is particularly true for a defined benefit pension plan, as well as for any unfunded plan. In addition, proposals to tax social security benefits may distress the donor as they increase his difficulty in projecting his future income. See generally Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983).

The same ERTA rate reductions that reduced the savings available from accumulating corporate income also reduced the savings available from shifting income away from a top bracket donor. Prior to ERTA there was a 56 percentage point differential between the highest and lowest bracket. In 1983, that differential is only 39 percentage points. Nevertheless, substantial savings are available, particularly if the donor regularly transferred after-tax income to the particular donee.

Obviously, he could be worse off if he had a choice between the stock and another income-producing asset or if the stock resulted in his incurring a state intangibles tax obligation.
An analysis limited solely to the current income tax treatment of distributions overlooks certain other important income tax consequences. These are discussed in the following paragraphs.

1. Ordinary Loss Potential

Section 1244, which originated in the Small Business Revision Act of 1958,\(^3\) is designed to reduce the adverse tax consequences of an unrecovered investment in a small corporation.\(^4\) Instead of a capital loss, the deductibility of which may be limited to $3,000 per year,\(^5\) a shareholder is allowed ordinary loss treatment of up to $50,000 for such a loss.\(^6\) Section 1244 thus offers shareholders in a C corporation delayed relief for the corporation’s unsuccessful operations. While delayed relief has a smaller present value than the immediate benefit enjoyed by shareholders in an unprofitable S corporation, small corporations rarely have the luxury of continuing unprofitable operations.

Only the individual or partnership to whom the common stock was originally issued is allowed ordinary loss treatment for unrecovered basis.\(^7\) Thus, the potential donor is the only person eligible to avoid capital loss treatment. If the business is quite profitable and well established, a decline in the stock’s value below the donor’s basis is sufficiently unlikely to make section 1244 status critical. The same is true for a fledgling business if the equity capitalization is minute compared to the corporation’s indebtedness.\(^8\) Moreover, section 1244 eligibility is automatically cancelled by a testamentary gift. The hazards of an inter vivos gift should thus prove inconsequential unless future business prospects are already bleak.

2. Donee’s Basis

A related consideration, in situations where the stock’s value is currently less than the donor’s basis, is the deductibility of the unrealized loss. The basis rules applicable to inter vivos gifts allow only the original owner to deduct such a loss.\(^9\) As is true of section 1244 eligibility, this consideration is rarely critical. Testamentary gifts of depreciated stock also rob the family of a deduction for the decline in value occurring during the donor’s ownership.\(^10\) Indeed, because

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\(^4\)Small businesses frequently fail because of chronic undercapitalization. Even the $1,000,000 capitalization allowed by I.R.C. § 1244(c)(3), assuming the corporation can raise that much, could ultimately prove inadequate.

\(^5\)See I.R.C. § 1211(b). Ordinary loss treatment is available whether the loss is incurred through sale or worthlessness, as I.R.C. § 1244(a) overrides I.R.C. § 165(g).

\(^6\)This limit is doubled on a joint return whether or not both spouses own stock. I.R.C. § 1244(b)(2).

\(^7\)I.R.C. § 1244(a).

\(^8\)But see I.R.C. § 385. The regulations ultimately adopted for this section may result in recharacterization of purported debt interests in many instances.

\(^9\)I.R.C. § 1015(a) ("except that if such basis . . . is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.")

\(^10\)I.R.C. § 1014.
the basis rules for property passing at death also increase the donee’s potential income tax consequences from a subsequent sale if the property regains its lost value, inter vivos gifts are favored.45

If the donee sells appreciated gift stock, his basis is generally greater (and his gain smaller) if a testamentary gift was employed. Assuming the stock is a capital asset, the maximum additional tax cost is twenty percent of the difference between the donor’s basis and the value of the property at the donor’s death.46 If section 2032A has been utilized, the difference will be even smaller.

Transfer taxes are imposed upon a property’s entire value at a minimum rate of thirty-four percent47 and not merely upon appreciation over the donor’s basis. Thus, inter vivos gifts offer overall savings to potentially taxable estates. However, they do not offer such savings for modest estates. Indeed, the income tax cost of foregoing a stepped-up basis makes inter vivos gifts highly undesirable if a modest estate is anticipated.

3. Provisions Involving Related Taxpayers

Section 267 disallows loss deductions and section 1239 transforms capital gains into ordinary income on sales between certain related parties, including shareholders and corporations. If the shareholder contemplates such transactions, inter vivos gifts to family members may help avoid these problems.

Section 1239 is easier than section 267 to circumvent, as its definition of “related persons” is limited to situations where the taxpayer owns at least eighty percent in value of the corporation’s stock. Further, family attribution is limited to shares owned by the taxpayer’s spouse.48 Bona fide transfers to children of stock worth more than twenty percent would be sufficient to avoid this provision.49

Section 267 problems will rarely be avoided by inter vivos gifts. The donor must part with at least fifty percent of the stock value50 and therefore risks losing control of his corporation. Further, section 267 employs very broad family attribution rules; stock owned by children and certain other relatives will be
attributed to the donor. Gifts to a son-in-law or daughter-in-law can avoid attribution, but the problem of loss of control will be substantially magnified.

If a son-in-law or daughter-in-law is an employee, and the sole shareholder and his children are not, inter vivos gifts to the children (or to their employee spouses) could result in the corporation’s pension plan becoming top-heavy, a concept introduced by TEFRA. As top-heavy plans are subject to more stringent qualification requirements than are other qualified retirement plans, this may be a factor to consider. Of course, if the plan is already top-heavy or there is no plan in existence or contemplated, this consideration can be safely ignored.

B. Transfer Tax Consequences

Because the donor can transmit shares during his lifetime, at his death, or at both times, transfer tax consequences are usually as important as income tax consequences. Relevant considerations are discussed in the following paragraphs.

The section 2503(b) exclusion allows a donor to make inter vivos transfers with no immediate federal transfer tax consequences. Even gifts exceeding the exclusion can be employed to the extent of the donor’s unified credit. Indeed, such larger gifts became desirable for 1982 and subsequent years because they no longer are subject to automatic inclusion in the estate of a donor who dies within three years after the transfer.

Unless bequests to the surviving spouse or charity are involved, the only estate tax exemption available is the remaining unified credit exemption equivalent. Thus, the same amount of property will trigger a larger taxable amount at death than it would if inter vivos gifts were made. Not only do inter vivos gifts allow a donor to utilize his own annual exclusions, they also allow him to transfer property at a lower value than if a testamentary transfer were employed. There are at least two aspects involved in this latter consideration. First, values tend to increase over time due to inflation, a condition which affects all of the donor’s assets; a family business may increase in value even faster than the rate of inflation if it has recently left behind its infancy, when mere survival was doubtful. Second, and perhaps more important, a lower per share valuation can be arranged if inter vivos gifts are utilized.

\[I.R.C. \textsection 267(c)(4).\]
\[I.R.C. \textsection 416. \text{Even gifts to grandchildren can have this result if their parent is a corporate employee.}\]
\[I.R.C. \textsection 416(b)-(e).\]
\[\text{State gift taxes could be imposed if state transfer taxes do not conform to federal rules. See, e.g., N.C. GEN. STAT. \textsection 105-188 (1979).}\]
\[I.R.C. \textsection 2505. The credit allows up to $275,000 in gifts to escape transfer taxes in 1983. By 1987, $600,000 will be exempt from tax. Of course, use of the credit during the donor’s life reduces the amount available at his death, but this is a timing question. The overall credit amount is unaffected.}\]
\[I.R.C. \textsection 2035(d).\]
\[If she consents, he can also use those of his spouse. I.R.C. \textsection 2513.\]
Valuation of shares in a closely-held corporation is clearly more difficult than valuation of interests in a publicly-held entity. If shares are held by one family, there are rarely any sales, much less "highest and lowest quoted selling prices on the valuation date . . . ." In addition, because most sales which do occur involve family members, the arms-length element of fixing value based upon such transactions may be lacking.

While objective factors such as book value and earnings will be used in valuing the stock, discounts are available for factors such as nonmarketability and minority interest.

If the donor desires to retain control during his lifetime, his inter vivos transfers would be of a minority interest and thus would enjoy substantial discounts from the per share value of his entire block of stock. Further, if he is willing to reduce his ownership interest to a minority, he may ensure a lower valuation for those shares remaining at his death.

Although inter vivos gifts may serve to reduce transfer taxes, testamentary transfers have certain advantages over inter vivos gifts. These advantages are discussed in the following paragraphs.

1. Family Business Discounts

Section 2032A allows a reduction in estate tax value of up to $750,000 for certain real property used in farming or other business activities. Because section 2032A applies only to estate tax valuation, inter vivos gifts of stock are ineligible for such treatment. Thus, it is possible for a higher transfer tax to be imposed upon an inter vivos gift of the business interest than would be imposed upon a testamentary transfer.

In addition to their own ineligibility for section 2032A treatment, inter vivos gifts may prevent other property owned by the decedent at his death from qualifying for this valuation reduction. To qualify, the property must represent a significant portion of a decedent's gross estate. Inter vivos gifts

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62A minority interest discount differs significantly from a discount for nonmarketability. Most interests in close corporations find few willing buyers outside the family group; a minority block would attract even fewer. A minority interest is thus worth less per share than a majority interest. See Estate of Andrews v. Commissioner, 79 T.C. 938 (1982).
64Lower income taxes may also result. See supra text accompanying notes 33-36.
65I.R.C. § 2032A(a). Stock in a corporation holding such real estate is also eligible. I.R.C. § 2032A(g).
66If the best and highest use for the property is as a condominium apartment and not as a restaurant parking lot, a substantial increase in value is possible.
67I.R.C. § 2032A(b).
of such stock are always risky with respect to that requirement, for the donor might survive the gift by more than three years.68 Testamentary gifts of stock would be in order in situations where the devisee is a qualified heir who plans to hold the stock for the period necessary to vest the estate tax reduction.69

2. Redemptions

Added in 1954,70 section 303 provides a safe harbor against dividend treatment when stock of a deceased shareholder is redeemed by the issuing corporation. Although enacted to reduce liquidity problems,71 section 303 applies even if other estate assets are sufficient to pay death taxes and funeral and administration expenses, the items which trigger its application.

This provision does not apply to all estate beneficiaries; the beneficiary’s interest must be reduced by payment of such items or by a binding obligation to pay them.72 Thus, if stock is left by specific bequest to an individual who is not a residuary legatee, section 303 relief may be unavailable.73

Even if the proper legatee receives the stock, section 303 treatment is accorded only if the value of the corporate stock included in the gross estate exceeds thirty-five percent of the gross estate less deductions allowed under sections 2053 and 2054.74 Although outright gifts within three years of death are no longer included in the gross estate for estate tax purposes, they are included for purposes of determining section 303 eligibility.75 Thus, substantial inter vivos gifts of other property during the three year period may not be used to strip the estate and ensure qualification for the stock left behind. Also, inter vivos gifts of stock during that same period will not necessarily prevent its qualification. Because death within three years cannot be guaranteed in any situation, gifts must be closely monitored.

Due to the fact that pre-death stock gifts themselves are ineligible,76 a decedent must choose carefully which donees take inter vivos and which take testamentary grants of stock. In this regard, sections 303 and 2032A work against

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68Although large gifts made within three years of the donor's death no longer receive automatic inclusion in his gross estate, such gifts are brought back for purposes of determining I.R.C. § 2032A eligibility. I.R.C. § 2035(d)(3)(B). Thus, deathbed gifts of nonbusiness assets cannot wipe out the damage done by gifts of business property made before the three year period commenced.

69I.R.C. § 2032A(c)(1) (ten years after the decedent’s death unless the qualified heir dies within that period).


72I.R.C. § 303(b)(3).

73FLA. STAT. § 733.817(1)(a) (1981) charges death taxes against the residuary share unless the will provides for contribution or the residue is inadequate.


76Such stock would have to be actually included in the gross estate and obligated for taxes and expenses of administration.

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each other. Only shares transferred as testamentary gifts are eligible to be redeemed using section 303, yet these are the same shares which must be held ten years to ensure the favorable section 2032A valuation.

Section 303 is not the only redemption section offering immunity from dividend treatment. Legatees can still attempt to bring themselves within the exemptions offered by section 302, a task made easier if all of their stockholdings are being redeemed.

Section 302 offers three routes for escaping dividend treatment: complete redemption, substantially disproportionate redemption, and distribution which is not essentially equivalent to a dividend. The first two of these are essentially mathematical computations; the last involves subjective judgment.

There are several factors to consider in determining whether or not there has been a complete redemption of a shareholder’s interest in the corporation. The most important of these is constructive ownership. Even though all of the stock actually owned by the legatee is redeemed, the redemption will fail to qualify as a complete termination if shares are constructively owned by him by virtue of section 318. That section’s attribution rules operate to treat a person as owning stock owned by family members or entities in which he has an interest, as well as stock on which he holds an option. Section 318 also operates to attribute ownership to certain entities from individuals beneficially interested in such entities. There can thus be no complete termination of a legatee’s interest if he is also a beneficiary of an estate or trust which owns stock in the redeeming corporation. Likewise, the estate may face similar problems if its stock is being redeemed and a beneficiary is also a shareholder.

Family attribution presents fewer problems than does entity attribution. First, the definition of family is sufficiently narrow to avoid attribution in many circumstances. Thus, if a father bequeathes all his stock equally among his children, and one of them has no desire to own shares in the business, that child’s stock can be redeemed using section 302(b)(3). Siblings are not considered family members under section 318. On the other hand, if stock is also left to the widow, and she plans to retain her interest, the uninterested sibling can qualify under section 302(b)(3) only if he also meets the tests for waiver of family attribution. In this instance, the child can initially retain no interest other than as a creditor, although he can inherit equity within the ten year period with no adverse tax consequences. Because Congress has made it clear that

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**Footnotes:**

3. I.R.C. § 302(c)(2).
4. I.R.C. § 302(c)(2)(A). The definition of debt and stock formulated in I.R.C. § 385 regulations will apply for this purpose. I.R.C. § 385(a). If the stock was acquired by inter vivos gift within the preceding ten
TRANSMITTING INTERESTS IN A FAMILY CORPORATION

entity attribution cannot be waived, section 302(b)(3) will be unavailable when an entity of which he is a beneficiary owns stock.

A substantially disproportionate redemption requires a reduction in both voting power and common stockholdings. Further, such reductions must meet the mathematical tests after application of the attribution rules. While the reduction required is clearly less than that necessary for a complete termination, family attribution cannot be waived. These requirements make such a redemption difficult in situations where the shareholder being redeemed is giving up non-voting common stock or preferred stock, whether or not voting, as the sole consideration for a partial redemption.

A distribution is not essentially equivalent to a dividend when there has been a meaningful reduction in the shareholder's interest. Essentially a subjective question, this type of redemption should be the subject of a ruling request.

Frequently the attribution problems inherent in section 318 can be resolved by having the reluctant shareholder wait for a particular event, such as the closing of the estate; or the shareholder may elect to sell his interest to another shareholder.

3. Estate Tax Deferral

Estate tax deferral of up to five years, followed by installment payments over ten years, is available for the estate taxes attributable to an interest in a closely-held business. The estate qualifies if the value of the business included in the adjusted gross estate exceeds thirty-five percent thereof and if the donor was still alive at the time of the redemption, the redeemed shareholder can waive attribution only if tax avoidance was not a principal purpose of the transactions. I.R.C. § 302(c)(2)(B). See, e.g., Priv. Ltr. Rul. 8245072 (Aug. 1982). Thus, inter vivos gifts to a reluctant donee may have undesirable tax consequences for that donee.

The donee could, of course, disclaim his interest in the entity. Even if the disclaimed interest passed to a relative, he would be able to waive family attribution. The disclaimant would, however, suffer an economic loss by giving up his interest in the entity gratuitously.

Family hostility probably does not affect the resolution of this issue. Compare Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975) with Metzger Trust v. Commissioner, 76 T.C. 42 (1981), aff'd 82-2 USTC (CCH) ¶ 9718 (5th Cir. 1982).

Sales are unlikely if the purchaser is already the sole remaining shareholder. A corporate redemption would allow him to maintain his control position while retaining his personal funds. If he plans to hold his shares until his own death, the increased basis for his interest a purchase would yield is irrelevant unless he needs basis to absorb prior S corporation losses.

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the decedent’s interest in the business itself was sufficiently large. When a corporation is involved, there must be fifteen or fewer shareholders or the decedent’s gross estate must include at least twenty percent in value of the corporation’s voting stock. For purposes of determining section 6166 eligibility, stock owned by family members is deemed owned by the decedent in applying the fifteen shareholder test. It is not deemed owned for purpose of the thirty-five percent of adjusted gross estate test. For purposes of section 6166, taxable gifts within three years of death can prevent qualification. The estate must qualify whether the computation is made up to three years before death or immediately thereafter.

Section 6166 is valuable not merely because of the estate’s ability to defer the tax. In addition, the interest rate imposed on tax installments attributable to the first $1,000,000 of value is four percent. Of course, that rate is applicable only if the amount involved in the particular estate exceeds the unified credit available that year. For this purpose the value of the business is assumed as representing the first item in the gross estate. Although the value of the deferral decreases each year through 1987, even in that year a tax burden of $153,000 will be imposed if an interest worth $1,000,000 is included in the decedent’s taxable estate. As is true for section 2032A benefits, section 6166 qualification is dependent upon the stock being devised to an heir willing to stay with the business for a substantial period of time. Because the donor is trying to facilitate retention by his heirs of the business he has built, he may decide to forego inter vivos stock gifts that would prevent his estate from qualifying under section 6166. This allows the heirs to judge the importance of deferral after the donor’s death, when his feelings about the business no longer influence the outcome. Because retention by the donor until his death may yield him adverse income tax consequences, he must not ignore the overall impact of his decision.

4. Credits Against the Estate Tax

Although there are no credits against the federal gift tax, there are two credits available against the estate tax which may be important for certain

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*I.R.C. § 6166(b)(1).
*I.R.C. § 6166(b)(2)(B)-(D). Section 267(c)(4) attribution rules are used for this purpose. Family attribution can, if necessary, be used to meet the 20% voting stock requirement, but an electing estate would forego use of the 4% interest rate on the deferred tax. I.R.C. § 6166(b)(7).
*I.R.C. § 6601(j). The $1,000,000 value yields a tax of $345,800 before credits.
*I.R.C. §§ 2001(c), 2010(a).
**The I.R.C. § 6166 extension terminates when 50% or more of the business interest is disposed of, including disposition by redemption. More liberal rules apply for the purpose of allowing redemptions under I.R.C. § 303. I.R.C. § 6166(g).
transferring interests in a family corporation

Donors. Section 2011 provides a credit for state estate and inheritance taxes as an offset to the federal estate tax. So long as the federal and state death tax system are in conformity, a full credit results.96 Even if the state death tax exceeds the amount of authorized federal credit, there could be a smaller tax than that imposed on an inter vivos gift.97 On the other hand, in those states which have death taxes but which ignore inter vivos transfers,98 the inter vivos gift may be less costly.

Section 2013, allowing a donee's estate credit for estate taxes assessed on the donor if their death's occurred within a ten year period,99 is a benefit that should be considered in situations where the donee is of middle age or older or is in relatively poor health. While no transfer tax savings is available to the donor, the benefit to the donee's estate will allow an increase in the amount passing free of estate tax within the family group.

Although inter vivos gifts do not give rise to the section 2013 credit, use of the section 2503 exclusion may allow even greater benefits. Indeed, the donor may be able to escape tax altogether. Further, if the donee's estate makes maximum use of the marital deduction, the section 2013 credit is worthless. Obviously, this is a factor of at best hypothetical importance in any situation.

III. Variations on the Basic Transfer Pattern

While the attorney planning for the transmission of his client's business interests will face an infinite variety of fact patterns,100 two major variations will be considered in this section. First to be addressed are the problems involved when the entity is an S corporation. Second, consideration will be given to problems engendered in preserving the donor's control following an inter vivos gift.

A. S Corporation

Several changes in subchapter S have made inter vivos transfers more practicable in recent years. Although the limits will rarely be reached by a strictly family-owned corporation, the increase in the number of permissible

96See, e.g., Fla. Stat. § 198.02 (Supp. 1982).
97I.R.C. § 2011(b) provides for the maximum federal credit based upon the "adjusted taxable estate." Although the credit granted the estate of an Ohio decedent is less than the state death taxes, it is still better than no credit at all. See Ohio Rev. Code Ann. §§ 5731.02 & 5731.18 (Page 1980). There will be no credit, of course, if state gift tax is paid with respect to an inter vivos gift, as the federal gift tax cannot be offset by levies owed a state. The I.R.C. § 2503(b) exclusion and any comparable state provision significantly reduce the importance of this factor.
98E.g., Ohio.
99The period begins two years before the donor's death and ends ten years thereafter. The credit available for tax on prior transfers is reduced proportionately every two years, so that its value diminishes as the time between the deaths increases.
100Although not considered in this article, buy-sell arrangements should be commonplace. This is particularly true if the donor has little wealth other than that represented by the business and wishes to benefit heirs who have no interest in continuing it as well as those who do.
shareholders and the change in the means of counting spouses as shareholders, make inter vivos gifts less risky even if they fail to make them more desirable. Likewise, the allowance of grantor trusts as shareholders during the grantor’s life and for a limited time after his death permits a revocable inter vivos gift that aids donors wishing to use such trusts for motives that have no tax consequences. Probate avoidance and planning for the possibility of their own incompetence are two such motives. A final change, the ability to maintain the grantor’s control until his death, is discussed in the next section.

Because the Subchapter S Revision Act grants most small business owners the ability to approximate partnership tax treatment while keeping the corporate attribute of limited liability, it is not unrealistic to assume that many existing C corporations will elect S status, and that a higher percentage of newly-formed corporations will elect this status than was previously the case. The changes described in the preceding paragraph are such that inter vivos gifts of S corporation stock may also become more commonplace. Thus, it is appropriate at this point to consider the tax consequences unique to inter vivos gifts of S stock.

The income tax consequences discussed in the C corporation setting are just as relevant when an S corporation is involved. In addition, the donor has other factors to consider.

A major factor for existing S corporations is that of taxable year. Until the Subchapter S Revision Act, an S corporation could elect any taxable year it wished. Thus its shareholders’ tax consequences could be deferred by a year if it chose a January 31 rather than December 31 year end. Newly-electing S corporations do not have that luxury; they must use the calendar year unless they establish a business purpose for doing otherwise. An S corporation in existence as such by October 19, 1982, may keep its fiscal year until there is a change in stock ownership of more than fifty percent.

Changes due to the transferor’s death do not count toward the prohibited transfer. On the other hand, changes caused by inter vivos gifts are exempt from taint only if made to family members as defined in section 267(c)(4). While section 267(c)(4) contains a very broad definition of family members, it does not include aunts, uncles, nieces, nephews, or cousins. Perhaps more

102 The addition of the qualified subchapter S trust also allows more flexibility in structuring ownership patterns. Because the grantor is not the beneficiary of such a trust, it can be used to reduce his income taxes without giving the donee-beneficiary immediate power to dispose of the stock.
103 See infra text accompanying notes 121-158.
104 See supra text accompanying notes 33-53.
105 I.R.C. § 1366(a)(1).
106 I.R.C. § 1378(a)-(b).
108 I.R.C. § 1378(c)(3).
importantly, it does not include in-laws.\textsuperscript{109} If a fiscal year is desired\textsuperscript{110} and there is no business purpose to support it, inter vivos gifts within the "family" circle but outside the section 267(c)(4) definition must be strictly limited. Testamentary gifts to these individuals, on the other hand, cause no problem.

Another situation in which inter vivos gifts present a problem concerns a corporation which formerly suffered losses and which has recently become profitable. Although a shareholder is allowed to deduct his share of the corporation's losses on his individual return,\textsuperscript{111} the deduction allowed him in any year cannot exceed his basis in the stock and any corporate indebtedness to him.\textsuperscript{112} Prior to the Subchapter S Revision Act, a loss which exceeded those amounts could not be used in any other year. Thus the shareholder with an unused loss deduction gave away no tax benefits by transferring his zero basis stock. Under current law, the shareholder receives the benefit of the unused loss in any future year in which his basis in stock or indebtedness is restored by operating profits or subsequent investments.\textsuperscript{113} A gift of all his stock will deprive him of the benefit of the unused loss carryover. A gift of less than all such stock will not have this effect, although the decline in his ownership percentage may delay his ability to use such losses.\textsuperscript{114}

Prior to the Subchapter S Revision Act, inter vivos gifts were often used as a means of revoking the S election when taxation as a C corporation became more desirable. A new shareholder then had the power to revoke the election by affirmatively refusing to consent.\textsuperscript{115} Under current law, revocation occurs only if the holders of more than one-half of the shares so agree.\textsuperscript{116} Thus, transfer to a new shareholder no longer automatically provides for termination by election.

A new shareholder will still cause automatic termination if he is not a qualifying shareholder.\textsuperscript{117} However, termination no longer relates back to the beginning of the taxable year in which the transfer occurred, a better-late-than-never

\textsuperscript{109}If the son-in-law or daughter-in-law is working in the family business and the donor's own child is not, the donor may deem the risk of divorce less important than the risk of losing a valued employee whom he considers a relative anyway.
\textsuperscript{110}The same problem exists in the area of fringe benefits. I.R.C. § 1372. S corporations in existence as such on September 28, 1982, can avoid the partnership fringe benefit rules until 1988 (for existing fringe benefit plans) so long as the 50% change in stock ownership is avoided. Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 6(d), 96 Stat. 1669, 1699.
\textsuperscript{111}I.R.C. § 1366(a).
\textsuperscript{112}I.R.C. § 1366(d)(1).
\textsuperscript{113}I.R.C. § 1366(d)(2).
\textsuperscript{114}Any delay is risky, as death could intervene or the S election terminate. But see I.R.C. § 1366(d)(3).
\textsuperscript{115}I.R.C. § 1372(e)(1) (amended 1982). If the existing shareholders were unable to find a transferee they could rely upon to disaffirm the election, they could achieve the same results through transfer to a prohibited shareholder or to an excessive number of shareholders.
\textsuperscript{116}I.R.C. § 1362(d)(1).
\textsuperscript{117}I.R.C. § 1362(d)(2).
means of avoiding the tax consequences of an unexpectedly profitable year. The corporation will instead have two years, an S year which predates the transfer and a C year which follows it. The transferring shareholder will continue to suffer the consequences of his allocable share of corporate profits attributable to the S year. Indeed, one can no longer transfer taxation of a full year’s profits to a qualifying shareholder by inter vivos gift, for profits as well as losses are now allocated based upon ownership throughout the year. These changes do not result in an advantage for testamentary gifts; they merely remove the retroactive tax planning opportunities formerly available in the inter vivos gift setting.

B. Retention of Control

As mentioned in the discussion of C and S corporations, founding shareholders may desire to transfer equity interests in the corporation without transferring voting rights. The decision to restrict such rights may stem from doubts as to the donee’s judgment, a factor which subsequent events may influence. In many instances, however, it will be a decision based upon necessity; the donee is too young to exercise his franchise, and fiduciary ownership must be arranged.

The discussion which follows is based upon the assumption that the donor will make inter vivos stock gifts and is limited to the advantages and disadvantages of several common restrictions the donor can employ. The special problems associated with gifts to minors will be integrated into the general discussion rather than treated separately.

1. Nonvoting Stock

Transferring nonvoting stock is an easy means of denying immediate control to donees. In the C corporation setting, such stock can be common or it can be preferred. If an S corporation is involved, only nonvoting common is permissible. Transfers of nonvoting stock allow the donor to shift immediate income tax consequences to the donee. Indeed, in situations where preferred stock is transferred, income can be allocated to a low income donee without the necessity of any taxable payments to a high income donor who retains only

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118 Before effectuating termination to avoid a large profit being taxed to them, the shareholders had to be certain (and still must be certain under current law) that future years would not be loss years. Once the election terminates, there is a 5 year waiting period for re-election. I.R.C. § 1362(g); I.R.C. § 1372(f) (amended 1982).

119 I.R.C. § 1362(e).

120 Ibid. § 1366(a); cf. I.R.C. § 1373(b) (amended 1982).

121 I.R.C. § 1361(b)(1)(D).

122 But see I.R.C. § 1366(e), limiting his ability to do so in an S corporation setting. This provision applies even if he divests himself of his entire equity interest but continues to work for the entity for an inadequate salary.
common stock. Further, gift tax valuations are reduced from the amount computed for a gift of the same number of voting shares.

Transfers of nonvoting stock have clear advantages, but they have disadvantages as well. First, to transfer such stock the donor must own it. If the corporate charter did not originally authorize nonvoting shares, it must be amended before such shares are issued. This entails some expense including additional attorney’s fees. In addition, the newly-issued stock must be acquired by the donor. Generally, he can acquire it by purchase, in which case he will be called upon for an additional investment, or he can acquire it through a stock dividend or recapitalization. If a stock dividend or recapitalization is chosen and preferred stock is received, that stock may be section 306 stock. If so, redemptions or sales might result in dividend or ordinary income treatment for the donee. A further problem with using preferred stock is the donor’s inability to shift future appreciation in the company’s value to the donee. Because the preferred stock would generally carry fixed dividend and liquidation rights, it would not increase in value to reflect the entity’s future success.

A variation on the above theme would involve gifting nonvoting common to the donee and having the donor retain voting preferred stock. While most of the problems discussed in this section would still be relevant, the donor’s estate tax problems would be minimized. Because he kept preferred stock, future increases in the company’s value would be transferred to the common stock owned by his donees. The donor’s income tax consequences are important if this device is used, as the preferred stock will generally pay dividends on which he will be currently taxed. In addition, his retained preferred stock will lose the section 1244 stock status enjoyed by his gifted common, so he must be certain the corporation’s profitability is more than transitory.

2. Custodianships and Trusts

If transfers to minors are envisioned, outright ownership is impossible and the transfer must be made to a guardian, custodian or trustee. Because the first method involves court supervision, which most families wish to avoid, only the latter two forms will be discussed herein.

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113This can be an inexpensive means of avoiding corporate level penalty taxes on accumulations.
114He could, of course, provide the funds to his donees and rely upon their using these funds for the purchase.
115I.R.C. § 306(o)(1).
116Transitory increases in value could occur if the dividend rate exceeded a market rate of interest, but the lack of a vote and inability to partake of future profits would keep the stock’s market value at or below its liquidation preference or call price.
117Because the bulk of the company’s value would initially be assigned to the retained preferred stock, there would be no adverse gift tax consequences.
118I.R.C. § 1244(c)(1). The donees who received common stock are also ineligible for I.R.C. § 1244 relief even though they are using the donor’s basis for the transferred stock. I.R.C. § 1244(a).
A custodian arrangement is feasible in both C and S corporations. Nevertheless, this arrangement has consequences which the donor may consider undesirable. First, who is to be the custodian? The donor may wish to make himself custodian so that he can continue to vote the stock. This could occur if he doubts the maturity of intervening generations (or if there are none). If that route is taken, the donor will be unable to remove the shares from his gross estate if he dies during the donee’s minority, for he will have a section 2038 power to terminate. Also, if the donee is one for whom he has a duty of support, section 2036 will be relevant. If the donor has a spouse she could be named custodian, but estate taxation might still be a problem if the Service argues that an indirect retention of voting rights has occurred or if reciprocal custodianships have been used.

Further, if the donor’s spouse predeceases him, he will not necessarily become the successor custodian (nor might he wish to be so named), nor even have any control over who would be so designated. Even if the donor can find a suitable custodian and is content with possible successors, he may balk at seeing the shares transferred to the donee when that individual reaches age eighteen. This will be a particularly acute problem if voting shares are transferred.

A trust arrangement avoids many of the drawbacks of the custodianship, but the trust device may be unavailable if an S corporation is desired. Grantor trusts can be shareholders, as can qualified subchapter S trusts, but non-grantor trusts providing for discretionary income accumulations cannot.

The donor’s ability to use a qualified subchapter S trust is dependent upon the income beneficiary’s willingness to elect grantor trust treatment with respect to trust income. Because an S corporation’s income is taxed to its shareholders whether or not they receive it, the trust beneficiary could be taxed on income he does not actually receive. While this is true for shareholders owning their stock outright, those individuals have the option of selling their shares (assuming a buyer can be found) and receiving their funds as sale proceeds. The trust beneficiary may never actually receive his share of S corporation income, for he may die before there is an actual distribution.

132 Both I.R.C. § 2036(a) & (b) would apply.
133 I.R.C. § 2036(b) specifically includes indirect retention of voting rights.
134 See, e.g., Exchange Bank and Trust Co. v. United States, 82-2 USTC (CCH) ¶ 13,505 (Fed. Cir. 1982).
136 Transfer at age fourteen would be even worse. Id. § 4(b)-(c). Such transfers would be limited to support needs, however.
If a C corporation is involved, a discretionary trust can be used as an income splitting device. The trustees can retain dividends in the trust or distribute them to the donee-beneficiary in amounts appropriate to minimize the overall tax consequences. So long as the beneficiary is a minor, the tax on future distributions of accumulated income can be ignored. Moreover, because the trust term can extend beyond (or even begin after) the donee's reaching majority, it is an appropriate device for gifts to adult beneficiaries as well as for gifts to minors.

Obviously, trusts present both income tax and transfer tax problems of which potential donors must be apprised. If the donor contemplates reducing the income tax burden of corporate distributions, he must avoid being taxed under the grantor trust rules on income distributed (or set aside for future distribution) to the donee. Such a result could occur if the donor is trustee, but, as will be discussed in the following paragraph, it is not limited to that situation.

If the income can be used to discharge the donor's support obligation, it will be taxed to him to the extent so used irrespective of who serves as trustee. Further, powers held by the donor which allow him advantageous terms in dealing with trust property carry similar risks. A retained power to vote the stock transferred to the trust is particularly troublesome in this regard, although a transfer of nonvoting stock would avoid that problem. If the grantor is to also be trustee, the attorney drafting the instrument must be careful to avoid allowing him a tainted power to control beneficial enjoyment. Powers to distribute corpus or withhold income are permissible under certain circumstances. But more broadly-drafted powers require independent trustees, and even these individuals cannot receive unfettered discretion.

Even if the trust is drafted in such a way that the donor escapes adverse income tax consequences, he must still concern himself with transfer tax problems. Since the donee is not receiving an outright gift of the stock being transferred, the donor may have made a taxable gift which would use up his unified credit. A discretionary trust for a minor can qualify for the present interest

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140The income allocation would take into account the trust's $100 exemption deduction, the donee's $1,000 exemption deduction, and the ability to utilize the lower brackets of two rate schedules.
141I.R.C. § 665(b).
142A gift in trust to an adult beneficiary could put the property beyond the reach of an ex-spouse should the donee later be involved in a divorce.
143I.R.C. § 677(b).
144I.R.C. § 675.
145A.R.C. § 675(4).
146I.R.C. § 674.
147See, e.g., I.R.C. § 674(c).
exclusion, in whole or in part, so long as the trustee has sufficient discretion and property will pass to the minor at age twenty-one.

If the trust was chosen in preference to a custodianship arrangement because the donor considered eighteen too young for outright ownership, he is unlikely to be significantly more enthusiastic about age twenty-one. The flexibility allowed by the trust device provides mechanisms for maintaining the gift tax exclusion while continuing the trust for a longer period. The donee can be given withdrawal powers which operate for a limited period of time. Such powers can be of the Crummey variety, exercisable at the trust’s commencement and on the occasion of any additions to corpus, or they can spring into existence at the beneficiary’s twenty-first birthday and lapse shortly thereafter. The Crummey power is particularly important if the property produces no current income, although either power may impose grantor trust treatment upon the donee.

Withdrawal powers depend for their effectiveness upon the donee’s acquiescence in not making the permitted withdrawal. If the donor cannot rely upon the donee’s cooperation, he can still obtain a partial exclusion for the income interest so long as such interest has value.

A discretionary trust for an adult beneficiary cannot qualify for a present income exclusion, although the value of mandatory income payouts will be eligible. In this situation, the donor must make choices as to whether income tax savings or transfer tax savings are more important. Because the transfer tax affects the donor directly, while the income tax may be paid solely by the donee, the choice will generally be an easy one.

Transfer tax problems associated with the trust include those associated with the donor’s death. Whether or not the trust is discretionary, the donor’s service as trustee can trigger estate tax inclusion because he is voting the stock transferred to the trust. Nonvoting stock prevents that problem in a nondiscretionary trust, but discretionary powers over income or corpus are likely to result in inclusion unless they rise to the level of an ascertainable standard.

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144It is possible to have the income interest qualify even though the remainder allocated to the same donee does not. Herr v. Commissioner, 35 T.C. 732 (1961), aff’d, 303 F.2d 780 (3d Cir. 1962).
146If the donee dies before reaching age 21, he must have a general power of appointment or the property must pass to his estate. I.R.C. § 2503(c).
147Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).
149I.R.C. § 678.
150Herr v. Commissioner, 35 T.C. 732 (1961), aff’d, 303 F.2d 780 (3d Cir. 1962).
151Nontax considerations, such as a spendthrift donee, are also important.
152I.R.C. § 2036(b). Lifetime gifts to siblings and in-laws may avoid this problem, but the donor would be left owning (actually or constructively) less than 20% of the voting power.
Powers which avoid grantor trust treatment for income tax purposes may still run afoul of the estate tax inclusion provisions. This is particularly true of section 2036, which is broad enough to include property subject to contingent powers.1

If the unified credit increases to the full $600,000 planned for 1987, most donors will have no transfer tax problems and can consider the trust as a mechanism for achieving their nontax transfer goals as well as their current income tax goals. Indeed, because the trust property may be potentially includible in the donor’s gross estate if he retains the requisite control, he might wish to create a trust which would be included so long as he expects no taxable estate. Such inclusion would allow a step-up in basis under section 1014, potentially benefitting the donee without incurring any transfer tax costs.

IV. CONCLUSION

As the preceding discussion illustrates, inter vivos gifts of close corporation stock are more attractive in 1983 than at any previous time. Inter vivos transfer tax costs have been reduced, and are scheduled to fall even further. Also, S corporation shareholder eligibility rules have been expanded. At the same time, the donor must balance other factors in making the decision between inter vivos and testamentary transfers. The estate tax itself may soon be ignored; but even where it does apply, several relief mechanisms are available. Further, current income tax savings are no longer as great as they were when the top rate applied to corporate dividends was seventy percent. Finally, many subsidiary tax attributes, such as section 1244 status or the donee’s ability to waive family attribution, can be adversely affected by an inter vivos gift.

Each business is unique, and each family may stress factors which the attorney considers relatively unimportant. A definitive statement cannot be made as to the absolute merits of inter vivos versus testamentary gifts of corporate stock. Consideration of the factors discussed in this article, and of any additional concerns raised by the potential donor, should lead to a rational decision and a successful transfer of the family business.

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