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BUSINESS SUCCESSION PLANNING FOR FAMILY BUSINESSES AND BUSINESS FAMILIES

By: Daniel H. Markstein, III, Esq.
Maynard, Cooper & Gale, P.C.
Birmingham, Alabama

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I. THE SOFT PART

A. Introduction

1. What's New

In 2005, I prepared the following materials, that have been updated for this presentation, for presentation to the Southern Federal Tax Institute. I must not have learned much in the intervening years, for my message continues to be much the same, informed somewhat by my having recognized the importance of family histories' and values' being shared with younger generations and the involvement of younger generations in family councils and family philanthropy. Meanwhile, family businesses appear to have become more formal, embracing many of the tools employed by non-family owned competitors.

2. No Need for Statistics

a. There are plenty of statistics available to support the propositions that business enterprises controlled by families constitute a large percentage of the Fortune 500's largest corporations, are major employers and job creators, and contribute a very large percentage of America's gross national product.

b. However, statistics are unnecessary to convince one of the importance of family businesses to the American economy, to the communities in which they are based, and to our practices.

c. Notwithstanding all of their contributions, family businesses' operations and ownership and management succession continue to be among the most difficult and challenging aspects of the duties that we owe our clients who own such enterprises.

3. The Generational Transition Challenge

Nonetheless, no statistics have been found that reflect any change in the inverted pyramid of family businesses which are able to succeed in passing ownership and management to succeeding generations. While not every family or family business harbors such a goal, for those that do, the challenges to their professional advisors remain. In order to serve them well, we must meet that challenge.

We proceed down two separate and distinct tracks that run parallel for long distances but sometimes intersect – the family and the business. Both deserve and demand our attention, experience, and expertise. We must engage and advise the family in the transfer of assets and the transition of roles so that it and its members will progress and prosper and so that family relationships are strengthened and remain strong. We must counsel the company and its officers and directors not only on legal aspects of operations, administration and finance, sales, and marketing but also on the legal aspects and business necessities of recruitment and retention, diversification, innovation, governance, and management succession.

4. One Man's Observations

a. Estate Tax.

(1) In the face of all of the political oratory and criticism of the "death tax" that gave us the Economic Growth and Tax Relief Reconciliation Act of 2001, that resulted in the attempt permanently to repeal the transfer tax, the American Taxpayer Relief Act of 2012, that provided an annually inflation-adjusted credit which through 2017 protected from transfer tax transfers of $5,490,000, and the Tax Cuts and Jobs Act, which from 2018 until 2026 protects from transfer tax transfers of $11,000,000 adjusted for inflation ($11,180,000 in 2018) in almost fifty years of practice I have never observed a family business that had to be sold in order to pay estate taxes.

(2) On the other hand, I have observed several instances in which family businesses had to be sold because business acumen cannot be transmitted genetically. In short, in my experience, family businesses have been sold typically because the founder or his or her descendants decided to grasp the opportunity to take advantage of a liquidity event, the lack of an identified and qualified successor or family disharmony made it necessary for there to be a liquidity event, or the ineptitude or lack of commitment (or both) of succeeding generations made it necessary to dispose of a family business before it withered away in voluntary liquidation or bankruptcy.

b. The Problem.

(1) Yet even where businesses have been successfully transferred to succeeding generations, by accident or design, it is the exception rather than the rule that formal succession planning is undertaken and implemented, with appropriate assistance from qualified professionals, at a time when such activity can make a difference in the outcome. In some cases there has been a member of the family who was the obvious successor; in some cases there has been competition that has either been healthy and productive or unhealthy and destructive; and in some cases it has been obvious that successor management must come from outside the family.

(2) As Amy Braden has observed, "Being the owner of a plane doesn't mean you have the right to fly it, and being the pilot doesn't mean you can decide which routes to fly."[1] In other words, ownership succession is different from management succession. Where the source and center of family wealth is the family business, if management succession is not planned and executed well, the golden egg-laying goose may be consumed and ownership succession will be much less of an issue.

(3) We proceed on the assumption that the best approach is to begin the process of business succession planning when the principal owner or owners are still in their fifties and are at the peak of their powers. The questions are what is the best approach given the particular familial circumstances and how to effect implementation of the process that is decided upon.[2]

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1 *Preserving Family Harmony*, JPMorgan Private Bank Portfolio, pp. 14, 18 (Fall 2005).

2 For a comprehensive summary of the issues and problems, see Charles D. Fox, IV, *Putting the Horse Before the Cart: Non-Tax Issues in Business Succession Planning*, 44 Philip E. Heckerling Inst. on Est. Pl., Ch. 9 (2010).

B. Anecdotal Experience

1. The Good, The Bad, And The Ugly

a. The Bad.

(1) "I have three sons. I want one of them to be president each year on a rotating basis. That way, all of them will understand what I have been through and what it takes to run a successful business."

(2) "This is my son, John. This is his first day at work. I want you to treat him like any other person who will one day sign your paycheck."

(3) An immigrant started a business that, through his hard work and diligence, was extraordinarily successful. His sons continued that successful operation, and the company went public. On the occasion of a visit of the senior executives to many of the company's far-flung locations, a plane crash wiped out all senior management. The company foundered and had to be sold.

b. The Ugly.

(1) A successful business moved south from the Midwest. It was owned and run successfully by the heads of two families. They were succeeded by their children and their children's spouses. By the time the second generation took over, there was a high sense of entitlement and a low commitment to hard work. There was no succession plan, there was infighting, and the business ultimately failed.

(2) A business was started from nothing by a hard-working immigrant. Through his efforts and innovation, the business prospered, and it continued to do so under the stewardship of his two sons. One of the sons produced a competent and hard-working businessman, while the children of the other son thought that a full day's work was four hours and made a practice of cursing at customers. There was no succession plan. After some threatening disharmony, the company redeemed the shares of the second son. None of the cousins speak to each other.

(3) An entrepreneur founded an extraordinarily successful company. He had many children to whom he gave his stock in an attempt to be forward-thinking in his estate planning. He came to work one day to find that the majority of his children had decided that he had outlived his usefulness and that he was no longer welcome at the company's office. Bitter courtroom warfare among his children ensued. As a result, the company had to be sold.

c. The Good.

(1) An entrepreneur founded a business and succeeded well beyond his expectations. He made a place in the business for his son but not his daughter (not that so doing is good; the daughter had no desire to participate in the business). Under the son's stewardship, the business prospered even more. The son made a place in the business for his son, and made other arrangements for his daughters, who had married and moved away, making all of his children aware of his plan and securing all of their endorsements of it. The business has continued to prosper and family relationships are strong.

(2) An entrepreneur founded a business and made it extremely successful. After over twenty-five years, he turned the reins over to the older of his sons who served along with his brother and two sisters on the board of directors and who owned the stock equally. Although at least one sibling bridled under the older son's management, all recognized his prowess and accepted his designation of his

successor. After thirty-five more years, the older son, who had been chief executive officer, became chairman and made his brother-in-law chief executive officer. After his tenure ended, an outsider was named chief executive officer. The business continues to prosper.

(3) A family business was founded by an entrepreneurial immigrant. He prospered and was succeeded by his two sons after he made other provisions for his daughters. One of his sons had only daughters and withdrew from the business leaving it to the other brother to be succeeded by his sons, after he made other provision for his daughters. Those grandsons of the founder were succeeded by their sons after having made other provision for their daughters. Those cousins continued the operation of the business successfully, and family relationships are strong.

(4) Control of an operating business was acquired by a young businessman with the financial assistance of some of his friends. The business was moderately successful until he was succeeded by the older of his two sons, who acquired majority control. The younger son came into the business and was successful. After twenty-five years as chief executive officer, the older brother became chairman and made his younger brother chief executive officer. The business has continued to prosper while the older brother's sons have entered the business, and one has succeeded his uncle. The board of directors is composed of three family members and three independent businessmen.

2. What We Know

a. Reportage.

Much of what we know about business succession planning involving family businesses has been gleaned from newspaper articles or courts' opinions involving prominent families such as the Pritzkers, the Dolans, the Ambanies, the Herzes, the Binghams, the Hafts, the Bancrofts, the Busches, the Strohs, the Rollins, and others. In addition, albeit rarely, we obtain anecdotal information from those families who overcome their penchant for privacy to speak to reporters.[3] Although it has been observed that the Pritzker family convinced themselves of the great fallacy that few people at the center can take care of all of the problems of a family business, an Alabama entrepreneur who was chief executive officer of his family business spoke to a reporter and admitted at age 68 and after a liver transplant that "I want to continue as long as I can."[4]

b. Studies.

A 2005 study found that only half of family-owned businesses had succession plans and of those about 50% were created by lawyers, 19% were created by the owners themselves, 15% were created by accountants, and the remaining 16% were created by a variety of other advisors and consultants.[5] A more recent study reports that much lower percentages of family businesses have written succession plans.[6] Only about one-third of significant shareholders report having knowledge of the senior generation's transfer plans.[7]

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3 Curt Hazlett, *All in the Family*, 143 Trusts and Estates 54 (Feb. 2004); Clare O'Connor, *The Exterminators*, Forbes 100 (Oct. 20, 2014); *Rollins v. Rollins*, 755 S.E. 2d 727 (Ga. 2014). See also, Sarah Ellison, *WAR AT THE WALL STREET JOURNAL: INSIDE THE STRUGGLE TO CONTROL AN AMERICAN BUSINESS EMPIRE* (Houghton Mifflin Harcourt 2010); William Knoedelseder, *BITTER BREW* (Harper Collins 2012).

4 Hazlett, *supra* n. 3 at pp. 55, 56.

5 Hannah S. Grove and Russ A. Prince, *What, No Succession Plan?* 143 Tr. & Est. 69 (Sept. 2004). PwC's 2014 survey of family businesses reported that only 27% had a robust and documented succession plan for senior roles. See text *infra* at n.21.

6 Avi Z. Kestenbaum and Christine K. Knox, *Baby Boomer Business Owners*, 154 Tr. & Est. 19 (Feb. 2015).

7 *Family Business in Transition: Data and Analysis*, Family Business Institute, Part 1, p. 2 (Jan. 2007).

3. Earlier Surveys

a. In 1995, Byrle Abbin reported on the results of surveys of family business owners, who ranked the issues that confronted them in the following descending order of importance:

- Organizational structure of the business
- Capable and supportive key management
- Motivation of successors and management
- Accommodation of family members
- Estate planning
- Retirement planning for current management
- Retaining competent professional advisors
- Operating with a board of outside directors[8]

b. He also reported on another survey that noted the pervasive informality in approaching both the business and the business succession plan, the limited use of a wide circle of advisors outside of the family, and the failure to use management tools that are common in public companies.[9]

4. The PwC Surveys

a. Every other year since 2002, the accounting and consulting firm of PricewaterhouseCoopers ("PwC") has conducted global surveys of family businesses, reports of which it has published, and since 2007 it has issued reports of such surveys limited to the United States. It defines a "family business" as a business where

(1) The majority of votes are held by the person or persons who established or acquired the firm (or his or their spouses, parents, children, or children's direct descendants); and

(2) At least one representative of the family is involved in the management of the business.

b. The title of the 2014 survey is "Professionalize to Optimize: U.S. Family Firms Are No Longer Winging It."[10] The focus on professionalization has been manifest in the following areas:

- Recruitment and retention of skilled personnel
- Addressing family issues
- Governance
- Succession planning

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8 Byrle M. Abbin, *Here a GRAT… There a GRAT—The Mass Merchandising of Estate Planning by Acronym—Planning for Family Business Succession Requires Much More*, 29 Philip E. Heckerling Inst. on Est. Pl. ¶ 1103 (1995). According to the 2014 PwC survey of family businesses, this has changed; for 64% of respondents reported boards that included non-family members. See text *infra* at n. 17.

9 Byrle M. Abbin, *supra* n. 8 at ¶ 1105.3. *See also Family Business in Transition*, *supra* n. 7, Part 2, pp. 3-4 (Feb. 2007).

10 Pricewaterhouse Coopers LLP, PWC Family Business Survey 2014, *www.pwc.com/us/en/private-company-services/publication/assets/pwc-family-business-survey-us/report.pdf*. The 2016 survey is entitled, "The Missing Middle: Bridging the Strategy Gap in U.S. Family Firms," Pricewaterhouse Cooper, PWC Family Business Survey 2016, *www.pwc.com/us/en/private-company-services/publications/family-business-survey.html*.

(1) Recruitment and Retention.

(a) The recruitment and retention of skilled personnel is challenging for any business enterprise. Such personnel include not just technology talent that is critical to maintain technological parity but also management talent. [11]

(b) The latter may be more difficult in the family business context because of concerns that having family members in key positions in the business may make the company less open to new thinking and ideas, and prospective employees may be wary of familial conflicts and concerned about a ceiling on their abilities to grow and their opportunities for promotion.[12]

(c) On the other hand, a short chain of command and lack of red tape facilitate agility and innovation.[13]

(2) The Family.

(a) Respondents reported that shareholder agreements were used by 67% to avoid conflict. Families also have established policies addressing whether and to what extent it is in the best interests of the business and the family for the company to employ family members and setting forth objective performance appraisals for purposes of evaluation and promotion as well as compensation.[14]

(b) Mission and values statements were used to maintain family values and corporate culture. These aims were often achieved by facilitated family meetings and family councils in order to align the family and the business with common or at least complementary visions and values. Family councils were used by 35% of the respondents.[15]

(c) The significance of such tools becomes clear when one realizes that in 60% of the family businesses surveyed family members held shares but were not employed by the company.[16]

(3) Governance.

(a) One of the most important aspects of good corporate governance is a board of directors populated by some independent outsiders.

(b) A board so composed brings both experience and perspective to the management of the business enterprise and adds formality, objectivity, and rigor to decision-making.

(c) Although electing such boards appears to have been rare in a previous generation, 64% of the survey respondents reported having non-family members on their boards of directors.[17]

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11 *Id*. at p. 7.

12 *Id*. at p. 23.

13 *Id*. at p. 24.

14 *Id*. at p. 29.

15 *Id*.

16 *Id*.

17 *Id*. at p. 24.

(4) Succession Planning.

(a) An independent and effective board of directors can have a profoundly positive impact on a family business as it approaches one of its most hazardous risks, management succession planning and transition.

(b) Part of the problem is current management, whose average tenure in the CEO position far exceeds the five-year average in Fortune 500 companies, and its reluctance to let go, giving rise to the "sticky baton" syndrome, where the older generation hands over management in theory but in practice retains control.[18]

(c) It is startling to read that only slightly more than one-third of survey respondents had a designated successor, and only 27% had a robust and documented succession plan for senior positions.[19]

5. The Condition of The Family Business in 2018

a. Its Predicted Demise was Premature.

(1) It has been reported recently that 50 years ago management experts predicted that family businesses would lose ground to professionally managed publicly-held firms because of the abilities of the latter to raise capital and attract top talent.[20]

(2) However, that has not happened. In fact, family businesses appear to be alive and well, increasing rather than diminishing their presence among the most significant businesses in the U.S. and the world. Some of the reasons given for this outcome are the following:

(a) Family businesses' ability to access capital markets without losing control.

(b) Family businesses' tendency to take a longer-term perspective.

(c) Family businesses' lesser likelihood to incur significant debt.

(d) Family businesses' tendency to have better labor relations.

(e) Family businesses' tendency to have a superior corporate culture.[21]

b. Differentiators.

(1) Another study of major global businesses controlled by families indicated that, during good economic times, family businesses did not earn as much as companies with a more dispersed if not publicly-held ownership structure; but, in bad economic times, the family businesses far outperformed their non-family-owned peers.[22]

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18 *Id*. at p. 31.

19 *Id*. According to the 2017 survey, that number is down to 23%. *See*, *supra*, n. 10 at p. 14.

20 *Business in the Blood*, The Economist, Nov. 2014, p. 59.

21 *Id*.

22 Nicholas Kachaner, George Stalk and Alain Bloch, *What You Can Learn From Family Businesses*, 90 Harv. Bus. Rev. 102 (Nov. 2012).

(2) That study reached the conclusion that family businesses focus on resilience more than performance, managing the downside more than the upside. The reasons given for this resilience are the following:

(a) They are frugal in good times and in bad times. Family businesses do a better job at keeping their expenses under control and maintain leaner cost structures that enabled them to avoid major layoffs during the recent recession.

(b) Family businesses keep the bar high for capital expenditures because they limit investments to very strong projects that provide a good return on their own merits and are sound when compared to other potential projects. The result is some missed opportunity during periods of expansion but limited exposure in times of financial crises.

(c) Family businesses carry comparatively little debt.

(d) Family businesses acquire fewer and smaller companies because they prefer organic growth, they are not energetic deal-makers, and often they pursue partnerships or joint ventures instead of acquisitions.

(e) Many family businesses are highly diversified.

(f) Many family businesses are more international. Ambitious overseas expansion has resulted in greater sales abroad than their non-family owned competitors. Foreign growth too has occurred either organically or through small local acquisitions without major cash outlays.

(g) Family businesses retain talent better than their competitors. Retention is not a result only of financial incentives but rather of creating a culture of commitment and purpose, avoiding layoffs during downturns, promoting from within, and investing in people.[23]

C. Some Approaches to the Process of Planning

1. Getting The Job Done

a. What Comes First?

(1) Byrle Abbin's experience led him to the conclusion that only once the "soft issues" have been addressed, assessed, and attended to, should the typical estate planner's bag of tricks be brought to bear.[24] That experience and conclusion caused him to recommend an approach that puts the family and business structure issues ahead of transfer tax and legal documentation and providing "holistic estate and succession planning" as the only logical and proper means of serving family business needs and providing solutions based on those needs.[25]

(2) When one considers a framework for the process of planning, practical reality dictates that business owners have estate plans. The preparation and implementation of the estate plan cannot be put on hold pending the completion of business succession planning. The business succession plan is a process that requires a considerable investment of time and the possible involvement of non-

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23 *Id*.

24 Abbin, *supra* n. 8 at ¶ 1114.

25 *Id*. at ¶ 1126.

traditional professional assistance, *i.e.*, the family business consultant. At the conclusion of that process, it is appropriate to revisit the estate plan.[26]

b. Tendencies of Professional Advisors.

(1) In many cases, the focus of advisors and commentators is retaining the role of quarterback.[27] Other advisors and commentators who are specialists in transfer tax law limit the succession planning discussion to transfer tax rules.[28] Moreover, many family business consultants are neither knowledgeable about nor experienced in family business operations, strategic planning, or management succession planning and for that reason concentrate on estate and ownership succession planning.[29]

(2) In other words, in advising their clients, many lawyers and accountants have exhibited tendencies to stick to what they know, focusing on the transfer and income tax aspects of business succession planning while giving short shrift to the emotional and relational issues that confront and sometimes confound members of families who are bound together by strands of DNA.

(3) Many professional advisors tend to shy away from these emotional issues. Many of them confront their clients in their offices and fail to take advantage of the opportunity, indeed the necessity, of getting on the ground: walking around the facilities of the family business with those in control and obtaining a complete understanding of the dynamics of both the business and the family which controls it.

(4) Almost three decades ago, Gerry LeVan, a lawyer who became a family business consultant, noted estate planners' myopic preoccupation with documents and tax planning and suggested that the passing of the family business to the next generation deserves more sensitivity on the part of estate planners and more willingness to seek expert assistance where needed.[30] LeVan was one of the first lawyers to suggest recognition of the necessary but temporary role of the family business consultant to serve as the facilitator and mediator who helps families resolve their issues and in doing so works himself out of a job.[31]

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26 Edward F. Koren, *Preserving the Patriarch's Patrimony for the Prodigal and Other Paranormal (or Normal) Progeny: Non-Tax Considerations in Family Business Succession Planning*, 31 Philip E. Heckerling Inst. on Est. Pl., Ch. 12 (1997).

27 Robert E. Coplan, Richard W. Jones, and Andrew D. Painter, *Succession Planning for Wealthy Family Groups*,133 Tr. & Est. 31 (Nov. 1994). Dirk R. Dreux, Steven M. Etkind, Joseph E. Godfrey, and Martin E. Moshier, *Succession Planning and Exit Strategies for the High-Net-Worth Business Owner*, 69 The CPA Journal 31, 32 (Sept. 1999). *But see* Glenn R. Ayres and Michael J. Jones, *Face the Fear*, 146 Tr. & Est. 50 (Feb. 2007).

28 Mark A. Conway, *Current Issues in Business Succession Planning*, 2003 Ohio ACTEC Meeting; Michael V. Bourland, *When the Kids Won't Play Well Together: Tax-Free Corporate Divisions in Family Business Succession Planning*, 38 Philip E. Heckerling Inst. on Est., Pl. Ch. 14 (2004); Michael V. Bourland, *Implementation and Documentation of the Family Business Succession Plan*, Univ. Tex. Sch. of L., Private Companies-Tools to Make Them Thrive (Jan. 13-14. 2005); Daniel M. Hess and Kristine L. Haulik, *Attitude Adjustment*, 144 Tr. & Est. 56 (April 2005). Jonathan C. Lurie, *Coordinating Estate Planning and Business Succession*, 41 Philip E. Heckerling Inst. on Est. Pl., Ch. 7 (2007).

29 *Family Business in Transition*, *supra* n. 7, Part 2, p. 2 (Feb. 2007).

30 Gerald LeVan, *Passing the Business to the Next Generation: Before Estate Planning Begins…* 14 Prob. Not. 257 (1987).

31 Gerald LeVan, *Passing the Family Business to the Next Generation: Handling Conflict*, 22 Philip E. Heckerling Inst. on Est. Pl. ¶ 1408 (1988).

(5) At the present time, many experienced and accomplished lawyers appear to have recognized that they may be in the best position to serve as counsellors to families.[32] Such counsellors can be especially important to family businesses and business families.

c. More is Required Than Professional Expertise. This process requires that the attorney or the accountant adopt the role of the counselor in assisting the owner to plan for the successful transition and transfer of a business.[33] In embracing the counselor role, the attorney (and the accountant) must be cognizant of their obligations and limitations under applicable rules of ethics.[34] In certain circumstances, the introduction of a family business consultant, who is specifically trained in family business dynamics and family relations, can improve the communications between family members in addressing both family and business issues and overcome some of the ethical constraints that limit the abilities of attorneys and accountants to do so.[35] On the other hand, Ron Aucutt encourages us to be bold and to put the family being served first, even at some risk to ourselves, lest we abandon families when they need us the most.[36]

2. Know Your Client

a. Stereotypes.

(1) Abbin identifies and categorizes stereotypical basic entrepreneurs and distinguishes them from technical entrepreneurs:

> The stereotypical entrepreneur has enormous ambition, energy and drive that manifests itself into an egotistical, compulsive, obsessive and impulsive nature. Often he or she possesses a mixture of stubbornness and arrogance and also may exhibit eccentricities. The basic entrepreneur is much more likely to exhibit intelligence than intellect, since focus is on intuition. Most have been rather successful in operating that way… Thus, there is little or no system to the decision-making process. Lack of communication is endemic. Lack of teaching, and disinterest in detail, is commonplace in the operations under his approach.
>
> It follows from this that the entrepreneur does not engage in the classic sense. He leads and does at the same time. Confusion results from poor delegation, with all decisions typically flowing through him. Uncertainty is rife through exercise of a code of secrecy, so little or no information flows down from the entrepreneur, and as a result, little comes back up to him for empirical thought. Domination by him includes all family members, whether in or out of the business, as well as all key employees who essentially are "yes men or women." Thus, the typical entrepreneur is told whatever everyone expects he wants to hear, whether it relates to reality or not.

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32 Ronald D. Aucutt, *Creed or Code: The Calling of the Counsellor in Advising Families*, 36 ACTEC L.J. 669, 672 (Spring, 2011); Joe Goodman, RICH WIDOWS LIVE FOREVER (Legacy Publishing 2004).

33 LeVan, *supra*, no. 31 at ¶ 1202.3; LeVan, *… and Counselor-At-Law*, ACTEC ListServe (June 16, 2004).

34 Edward F. Koren, supra n. 26, at ¶ 1205; Edward F. Koren, *Non-Tax Considerations in Family Business Succession Planning, Estate Planning for the Family BusinessOwner*, pp. 17 et seq. (ABA Joint Fall CLE Meeting, Oct. 21, 2011).

35 *Id*. at ¶ 1205.1F.

36 Aucutt, *supra* n. 32 at 688.

> Inherent also is the entrepreneur's sexist attitude about the business acumen of daughters and the likelihood that, although the best in abilities, a daughter will be overlooked in favor of the less competent sibling-son. The history of family business is replete with the entrepreneur's domineering demeanor resulting in sons who lack the strength of their own convictions, obviously a self-fulfilling prophecy emanating from his activities as a patriarch, both of the family and the family business. Too frequently it includes his conclusion that the daughter married poorly and the son-in-law has to be taken care of, but has absolutely no abilities to provide input into the management of the company. Often this is an emotional conclusion devoid of any objective rationale.[37]

While the above described entrepreneur is dynastic, always wanting the family flag to fly high above the family business pole, that is not necessarily true of the "technical entrepreneur," whose goal

> is to build an enterprise, see it grow and prosper, gain financial independence or success, and ultimately 'cash in on it' whether by an outright sale or going public. This type of entrepreneur has much weaker emotional ties to the business as it affects his personal attitudes and ego, let alone as it impacts family members, employees and business associates. …

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> It is evident that the "technical entrepreneur's" attitude toward their own children and business often is significantly different, since they have less emotionalism about continuing family ownership of the business. They more likely recognize that their children either are not interested in being successors in management or are not capable and perhaps should not be involved in the business because their own interests in life differ from that of the company. Making this decision about their children's capabilities, limitations and weaknesses appears to be much easier for the technical entrepreneur than for the general business entrepreneur. As a result, often their business succession plans do not consider having their children take over. This more cold-blooded attitude exhibits itself in a mindset that is much less dynastic, i.e., a commitment to keep the family business as a monument that often intrigues and drives the more typical business entrepreneur.
>
> Because the technical entrepreneur is more analytical by nature and training, there is a greater likelihood he or she would be interested in implementing better business procedures. Their business organizations tend to be better organized and on a less intuitive basis than that of the older style business entrepreneur.[38]

(2) Even so, personality studies show that controlling entrepreneurs, the risk-takers with capital, are primarily concerned about minimizing risk. That accounts, at least in part, for their guarding control and their having difficulty in trusting their best employees or their children. In the second generation, it appears that sibling groups are even more risk-averse than the founder was. Their mantra is to avoid losing their inheritance as opposed to building a legacy for future generations. Succeeding generations may have a greater challenge because they have had no appropriate role models for collective ownership. Thus, the success of those who wish to transfer stewardship and a sense of legacy to succeeding generations has been possible only because "both the generation in charge and the successors

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37 Abbin, *supra* n. 8 at ¶ 1108.1.

38 *Id*. at ¶ 1108.2.

were willing to do the hard work of hashing out administrative issues, redefining their mission and designing new structures to serve the broadening and diversifying family."[39]

b. Some Expert Opinion.

(1) One commentator suggests organizing a nine-member team that includes an accountant, a business appraiser, a financial planner, a psychologist, a banker, an insurance agent, a broker, an actuary, and an attorney.[40] This is reminiscent of the old saw that a camel is a horse designed by committee. Still another extreme suggestion is to closet family members with one or more mediators or facilitators in an extensive multi-day retreat.[41] In my experience, neither works.

(2) Another commentator who is experienced in counseling family business expressed the point of view that, "if you protect the viability of the business, matters seem to work out."[42] Yet family and business succession planning must proceed on the aforementioned parallel and frequently intersecting tracks. He also made the following salutary suggestions:

- Keep in mind that this is an iterative process. Have patience….
- Do not sell the softer issues short. Remember, your client, her family members, and business management team have never done this before. Be sure that all of the relevant people are included in the process, erring on the side of completeness and inclusion.
- Try to get the client and the members of her family system to identify their goals, core values, and beliefs.
- Many clients are geniuses at what they do but are not experienced in working with conceptual problems.
- The most important element in the larger transition process is the management succession plan.[43]

c. Why Family Business Succession Fails

(1) One recent analysis of family business succession failures attributes such outcomes to relationship issues (66%), lack of competence and preparation (25%), tax and estate planning issues (10%), and miscellaneous problems (5%).[44]

(2) Another study of families who failed to preserve their family businesses, wealth, and sense of family found that 60% of the failures was due to a lack of communication and trust, 25% by unprepared heirs, and only 3% by errors in planning and investing.[45]

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39 Sara Hamilton and Kenneth Keye, *High Net-Worth Families*, 142 Tr. & Est., 42, 44-45 (May 2003).

40 Bart Basi, *Professionals in Business Succession Planning*, Am. Bar Assoc. Sect. of Tax'n 2001 mid-year meeting; Fox, *supra* n. 2 at ¶905.8.

41 David Gage, John Gromala, and Edward Kopf, *Holistic Estate Planning and Integrating Mediation in the Planning Process*, 39 Real Prop. Prob. & Tr. J. 509, 538 (Fall 2004).

42 Dreux, et al. *supra* n. 27 at p. 35.

43 *Id*.

44 Avi Z. Kestenbaum and Christine K. Knox, *Navigating the Discussion of Business Succession Planning*, 154 Tr. & Est. 15 (Feb. 2015).

45 Tom Rogerson, *Help Clients Prepare Their Families for a Successful Future*, 42 Est. Pl. 25, 26 (May 2015).

d. Enhancing the Chances for Success.

(1) How may the chances of success be enhanced? One family business consultant, Earnest Doud, suggests that it is critical to recognize that the answers that worked for the last generation may not be the right answers for the next generation.[46]

(2) He has developed a framework for effective succession planning that involves a six-transition model:

(a) The Founder's (current leader's) Transition. The founder must have a clear sense of personal direction for the future; become a good teacher, mentor, and door opener; and have financial resources independent of the operating results of the business.

(b) The Family Transition. In order to achieve the goals of business success, prosperity, family harmony, and personal well-being, adult family members must have the ability and willingness openly to confront issues which may have a high emotional content.

(c) The Business Transition. In order to achieve operating efficiency, change must be embraced where it is indicated, and management teams must be strengthened. The family must define and abide by the rules by which it will manage both the family and the business relationship. In addition, a strategic vision is necessary in order to achieve the discipline of participatory systematic strategic thinking.

(d) The Management Transition. A determination must be made as to whether a family member can succeed to the chief executive's position, and, if so, he or she must be identified. If not, other alternatives to family management must be considered. Competency and potential must be addressed objectively.

(e) The Ownership Transition. It must be determined who should have ownership, how to transfer ownership to the future owners in a manner that is both tax effective and respectful of the needs of the business, and a sense of responsibility must be inculcated into the family members who will succeed to ownership. Remember that fair is not equal and equal is not fair, the sooner the ownership transfer decision is made the more flexibility is available, and the sooner the transfer occurs the more tax effective it can be, but the plan should not necessarily be tax driven.

(f) The Estate Transition. While equal is not fair in the division of business ownership among family members, estate transfer decisions typically emphasize the family value of equality. Thus, the estate transition should follow decisions with respect to the ownership transition, which must ensure fairness and business continuity. An exit strategy is essential for those who do not participate in management of the business.[47]

(3) Finally, Doud suggests that the following qualities are required to succeed in pursuing the framework described above:

- Vision: knowing what the family stands for.
- Values: knowing what the family stands on.
- Voice: having and using the ability to communicate effectively.

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46 Ernest A. Doud, *Challenges and Opportunities in Family Business Succession*, 59 N.Y.U. Inst. on Fed. Tax § 1401[2] (2001).

47 *Id*.

- Vehicles: designing the mechanisms by which to implement decisions.
- Viability: knowing whether the required financial, management, and personal resources are available or are able to be developed when needed.
- Volition: commitment and guts.[48]

3. Vision and Values

a. Organizing Families around Values and Vision.

(1) Jay Hughes, a distinguished lawyer and counselor to family businesses learned from his father that businesses rarely fail due to a failure of their financial practices, but rather they most often fail because of poor long-term succession planning.[49] Hughes suggests that the proverb "shirt sleeves to shirt sleeves in three generations," or its Chinese and Irish analogs, "rice patty to rice patty in three generations," and "clogs to clogs in three generations," results from a classic three-stage process of business development: a period of creativity, a period of stasis, and a period of decay.[50]

(2) Hughes observes some of the reasons why those proverbs come true in some cases:

(a) Wealth preservation has connoted wealth measured as financial capital. Few families have understood that their wealth consists not only of financial capital but also of human and intellectual capital; and "Even fewer families have understood that, without preservation of their human and intellectual capital, they cannot preserve their financial capital."

(b) "Families fail to understand that the preservation of their wealth is a dynamic, not a static, process and that each generation of the family must be the first generation the wealth-creating generation."

(c) Families lack the discipline of patience and, therefore, fail properly to measure the timeframe for successful wealth preservation. The result is that planning for the use of the family's human and intellectual capital is far too short-term and individual, and family goals for achievement are set far too low.

(d) "Families fail to comprehend and manage the external and internal liabilities on their family balance sheets." A family business that is trying to preserve wealth may be in a blissful state of status quo, but in fact what is developing is a state of entropy or decay because liabilities were not managed properly in the earlier stages of the family's lives.

(e) "Families fail to understand that the fundamental issues of wealth preservation are qualitative, not quantitative. Most families manage themselves to attain quantitative goals. These families measure success based on the size of their financial balance sheet. … Unfortunately, this exercise omits the preparation and review of the family's and each individual member's qualitative balance sheets." Without a description and a valuation of a family's and its individual members' human and intellectual capital, the family and individual balance sheets are incomplete in measuring success in meeting the family's wealth preservation mission and goals. The following questions are critical to measuring whether a family is actively wealth preserving:

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48 *Id*.

49 Jay Hughes, *Family Wealth—Keeping it in the Family: How Family Members and Their Advisors Preserve Human Intellectual, and Financial Assets for Generations*, p. 3 (Bloomberg Press 1997).

50 *Id*. at pp. 5 and 6.

- Is each individual member thriving?
- Is the family social compact among the members of each generation providing an incentive to the leaders of each generation to stay in the family and to listen to the individual issues of those whom they lead so that the latter choose to follow?
- Do the individual family members know *how* to leave the family wealth management business so that they do not feel that they *have* to leave?
- "Are the selected representatives of the family meeting their responsibilities to manage the family's human, intellectual, and financial capital in order to achieve the individual pursuits of happiness of its members, and does each individual member perceive that they are doing so?"

(f) Families fail to tell the family's stories that relate the family's history and its values.

(g) "Families fail to understand that the preservation of family wealth over a long period of time is unbelievably hard work—with a tremendous risk of failure balanced by the highest possible reward. Most of us know that process is essential to the successful achievement to any endeavor. Most of us also know that leaving the process too soon, because it seems too hard, is the most common reason why the process fails. Families who choose to enter the process of long-term wealth preservation face the daunting fact that their process will never end if they are successful. They have to decide to stay in the process literally for all the generations to come."[51]

b. Other Approaches.

(1) One answer to the question posed above of how families can be organized around a vision and values that includes both a summary of Hughes' points and a thoughtful reaction to them is offered by Gerald LeVan.[52] That response includes the organization and operation of a family council.

(2) A family council is simply a meeting of multiple generations of family members that occurs regularly in order to educate family members and help them to make informed decisions on issues of interest to the family.[53]

(a) It creates its own rules of operation and, hopefully, adopts a mission statement and a values statement.

(b) It can provide linkage to the boards of family-controlled operating entities, it can provide a voice for non-active family members to express their views, and it can provide linkage to estate planning entities and structures.[54]

(3) An important step in the achievement of family harmony and business success is to engage in the process of strategic planning.[55]

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[51] *Id*. at pp. 7-13.

[52] Gerald LeVan, *Organizing Wealthy Families Around Family Value and Vision*, 30 ACTEC Journal 150 (Fall 2004). **See also**, Dennis T. Jaffe, *Succeeding Against All Odds: Lessons Learned from 100-Year-Old Family Businesses*, 155 Tr. Est. 25 (Aug. 2016).

[53] Mike Cohn, *They Lived Happily Ever After and Other Family Business Fairy Tales: Non-Tax Issues That Paralyze Succession and Estate Planning*, 40 U. Miami Heckerling Inst. on Est. Plan., Ch. 11 (2006).

[54] *Id.*

[55] See Pricewaterhouse Coopers, LLP, Family Business Survey 2016, *supra*, n. 10 . John L. Ward, *The Special Role of Strategic Planning for Family Business*, 1 Fam. Bus. Rev. 105 (Summer 1988).

(a) Strategic planning is the process of developing a business strategy for profitable growth.[56]

(i) Strategic planning creates insights into both the company and the environment in which it operates.

(ii) It asks key business questions.

(A) In what markets does the company want to compete?
(B) How can the company compete effectively in those markets?
(C) How aggressively should the company reinvest both corporate and family resources.[57]

(b) Such planning both builds the ability of key people to work toward consensus, teamwork, and shared decision-making and it makes for healthy communication on critical business issues.[58]

(c) Generally speaking, success tends to tamp down dissension. The better and more successful the family business can become, the more opportunities will present themselves for family members to be productive, happy, and agreeable.

(4) Tom Rogerson recommends a five-step process to prepare families for the money as well as the money has been prepared for the family in hopes of preventing their eating the golden egg-laying goose.

(a) Family education regarding wealth

(i) Dealing with in-laws

(ii) Dealing with uncooperative family members

(iii) Creating independence and interdependence among younger generation family members

(b) Family communication

(c) Shared family experiences/values – experiential team-building exercises

(d) Group decision making – philanthropy

(e) Family governance[59]

(5) Regardless of whether a family owns an operating business or whether the operating business has been sold and other assets have replaced it, family governance is important.

(a) In 2003, JPMorgan published an excellent portfolio in its Challenges of Wealth series entitled, "Effective Governance: The Eight Proactive Practices of Successful Families". While the

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56 *Id*. at p. 108.

57 *Id*.

58 *Id*. at p. 116.

59 Rogerson, *supra* n. 45.

circulation of that portfolio was limited, in 2005 the practices that are described in the portfolio were enumerated and elaborated upon in an article that is easily accessible to everyone.[60]

(b) The authors suggest that governance is important and that the issue is appropriately addressed by families when family members are committed to a collective identity (sharing a compelling economic and social reason for being connected), see themselves as stewards rather than owners, and are dedicated to empowering individuals.[61]

(c) The eight proactive practices of successful families are as follows:

(i) Articulate a clear vision. This requires defining the company's mission and setting forth the values that guide the family in conducting the business or, when there is no business, the purpose of the family wealth.

(ii) Cultivate entrepreneurial strengths.

(iii) Plan ahead to reduce risk and act on opportunities.

(iv) Build unifying structures that connect family, assets, and community. This might involve a family constitution and a family council, as well as a family office, trusts, private investment funds, and philanthropic activities.

(v) Clarify roles and responsibilities. It is important to distinguish between the responsibility of individuals as family members and their duties as asset owners or enterprise managers.

(vi) Communicate. This must be a studied activity rather than one left to chance.

(vii) Help individuals develop competencies. Doing so will foster individual fulfillment as well as family harmony.

(viii) Foster independence and provide exit options.[62] The ability to exit gracefully without recrimination should make a trip to the courthouse unnecessary.

D. Conclusion

1. The Virtue of Patience

a. It is sometimes difficult for solution-oriented experts to avoid a rush to solution and instead acknowledge the importance of and embrace the concept of process.[63] In order to achieve the best results, the process must be permitted to play out. Patience is required of both the family and the counsellor.

b. The hardest step is the first one, for procrastination is the greatest risk not only to estate planning but also to business succession planning. In my experience, most entrepreneurs would rather

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60 Amy Braden and Julia Fisher, *After the Sale*, 144 Tr. & Est. 63 (Apr. 2005).

61 *Id.* at p. 64.

62 *Id.* at pp. 64-67.

63 Fredda H. Brown and Mark B. Rubin, *Attitude Adjustment*, 143 Tr. & Est. 57 (Aug. 2004).

address the issues in a business transaction, that might involve a minor part of the assets of the business, rather than address the problems of, much less engage in, estate planning and succession planning that involve essentially all that they have.

c. The best weapons with which to attack procrastination are talent as a counselor and persistency.

2. The Role of The Counsellor

By enhancing one's capacities as a counselor, the estate planning attorney or the accountant has an extraordinary opportunity to serve not only the family business but also the family of his or her clients and to ensure its financial and emotional well-being over several generations. Doing so may require some reorientation and some refinement of old skills as well as the acquisition of new ones. However, doing so is critically important in carrying out one's obligations; for, dressed up in whatever technical garb there may be, the problems that cross our desks are essentially the problems of human beings. In order to serve our clients well, we must understand the panoply of issues facing them and the waves of emotion on which they float, be prepared to help our clients deal with them, and never shrink from the tasks that our professional forbears confronted and our successors surely will confront, whether there are transfer tax considerations to take into account or not.

II. THE HARD (TRANSFER TAX) PART

A. Paying the Estate Tax.

1. Options Available.

Upon the death of a partner or shareholder who is not survived by a spouse or who fails to take advantage of the marital deduction and who does not leave his or her estate to charity, his or her personal representative must deal with the problem of paying the estate tax.

a. Extending the Time for Payment.

(1) The Internal Revenue Code contains provisions for extending the time for payment of estate tax.[64] However, in the case of the first of those provisions, the extension is discretionary based upon a demonstration of "reasonable cause;"[65] and in the other, the extension is elective but only if an "interest in a closely held business" constitutes 35 percent of the adjusted gross estate.[66] The term "interest in a closely held business" is defined to include "an interest as a partner in a partnership carrying on a trade or business" that meets tests relating to the percentage interest in the partnership included in the gross estate (20%) or the number of partners in the partnership (45 or fewer) and stock in a corporation carrying on a trade or business if 20% or more in value of the voting stock is included in the gross estate or the corporation has 45 or fewer shareholders.[67]

64 I.R.C. §§ 6161 and 6166.

65 I.R.C. § 6161 (a)(2).

66 I.R.C. § 6166 (a)(1).

67 I.R.C. §§ 6166 (b)(1)(B) and (C). See Amy K. Kanyuk, *Death Is No Excuse: Use Postmortem Planning - Part 1*, 43 Est. Pl. 30, 33 (Jan. 2016); Jonathan G. Blattmachr, Mitchell M. Gans, and Elizabeth O. Madden, *Untangling Installment Payments of Estate Tax Under Section 6166*, 36 Est. Pl. 3 (July 2009); Louis S. Harrison, *Borrowing to Pay the Estate Tax*, 148 Tr. & Est. 46 (May 2009). A distinguished commentator reported on the Treasury Department's renewed emphasis on the lien that is created by a § 6166 election. Dennis I. Belcher, *Paying the Estate Tax Attributable to a Private Business Using IRC Section 6166, IRC*

(2) For partnerships and corporations that meet those Section 6166 tests, special low interest rates are provided;[68] however, for decedents dying after 1997, any interest incurred cannot be deducted as an administration expense.[69] No such limitation is imposed upon the deduction of interest incurred under Section 6161 or upon interest incurred on amounts borrowed from a third-party lender, such as a bank, provided that the interest expense is "actually and necessarily" incurred and is allowable under local law.[70]

b. Borrowing.

Thus, the problem of raising the cash required to pay the income tax attracted by closely-held corporate stock or a partnership interest that is illiquid presents an opportunity for a significant estate tax reduction.

(1) Prior to the amendment of Section 2053 denying the deduction for interest incurred on tax deferred under Section 6166, the Service had ruled that where liquidation of debt incurred to pay estate tax could be accelerated by election or default, that possibility rendered any estimate of future interest charges vague and uncertain; and for that reason the interest expense was deductible only when the interest accrued and was paid, requiring annual re-computation of the estate tax and filing of claims for refund.[71]

(2) In a subsequent ruling, the Service addressed the estate of a decedent which consisted almost entirely of stock in a closely held corporation. Because the estate did not have sufficient liquidity to pay the estate tax and because no election was made under Section 6166, the executor borrowed the funds required, which were to be repaid over a period of six years at 10 percent interest with a privilege of prepayment without penalty and acceleration at the lender's option upon default. The Service ruled that because of the possibilities of prepayment or acceleration of the debt upon default, any estimate of the interest to be paid was vague and uncertain; and, for that reason, the estimated amount of interest that would accrue on the loan was not deductible under Section 2053, but interest was deductible only to the extent that it had accrued.[72]

(3) A line of cases approves the deduction for estate tax purposes of interest incurred on money borrowed to pay estate taxes as an administration expense.[73]

Section 303, and Graegin-Style Promissory Notes, 39 Philip E. Heckerling Inst. on Est. Pl. ¶ 607 (2005).

68 I.R.C. § 6601 (j).

69 § 2053 (c)(1)(D). No income tax deduction is available either. §163(k).

70 I.R.C. § 2053 (a)(2) Treas. Reg. § 20.2053-3 (a); Hibernia Bank v. U.S., 581 F.2d 741 (9th Cir. 1978); *Estate of Millikin v. Commissioner*, 125 F.3d 339 (6th Circuit 1997); *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977); Rev. Rul. 81-154, 1981-1C.B. 470 (The interest on debt incurred to satisfy federal estate tax liability is a deductible administration expense to the extent allowable under local law); Priv. Ltr. Rul. 200020011 (Feb. 15, 2000); Priv. Ltr. Rul. 199952039 (September 30, 1999). That standard was not met in *Estate of Koons v. Comm'r*, T.C. Memo 2013-94, aff'd 119 AFTR 2d 1609 (11th Cir. 2017); *Estate of Stick v. Comm'r*, T.C. Memo 2010-192; and *Estate of Black v. Comm'r*, 133 T.C. 340 (2009); see Stephen Liss, *Estate of Black: When Is It "Necessary" To Pay Estate Taxes With Borrowed Funds?* 112 J. Tax'n. 373 (June 2010).

71 Rev. Rul. 80-250, 1980-2 C.B. 278.

72 Rev. Rul. 84-75, 1984-1 C.B. 193. In such cases, supplemental information must be filed on form 706 to report and deduct interest as it accrues. Rev. Proc. 81-27, 1981-2 C.B. 548.

73 *Estate of Murphy v. United States*, 104 AFTR 2d 7703 (W.D. Ark. 2009); *Keller v. United States*, 106 AFTR 2d 6309, *supp.* 106 AFTR 2d 6343 (S.D. Tex. 2010), *aff'd*, 697 F. 3d 238 (5th Cir. 2012). *Hipp v. United States*, 72-1 U.S.T.C. ¶ 12,824 (D.C.S.C. 1971); *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971); *Perdue v. Commissioner*, T.C. Memo 2015-249; *Estate of Thompson v. Commissioner*, 76 T.C.M. 426 (1998); *Estate of Graegin v. Commissioner*, 56 T.C.M. 387 (1988); *Estate of*

(a) In some of these cases, the estate borrowed from the partnership or closely held corporation whose stock constituted a substantial portion of the decedent's estate.[74] In some of these cases money was borrowed from a bank.[75] In one case, the funds were borrowed from the decedent's irrevocable life insurance trust.[76]

(b) Court approval for the borrowing was obtained in some of the cases,[77] and not in others,[78] but in all cases the borrowing and/or the deduction of the interest expense was allowed under the applicable state law.

(c) In one case, the major asset of the estate was thinly traded over-the-counter stock; and the administrator, who was also chairman of the company, felt that liquidation of the stock would drive the price lower.[79]

(d) In one case, the borrowing occurred notwithstanding the holding by the estate of significant liquid assets in light of very substantial holdings of timberland.[80]

(e) In one case, the executor declined the opportunity to clear-cut timber.[81]

(f) The consistent themes that underlie these cases are that the executor determined that borrowing was necessary in order to avoid the forced sale of illiquid assets, and the courts were loath to second guess the judgment of the fiduciary who was not shown to have acted other than in the best interest of the estate in question.

(4) In a case where corporate stock or a limited partnership interest makes up a substantial portion of the decedent's estate, a redemption or a distribution of marketable securities or funds sufficient to enable the estate to pay the tax would appear to weaken the argument that the interest in question is illiquid and should be subject to valuation discounts.[82] While borrowing from the entity itself has been approved, such action may give rise to some of the same arguments that could be advanced in the

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McKee v. Commissioner, 72 T.C.M. 324 (1996); *Estate of Sturgis v. Commissioner*, 54 T.C.M. 221 (1987).

[74] *Estate of Murphy, supra* n. 73; *Keller v. United States, supra* n. 73; *Estate of McKee v. Commissioner, supra* n. 73; *Estate of Graegin v. Commissioner, supra* n. 73; *Estate of Todd v. Commissioner, supra* n. 73. *But see* Tech. Adv. Memo. 200513028 (September 15, 2004), denying the estate tax deduction for interest on a ten-year loan with principal and interest payable on the maturity date where 57.6 percent of the limited partnership's assets were substantially liquid and decedent's child was the co-executor of the estate, the general partner of the limited partnership, and the beneficiary of one of two testamentary trusts to which the residue of the estate, primarily a 99% limited partnership interest was bequeathed.

[75] *Estate of McKee v. Commissioner, supra* n. 73; *Estate of Sturgis v. Commissioner, supra* n.73; Hipp v. U. S., *supra* n. 73.

[76] *Estate of Thompson v. Commissioner, supra* n. 73. *See also Estate of Duncan v. Comm'r,* TC Memo 2011-255.

[77] *Hipp v. U.S., supra.* n. 73.

[78] *Estate of Thompson v. Commissioner, supra* n. 73; *Estate of McKee v. Commissioner, supra* n. 73; *Estate of Todd v. Commissioner, supra* n. 73.

[79] *Hipp v. U.S., supra* n. 73.

[80] *Estate of Sturgis v. Commissioner, supra* n. 73.

[81] *Estate of Thompson v. Commissioner, supra* n. 73.

[82] *See Strangi v. Commissioner*, 429 F.3d 1154 (5th Cir. July 15, 2005); *Estate of Rosen v. Commissioner*, T.C. Memo 2006-115 (June 1, 2006). But *see Estate of Mirowski v. Commissioner,* T.C. Memo 2008-74.

case of redemptions or distributions by the corporation or partnership. The position of the estate would appear to be strengthened if the lender were an independent third party.

(5) Although commercial banks may be reluctant to make fixed-rate term loans of up to six years, such a loan with a prohibition against prepayment would appear to be necessary in order to insure deductibility of the interest on the estate tax return as an administration expense. If the interest is deductible as an administration expense, then the effect is significantly to lower the estate tax by the deduction of all interest to be paid in the future without discounting that future interest to present value.

(6) Thus, a double benefit becomes available: the amount of the estate tax is reduced by the interest deduction, and the interest deduction is available on the estate tax return well before any, much less all, of the interest shall have been paid. Obviously, the greater the deduction the less the amount that must be borrowed in order to pay the estate tax.

(7) Of course, there may be other financial benefits, such as growth in the capital that would otherwise have been used to pay estate taxes or continued enjoyment of income generated by that capital, in both cases at rates more favorable than the cost of borrowing.

(8) The cost of achieving these benefits is that amounts deducted as administration expenses on the decedent's estate tax return cannot be deducted from income on the estate's fiduciary income tax return.[83]

c. Variable Rate Demand Notes.

(1) The question that arises is how can the personal representative make a fixed-rate third-party loan interest upon which will be deductible in full on the estate tax return. The answer may lie in a corporate financing technique that has become popular in recent years - the variable rate demand note ("VRDN").

(a) VRDNs are taxable, floating-rate, credit-enhanced securities that are sold to institutional investors in the public capital markets, essentially a floating-rate bond issue.

(b) They are normally re-priced on a weekly basis between five to 30 basis points over the 30-day London interbank offered rate ("LIBOR"), although the VRDN rate is not fixed to LIBOR at any fixed spread.

(c) The holder of the VRDN can put the note to the issuer upon seven days' notice; and, in the event that the put is exercised, a re-marketing agent re-markets the notes.

(d) The coupon is generally a very low rate, but it does not reflect the cost of the liquidity facility/letter of credit.

(e) In the case of a financing by a decedent's estate, VRDNs are issued by the estate with a rating based not upon the estate's financial condition but rather upon the financial condition of the bank that supports the facility by its letter of credit .

(2) The Parties to the Transaction.

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83 I.R.C. § 642 (g).

(a) The parties involved are the estate as the borrower, a bank as the letter of credit provider, a trustee as the fiduciary agent for the note holders, and a placement/re-marketing agent.

(b) The purchasers of the VRDNs rely upon the financial condition of the bank as the letter of credit provider.

(c) The placement/re-marketing agent initially prices, places, and from time to time re-markets the notes.

(3) How It Works.

(a) The letter of credit terms, including security, are negotiated between the borrower (the estate) and the bank as the letter of credit provider.

(b) The letter of credit is used as a liquidity instrument if the notes are put back to the re-marketing agent.

(c) No securities law registration requirements are applicable if a letter of credit is used.[84]

(4) Fixing the Interest Rate. The estate can establish a fixed rate upon issuance by the use of an interest rate swap.

(a) An interest rate swap is an exchange of interest payments that converts a variable rate note into a fixed rate obligation. In an interest rate swap, the principal amount is never exchanged and, therefore, is referred to as a "notional amount." A swap is effected by a contract which states that the borrower will pay the counter-party a fixed rate and the counter-party, in turn, will pay the borrower a floating rate.[85]

(b) Since the swap will be based off LIBOR and the VRDN will be based on the credit of the bank issuing the letter of credit, the correlation will not be exact every month. Therefore, in determining the fixed rate cost, additional basis points are added to obtain the all-in costs.

(5) The Cost of Borrowing. In determining the cost of a VRDN, the borrower must consider the associated fees. There are two types of fees: the first is issuance fees, which are non-recurring, and the second is annual fees, which recur for as long as the notes are outstanding.

(a) Issuance Fees. Included in the one-time only fees are the placement fee, fees for the bank's legal counsel, bond counsel, trustee's counsel, and borrower's counsel, the trustee's origination fee, and the rating agency fee. These fees are substantial, but they can be included in the amount of the loan. In order to show the true costs of the borrowing, these fees are amortized over the life of the bond issue in calculating the all-in rate.

(b) Annual Fees. The fees that are paid annually throughout the life of the issue are the letter of credit fee, the re-marketing fee, and the trust administration fee. The letter of credit pricing varies based on the length of the term selected, for example 45 basis points for a four-year maturity and 65 basis points for a six-year maturity. The re-marketing fee might be 12.5 basis points per year. The

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84 Securities Act of 1933 § 3, 15 U.S.C.A. § 77c (a)(2) (1933).

85 Harrison B. McCawley, *Transactions in Stock, Securities and Other Financial Instruments*, 184-4th TAX MGMT. VII.C.

trust administration fee is paid annually to the trustee of the bond issue. The rating agency may also charge a maintenance fee.

(6) Covenants. Typical covenants which are set forth in the credit agreement between the estate and the bank include the following:

(a) The estate cannot incur any additional indebtedness.

(b) The estate cannot permit the imposition of any liens on estate assets.

(c) The estate will provide monthly financial statements on the corporation or partnership.

(d) For so long as the estate owns its interest in the corporation or partnership, the business entity must maintain a minimum level of liquid assets.

(e) The estate can make no distributions other than to pay debt service or taxes.

(7) Collateral.

(a) Typically, collateral includes a pledge of the estate's stock or partnership interest and that of the heir to the stock or limited partnership interest and the estate's and the heir's interest, if any, in the corporate general partner of the partnership if it is a limited partnership.

(b) In addition, the heir to the corporate stock or the partnership interest probably will be required to guarantee the obligations of the estate to the bank that issues the letter of credit.

(8) Rev. Rul. 73-142.

(a) Tax planners are familiar with the so-called *Bosch* rule that state court decisions other than decisions by a court of last resort handed down after the time of the event giving rise to the tax (the date of the grantor's death in that case) are not binding for purposes of determining federal estate tax liability, but the federal court must apply what it finds state law to be after giving proper regard to decisions of other courts of the state.[86]

(b) Nevertheless, where a decree is handed down by a state court other than a court of last resort and the time for appeal has elapsed before the time of the event giving rise to the tax, its judgment is final and conclusive even though it might have been erroneous, and it is binding on the Internal Revenue Service.[87]

(c) Consequently, it appears that if a state court issues a decree finding that the estate's interest in the corporation or partnership is illiquid and directing that the estate borrow the funds required in order to pay estate tax, the Service may be foreclosed by such a decree. In other words, the decree may answer the question regarding the liquidity of the interest as well as the necessity of borrowing and the deductibility of the interest in full on the estate tax return under Section 2053.

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86 *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

87 Rev. Rul. 73-142 1973-1 C.B. 405.

B. Avoiding The Estate Tax.

1. Bequests to Charitable Lead Trusts.

a. In some cases, the family patriarch or matriarch owns virtually all of the stock or partnership interests; and in others, by virtue of either sales for adequate consideration or donative transfers or both, he or she owns only a partial interest in the corporation or partnership the balance of which is owned by family members.

b. In some of those cases, the matriarch or patriarch takes the view that the best solution to the problem of avoiding the payment of estate tax is to bequeath all of his or her remaining assets either outright to a charity or for the benefit of a charity through the use of a charitable lead trust.[88]

c. In some of those cases, the charity selected is not a public charity but is rather a private foundation.

d. Such arrangements not only avoid transfer taxes but also satisfy charitable inclinations while creating the opportunity for family members to realize significant benefits.

e. Caveat the Reverse *Chenoweth* Problem.

(1) In the case of closely held corporations, the funding of a marital deduction bequest with a control block of stock carries with it a premium.[89]

(2) The reverse situation, in which the decedent owned a controlling interest but bequeathed a non-controlling interest to charity, resulted in full valuation for estate tax purposes but valuation at a minority discount for charitable deduction purposes.[90]

(3) Hence, it should have come as no surprise that the same result obtained where the decedent owned a controlling interest, but the amount passing to a surviving spouse (by reason of disclaimer) was a minority interest.[91]

(4) Does the Limited Partnership Avoid the Problem?

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88 Gopman, The *Formula CLAT and the Super* Formula *CLAT: Estate Planning with Charitable Lead Annuity Trusts Established at Death*, 23 TAX MGMT. EST., GIFTS & TRUSTS J. 186, 203 (1998).

89 *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987).

90 *Ahmanson Foundation v. U. S.,* 674 F. 2d 761 (9th Cir. 1981).

91 *Estate of DiSanto v. Commissioner*, 78 T.C.M. (CCH) 1220, 1226 (1999). ("Petitioners contend that we must base the marital deduction on the value of Mr. DiSanto's controlling interest in MD&F stock. We disagree. An estate may deduct 'an amount equal to the value of...property which passes or has passed from the decedent to his surviving spouse...' The value of the marital deduction for a devised interest of stock of a closely held corporation equals the value of the interest that passes to the surviving spouse. [Citing authorities]. Thus, the marital deduction from Mr. DiSanto's estate is based on the value of the interest that passed from Mr. DiSanto's estate to Mrs. DiSanto."); Tech. Adv. Mem. 9403005 (October 14, 1993); Tech. Adv. Mem. 9050004 (August 31, 1990). *But see Jameson v. Commissioner*, 77 T.C.M. 1383 (1999), T.C.M. 1999-43, *vacated and remanded on other grounds*, 267 F.3d 366 (5th Cir. 2001), where the Tax Court held that minority shares used to fund a bequest to children could not be valued lower than the shares which funded the residuary marital bequest, frustrating the attempt to place more shares in the children's hands (The Tax Court distinguished the Jameson case from the DiSanto case on the ground that in the former case the spouse did not disclaim).

(a) The Nature of A Limited Partnership.

(i) The very nature of a limited partnership may avoid these issues.[92] The general partner of a limited partnership is responsible for the management and control of the partnership under the laws of the state in which it was organized.[93] The general partner owes fiduciary duties to the limited partners.[94]

(ii) The rights of limited partners are limited to the following: the right to information,[95] the right to vote on such matters as are provided in the partnership agreement[96] or state law, the right to agree to the continuance of the partnership after the withdrawal of the general partner,[97] the right to bring a derivative action,[98] and the right to approve the admission of an additional general partner.[99]

(iii) Limited partners, who enjoy limited liability, risk that limited liability by participation in management; but their role is essentially a passive one that is similar to that of minority shareholders in a closely held corporation.[100]

(iv) Accordingly, unless a limited partnership interest is held in conjunction with a general partnership interest or a controlling interest in a corporate general partner, the value of a limited partnership interest should be discounted from the value of the partnership's assets for federal transfer tax purposes.[101]

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92 *See* Robert R. Keatinge, *Transfers of Partnership and LLC Interests-Assignees, Transferees, Creditors, Heirs, Donees, and Other Successors*, 32 U. Miami Philip E. Heckerling Est. Plan. Inst., ¶ 500 (1998).

93 Rev. Unif. Ltd. Partnership Act § 403 (1976, Amended 1985) 6B U.L.A. 222; *Lifecare Centers of America, Inc. v. Charles Town Associates Limited Partnership*, 79 F.3d 496 (6th Circuit 1996); *U.S. v. Heffner*, 916 F. Supp. 1010 (S.D. Cal. 1996); *Hopper v. Commissioner of Taxation and Finance*, 637 NYS 2d 494 (1996); In Re Cincinnatian Limited 143 B.R. 108 (S.D. Ohio 1992). Unif. Ltd. Partnership Act § 406 (2001) 6A U.L.A. 434.

94 Rev. Unif. Ltd. Partnership Act § 403 (1976, Amended 1985) 6B U.L.A. 222; Unif. Ltd. Partnership Act § 408 (2001) 6A U.L.A. 439; *See also,* Kenneth M. Jacobson, *Fiduciary Duty Considerations in Choosing between Limited Partnerships and Limited Liability Companies*, 36 Real Prop., Probate & Tr. J. 1 (2001).

95 Rev. Unif. Ltd. Partnership Act § 305 (1976, amended 1985), 6B U.L.A. 206. Unif. Ltd. Partnership Act § 304 (2001) 6A U.L.A. 419.

96 Rev. Unif. Ltd. Partnership Act § 302 (1976, amended 1985), 6B U.L.A. 178.

97 Rev. Unif. Ltd. Partnership Act § 801(4) (1976, amended 1985), 6B U.L.A. 619; Unif. Ltd. Partnership Act § 801(3) (2001) 6A U.L.A. 466.

98 Rev. Unif. Ltd. Partnership Act § 1001(1976, Amended 1985), 6B U.L.A. 370; Unif. Ltd. Partnership Act § 1002 (2001) 6A U.L.A. 500.

99 Rev. Unif. Ltd. Partnership Act § 401 (1976, Amended 1985), 6B U.L.A. 213; Unif. Ltd. Partnership Act § 401(4) (2001) 6A U.L.A. 428.

100 Rev. Unif. Ltd. Partnership Act § 303 (1976, Amended 1985) 6B U.L.A. 180; *Duke & Benedict, Inc. v. Wolstein*, 826 F. Supp. 1413 (M.D. Fla. 1993); *Video Entertainment, L.P. v. Video USA Associates 1 L.P.*, 601 A.2d 724 (N.J. 1992); Hommel v. Micco, 602 N.E. 2d 1259 (Ohio App. 1991). No liability attaches even if the limited partner participates in management under the Unif. Ltd. Partnership Act § 303 (2001); 6A U.L.A. 418.

101 As the Court of Appeals for the 9th Circuit wrote in the Ahmanson case, *supra*, n.90 at 769, "The record simply does not contain support for the proposition that non-voting shares are sold at a discount when sold together in a package with sufficient

Therefore, the funding of either a credit shelter bequest or a bequest qualifying for the marital deduction should not be affected by the percentage limited partnership interest with which it is funded.

(b) Application of the Reverse *Chenoweth* Problem to Partnerships.

However, if the person who is the general partner or who owns a controlling interest in the entity that is a general partner also owns limited partnership interests at death, the general corporate rules would appear to apply with potentially catastrophic results. [102] The solution to this problem is to decontrol the position of the prospective decedent so that at death he or she does not own a controlling position.

2. The Excise Taxes on Self-Dealing.

a. The Internal Revenue Code imposes punitive excise taxes on "foundation managers" and "disqualified persons" of private foundations who engage in acts of self-dealing[103] and on private foundations which maintain "excess business holdings" in a business enterprise.[104]

b. With respect to the former, the term "self-dealing" is defined to mean, among other things, any direct or indirect sale, exchange, or leasing of property between a private foundation and a disqualified person; lending of money or extension of credit between a private foundation and a disqualified person; furnishing of goods, services, or facilities between a private foundation and a disqualified person; payment of compensation or reimbursement of expenses by a private foundation to a disqualified person; or transfer to, or use for the benefit of, a disqualified person of the income or assets of a private foundation.[105]

c. The term "disqualified person" is defined to mean, with respect to a private foundation, a person who is a substantial contributor to the foundation, a foundation manager, an owner of more than 20 percent of the voting power of a corporation or the profits interest of a partnership which is a substantial contributor to the foundation, a member of the family of any individual described above, or a corporation, partnership, or trust in which the ownership interests of the persons described above are more than 35 percent of the combined voting power, profits interest, or beneficial interest.[106]

d. A "foundation manager" is defined to mean, with respect to any private foundation, an officer, director, trustee, or responsible employee.[107]

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voting shares to give control. Indeed, it seems difficult to imagine how there could be a discount in such a case, as the buyer of the package would have the ability simply to recapitalize and remove the distinction in the classes of stock and thus the need for the hypothesized discount affecting the portion of the shares which theretofore were without voting rights." *See* also Treas. Reg. §25.2704-1(f), Example (5): "Because of a general partner's right to dissolve the partnership, a limited partnership interest has a greater fair market value when held in conjunction with a general partnership interest than when held alone." *See also* Byrle M. Abbin, INCOME TAXATION OF FIDUCIARIES AND BENEFICIARIES, Ch. 14, ¶ ¶ 1407, 1712 (2002 Ed.).

102 *See* Abbin, *supra*, n. 101.

103 I.R.C. § 4941.

104 I.R.C. § 4943.

105 I.R.C. § 4941(d).

106 I.R.C. § 4946(a)(1).

107 I.R.C. § 4946(b).

e. The "family" of any individual includes his or her spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of the afore-named descendants.[108]

3. The Estate Administration Exception to the Indirect Self-Dealing Rules.

a. Although the self-dealing rules encompass indirect self-dealing,[109] the term "indirect self-dealing" expressly does not include a transaction with respect to a private foundation's interest or expectancy in property held by an estate or a revocable trust, including a trust that has become irrevocable on the grantor's death, regardless of when title to the property vests under local law, if the following conditions are met:

(1) the administrator or executor of an estate or trustee of a revocable trust either has a power of sale with respect to the property, has the power to re-allocate the property to another beneficiary, or is required to sell the property under the terms of any option subject to which the property was acquired by the estate or the trust.

(2) the transaction is approved by the probate or such other court that has jurisdiction over the estate or trust or over the private foundation.

(3) the transaction occurs before the estate is considered terminated for federal income tax purposes or before the trust is considered to be a split-interest trust.

(4) the estate or trust receives an amount which equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate or trust.

(5) the transaction either results in the foundation's receiving an interest or expectancy at least as liquid as the one it gave up, results in the foundation's receiving an asset related to the active carrying out of its exempt purposes, or is required under the terms of any option which is binding on the estate or trust.[110]

4. Planning Opportunities.

a. The regulation cited above contains an example that suggests an interesting planning opportunity. It is set forth in full below:

> *Example* 4. A, a substantial contributor to P, a private foundation, bequeathed one-half of his estate to his spouse and one-half of his estate to P. Included in A's estate is one-third interest in AB, a partnership. The other two-thirds interest in AB is owned by B, a disqualified person with respect to P. The one-third interest in AB was subject to an option agreement when it was acquired by the estate. The executor of A's estate sells the one-third interest in AB to B pursuant to such option agreement at the price fixed in such option agreement in a sale which meets the requirements of

108 I.R.C. § 4946(d).

109 Treas. Reg. § 53.4941(d)-1(a).

110 Treas. Reg. § 53.4941(d)-1(b)(3).

sub-paragraph (3) of this paragraph. Under these circumstances, the sale does not constitute an indirect act of self-dealing between B and P.[111]

b. Several private rulings and articles of expert commentary[112] indicate that taxpayers have awakened to the benefits offered by that regulation and that example. In one of the rulings, the decedent had burdened his undivided interest in timber property with an option to purchase the property at fair market value determined by independent appraisal, and the option was held by a corporation owned by the decedent's son.

(1) The decedent was the founder of a private foundation which was the sole remaining beneficiary of his estate, and the decedent's son and daughter served on its board of directors.

(2) The Service ruled that because the exercise of the option met the five-prong test of the regulations, the sale by the estate and the purchase by the son's corporation would not be an act of self-dealing. [113]

c. In several other rulings, executors made sales of estate assets for installment notes prior to funding charitable lead annuity trusts ("CLATs").[114] Charitable lead trusts are subject to the self-dealing rules just as though they were private foundations.[115]

(1) In the ruling numbered 200124029, remainder interests in a testamentary QTIP trust passed to five CLATs the term of each of which was 21 years and the annuity amount with respect to which was described as the smallest amount that could be provided to produce a federal estate tax deduction equal to one hundred percent of the federal estate tax value of the assets of the CLATs.

(2) The executors proposed to sell interests in real estate and various real estate partnerships and corporations to a newly-formed limited liability company which would be owned by or

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111 Treas. Reg. § 53.4941(d)-1(b)(8).

112 Richard S. Franklin and Jennifer A. Birchfield Goode, *The Intermediary CLAT Alternative to the Residuary Estate Family Foundation Gift*, 39 ACTEC L.J. 355 (Winter 2013); Paul S. Lee, Turney P. Berry, and Martin Hall, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhorse*, 37 ACTEC L.J. 93 (Summer 2011); Donald R. Tescher and Barry A. Nelson, *The Frozen T-CLAT*, 33 TR. & EST. 33 (July 2004); Matthew J. Madsen, *Funding a CLAT With a Note Can Accelerate the Transfer of Wealth to Heirs*, 30 EST. PL. 495 (2003).

113 Priv. Ltr. Rul. 199930048 (May 6, 1999). The Service has issued other private letter rulings to the same effect where options were exercised by the option holder's tendering a secured promissory note, Priv. Ltr. Rul. 9724018 (March 17, 1997), or unsecured promissory notes, Priv. Ltr. Rul. 9818063 (February 4, 1998). *See also* Priv. Ltr. Rul. 8335114 (June 3, 1983); Priv. Ltr. Rul. 8026061 (April 3, 1980).

114 Priv. Ltr. Rul. 200232033 (May 16, 2002); Priv. Ltr. Rul. 200207029 (November 21, 2001); Priv. Ltr. Rul. 200124029 (March 22, 2001); Priv. Ltr. Rul. 200024052 (March 9, 2000); Priv. Ltr. Rul. 9501038 (October 6, 1994). *See also* Priv. Ltr. Rul. 8006029 (November 14, 1979). Interestingly, since 2011 the Service has published a no ruling position with respect to the estate administration exception to §4941 in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust. Rev. Proc. 2011-4, 2011-1 I.R.B. 123, §6.19; Rev. Proc. 2012-4, 2012-1 I.R.B. 125 §6.19; Rev. Proc. 2013-4, 2013-1 I.R.B. 126 §6.18; Rev. Proc. 2014-4, 2014-1 I.R.C. 125 §6,18; Rev. Proc. 2015-3, 2015-1 I.R.B.129 §3.01 (102); Rev. Proc. 2016-3, 2016-1 I.R.B. 126 §3.01 (110) Rev. Proc. 2017-3, 2017-1 IRB 130 §3.01 (112). Nevertheless, the Service has issued in addition to the aforementioned rulings the following that involved notes issued by disqualified persons: Priv. Ltr. Rul. 201129049 (April 26, 2011) noting that the ruling request was submitted prior to the publication of Rev. Proc. 2011-4; Priv. Ltr. Rul. 201206019 (November 5, 2011) noting that the ruling request was submitted prior to the publication of Rev. Proc. 2011-4; Priv. Ltr. Rul. 201448023-25, 27, 28, and 31 (September 4, 2014); Priv. Ltr. Rul. 201446024 (August 21, 2014); Priv. Ltr. Rul. 201445017 (August 14, 2014); Priv. Ltr. Rul. 201407021 (November 18, 2013); and Priv. Ltr. Rul. 201407023 (November 18, 2013).

115 I.R.C. § 4947(a)(2).

for the benefit of the decedent's children and their issue, in exchange for a secured promissory note which would bear interest at the applicable federal rate for the month in which the sale occurs, would have a term of not greater than 30 years, and would be secured by the real estate interests.

(3) Since the interests to be sold would be sold at their appraised fair market values, the note would bear a market interest rate, and the note would be secured by the property sold, the effect of such arms-length terms and conditions would be that the charitable beneficiaries would be in a position at least as favorable as their current position and would likely be in a more favorable position for the following reasons:

(a) The CLATs would be protected from fluctuations in the real estate market that might occur prior to the death of the decedent's wife because the note would fix the value of the CLATs' assets at the current value of the real estate interests and would fix the return of the CLATs through a fixed rate of interest, thus also protecting the CLATs from fluctuations in the results realized by operating the real estate.

(b) As a result of the proposed transaction, the cash flow of the CLATs would be improved and stabilized so that the CLATs would be better able to satisfy their annuity obligations. Without the sale, the CLATs would receive the real estate interests and would be required to engage in the real estate business. Rental income would be subject to market fluctuations, and the CLATs would be required to incur debt in order to sustain and grow the business. Thus, the net rental income of the CLATs would be subject to unknown future interest rates and to interest rate fluctuations. With the proposed transaction, the CLATs and their charitable beneficiaries would be less concerned about fluctuations in the real estate market and in interest rates since the income of the CLATs would be fixed in accordance with the terms of the note.

(c) The CLATs would receive property that would be at least as liquid as the property sold because the note would be negotiable and could be sold to a third party for cash at any time, the note would be secured by the real estate interests, and the LLC that would purchase the real estate interests would have substantial capital that would be available to satisfy the note payments to the CLATs.

(d) For all of the above reasons, the Service ruled that:

(i) The sale of the property of the estate to the related family members would not be an act of self-dealing.

(ii) The receipt and holding of the note by the CLATs and the payment of principal and interest on the notes by disqualified persons would not constitute acts of self-dealing.

(iii) The continued operation of the real estate businesses by the LLC or any other related family members, including borrowing against or selling assets pledged to the CLATs as collateral for the note and the acquisition of new assets, would not constitute acts of self-dealing so long as the value of the collateral remained as required by the terms of the note.

d. In the private letter ruling numbered 9501038, the decedent's will provided for two CLATs and two QTIP trusts the remainder of which was distributable to CLATs upon the death of the surviving spouse. The estate included all of the stock of an S corporation.

(1) The executors proposed that the decedent's widow create qualified sub-chapter S trusts[116] ("QSSTs"), and the executors proposed to sell the stock of the S corporation to the QSSTs at its appraised value for cash down payments and 15-year installment notes that bore interest at the applicable federal rate.

(2) It was represented that the court having jurisdiction over the estate would approve the sale and that the executors would distribute the notes to the QTIP trusts and the CLATs.

(3) The Service ruled that the regulatory exception applied so that the sale of the stock to the QSSTs in exchange for the promissory notes and the transfer of the notes to the CLATs would not constitute acts of self-dealing, nor would the payment by the QSSTs of the principal and interest on the notes constitute acts of self-dealing, nor would the holding of the notes by the CLATs and the receipt of payment of principal and interest on them constitute acts of self-dealing.

e. In three identical rulings,[117] the taxpayers created single-member LLCs and contributed their notes to the LLCs in exchange for voting and nonvoting units. The LLCs were to be engaged solely in passive investment activities, were not to engage in the operation of any business enterprises, and were to receive at least ninety-five percent (95%) of their gross income from passive investments. The taxpayers also created twenty-year CLATs and separate revocable trusts. Pursuant to the provisions of the revocable trusts, the nonvoting units in the LLCs were allocated to the CLATs. Then the taxpayers entered into option agreements granting their children and/or the business entities controlled by them and their families an option to purchase specific assets including the promissory notes and the nonvoting units from the current owners for a purchase price equal to the fair market value of those assets as determined for federal estate tax purposes, at any time within nine (9) months of the taxpayer's death. The purchase price was payable in cash, marketable securities, or a combination of both. The taxpayers represented that the exercise of the options and the underlying transfers and receipts of property would be approved by a court of competent jurisdiction as a condition of the transactions' closing. The Service ruled that:

(1) The transactions would not constitute impermissible acts of self-dealing for purposes of §§ 4941(a) and 4941(d)(1). The exercise of the option and the purchase of the assets subject to the option from a taxpayer's estate or revocable trust by the optionholders, the tendering of consideration by the optionholders to the taxpayer's revocable trust or estate, the receipt of such consideration by the taxpayer's revocable trust or estate, and the distribution of such consideration from the taxpayer's revocable trust or estate to the CLAT will satisfy the requirements for the exception to indirect self-dealing described in Reg. 53.4941(d)(1)(b)(3) and, therefore, will not constitute impermissible acts of self-dealing under § 4941.

(2) Neither (i) the exercise of an option and the related sale and purchase of the assets subject to the option between one or more disqualified persons as to a taxpayer's CLAT and the taxpayer's LLC nor (ii) the retention by that LLC of a note following the taxpayer's death will constitute indirect acts of self-dealing pursuant to Reg. § 53.4941(d)(1) and will not violate § 4941. If the optionholders fail to exercise their option after a taxpayer's death, the taxpayer's LLC would retain ownership of the note, and the taxpayer's CLAT would own nonvoting units in the LLC. Because the CLATs would not have control over the LLCs, any transactions between the LLC and a disqualified person of the CLAT, such as interest paid by disqualified persons to the LLC, would not be attributable to the CLAT. Therefore, the retention by the LLC of the note following the taxpayer's death would not be an act of indirect self-dealing between the CLAT or one or more disqualified persons under § 4941 of the Code or Reg. § 53.4941(d)(1).

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[116] I.R.C. § 1361(d)(3).

[117] Priv. Ltr. Ruls. 200635015, 200635016, and 200635017 (June 8, 2006).

(3) Because each LLC is excluded from the definition of "business enterprise" under § 4943(d)(3)(B) and Reg. § 53.4943-10(c)(1), the CLATs' nonvoting units will not constitute "excess business holdings" under § 4943.[118]

5. The Excess Business Holdings Rule.

a. Internal Revenue Code also imposes punitive excise taxes on the excess business holdings of private foundations.[119]

(1) The term "excess business holdings" means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.[120]

(2) "Permitted holdings" in a corporation or partnership which operates a business enterprise are 20 percent of the voting interest reduced by the percentage of the voting interest owned by all disqualified persons; but in any case in which all disqualified persons together own 20 percent or less of the voting interests, non-voting interests will also be treated as permitted holdings.[121] Permitted holdings increase to 35 percent if the private foundation and all disqualified persons together own 35 percent or less of the voting interest and effective control of the entity is held by others than disqualified persons.[122]

(3) In the case of gifts and bequests of an interest in a business enterprise, the private foundation has a period of five years within which to dispose of such interests.[123] The term "business enterprise" does not include a trade or business at least 95 percent of the gross income of which is derived from passive sources.[124]

b. In private letter ruling 9501038 discussed above, the reason for which the S corporation's stock had to be sold by the executors was that funding the CLATs with the stock of the corporation would result in the CLATs' having excess business holdings in violation of Section 4943.

c. By making the sale, the excess business holdings problem was avoided. A similar problem would arise if a decedent's estate held stock in a corporation or an interest in a limited partnership that qualified as a business enterprise. A corporation or a limited partnership that owned only investment securities would not appear to present the same problem.

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118 See also Priv. Ltr. Rul. 201407021 (November 18, 2013), Priv. Ltr. Rul. 201407023 (November 18, 2013), Priv. Ltr. Rul. 2014460244 (August 21, 2014), none of which involved CLATs.

119 I.R.C. § 4943.

120 I.R.C. § 4943(c)(1).

121 I.R.C. § 4943(c)(2)(A).

122 I.R.C. § 4943(c)(2)(B).

123 I.R.C. § 4943(c)(6).

124 I.R.C. § 4943(d)(3).

d. Similar results obtained in a more recent private letter ruling in which a husband and wife each created a revocable trust that provided for the creation of a marital and another trust for the benefit of, and for the creation of a CLAT and a charitable lead unitrust ("CLUT") upon the death of, the survivor.[125]

(1) The trustee of the charitable lead trusts and all of the other trusts was a child of the couple. It was expected that the charitable lead trusts would be funded by the stock of an investment company wholly owned by the husband's revocable trusts and by interests in other similar entities that would constitute excess business holdings in the hands of the lead trusts.

(2) It was expected that the stock or the assets of those entities would be sold after the death of the survivor. The purchasers of such assets could include the children of the settlors or entities which they owned or controlled.

(3) The charitable lead trusts contained powers of sale under the following explicit conditions:

(a) The sale is for fair market value.

(b) The value is determined by a qualified appraiser.

(c) The sale is approved by the probate court having jurisdiction over the trusts.

(d) The sale is completed prior to the time when the charitable lead trusts become subject to Section 4947.

(e) If notes are received as consideration for the purchase, they will be negotiable instruments, will be payable over a 10-year term, will bear interest at the payment rate of the CLAT or the CLUT that ultimately receives the note, and will be secured by the assets sold, and the sum of the cash and notes received will have the same appraised value as the assets sold.

(f) The charitable lead trust must receive assets at least as liquid as those sold.

(g) The buyer may be a disqualified person so long as the sale does not constitute self-dealing; and the transaction must be approved in a letter ruling issued by the Service.

(4) The Service ruled that:

(a) The charitable lead trust would not be deemed to become a split-interest trust until the expiration of a reasonable period for settlement after the death of the survivor of the settlors.

(b) The trustee of the revocable trust would have up to five years beyond the expiration of a reasonable period of settlement of such trusts within which to dispose of excess business holdings.

(c) The retention of notes of a disqualified person by the charitable lead trust would not constitute a business holding, assuming that such notes qualify as debt rather than equity in a business enterprise for federal tax purposes.

125 Priv. Ltr. Rul. 200024052 (March 9, 2000).

(d) The sale would not violate the self-dealing rules.

6. Jeopardizing Investments.

a. Penalty taxes are imposed on private foundations and foundation managers who make or participate in the making of an investment that jeopardizes the carrying out of any of the foundation's exempt purposes.[126]

(1) Generally, an investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation's managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, and providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.[127]

(2) However, the jeopardizing investment rule does not apply to an investment made by a person which is later gratuitously transferred to a private foundation.[128]

(3) A private foundation which changes the form or terms of an investment will be considered to have entered into a new investment on the date of such change so that a determination as to whether such change in the investment jeopardizes the carrying out of the foundation's exempt purposes is made at that time.[129]

b. In the private letter ruling numbered 200024052, the Service concluded that a charitable lead trust's receipt by gift and holding notes of disqualified persons is not a jeopardizing investment under the second of the regulations cited above.

7. The Strategy.

a. The strategy that is suggested by the regulations and rulings cited above is described in the form of letter attached as Exhibit I. The same strategy that works with an unrelated employee to whom the owner wants to sell the business at a bargain price is described in Exhibit II.

b. When using a charitable lead trust with an option to purchase from the decedent's estate, it is not possible to do effective generation-skipping planning with the lead trust.[130]

c. However, it is possible to do generation-skipping planning if the option to purchase is granted to a funded generation-skipping grantor trust.

8. Conclusion. Based on the foregoing regulations and private letter rulings, it is clear that business owners can avoid taxes by benefiting charities, including private foundations controlled by their family members.

a. It is also clear that even though a stream of income must be produced in order to fund the payments to charities by charitable lead trusts, family benefits may be derived from continued control of all or part of a business.

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[126] I.R.C. § 4944(a) and (b).

[127] Treas. Reg. § 53.4944-1(a)(2)(i).

[128] Treas. Reg. § 53.4944-1(a)(2)(ii)(a).

[129] Treas. Reg. § 53.4944-1(a)(2)(iii).

[130] I.R.C. § 2642(e). Priv. Ltr. Rul. 200107015 (November 14, 2000).

b. If the estate tax deduction is equal to or approximates 100 percent of the value of the assets ultimately destined for the charitable lead trust or the private foundation or all in excess of available estate tax credits, discounting the business interest[131] requires less of a distribution in order to fund the payments by the charitable lead trust because the cash flow distributed is a greater portion of the discounted value of the corporation or business interest.

c. Moreover, in addition to the benefits of continued operation of the business entity by family members, the amount of the discount may be realized by family members immediately after termination of the lead trust. Of course, any appreciation in the value of the entity's assets will redound to their benefit as well.

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[131] Rev. Rul. 93-12, 1993-1 C.B. 202.

MAYNARD COOPER & GALE PC
ATTORNEYS AT LAW

EXHIBIT I

DANIEL H. MARKSTEIN, III
DIRECT DIAL: 205. 254.1043
EMAIL: DMARKSTEIN@MAYNARDCOOPER.COM

September 13, 2018

Mr. John Deer

Dear John:

I want to describe in writing the plan that I outlined for your stock in XYZ Corp. an S corporation, during our meeting on May 10, 2018. Assuming that you own less than 50% of the outstanding common stock of XYZ Corp., and that your pro rata portion of the fair market value of its assets is $20,000,000, you would hold your stock for the rest of your life. Your will would provide that the stock would pass to a charitable lead annuity trust ("CLAT") of which the lead interest could be payable to your family foundation (or some other charity) and the remainder interest would be payable to your children.

The CLAT would last for a term of 20 years with an annuity set, based on prevailing interest rates (published monthly by the Internal Revenue Service) at the time of your death, at an amount that would result in the remainder interest's having a value of zero. That would mean that the estate tax value of the charitable deduction would be 100%, with no resulting estate tax. Your will would also grant an option to your children to purchase the stock from your estate at the fair market value thereof on the date of death, payable 20 years from date of purchase with interest only being payable annually in the interim. The purchaser(s) would get immediate access to and control of the stock, hopefully at a discount that would approximate 30%; but the purchaser would have to pay such interest as would be necessary in order to enable the CLAT to pay the annuity to the charity and to pay the CLAT's administration expenses.

For example, your children might buy your stock for $14,000,000. If they had to pay interest at the rate of 6.973% in order to enable the CLAT to pay the charitable annuity (based on the September, 2018 rate (3.4%) that is available for those dying in September of 2018), that would only be 4.88% of the value of their pro rata portion of the fair market value of all of the corporation's assets. Not only would your children control the stock immediately after exercising the option, shortly after the time of your death, but all that you would have to do during your lifetime would be to hold your stock. In short, it would not be necessary for you to engage in any legal or financial gymnastics during your lifetime. Just before the end of the 20-year term, your children would pay off the note; and, at the end of the term, your children, as the remainder beneficiaries, would receive a distribution of all of the assets of the CLAT. If and to the extent that interest rates rise during your lifetime, the amount of the annuity will increase, requiring a higher interest rate on the note and additional cash flow with which to fund it.

I call this the ultimate boot-strap purchase. It should enable your children to purchase your stock at a discount by paying nothing down and interest only at a favorable rate that is related to the rate at which the U.S. government borrows. Any post-mortem appreciation would redound to the benefit of your children. The children would own the stock, and through the board of directors they would control the distributions by the corporation. They would also control the family foundation and, therefore, also the distributions for charitable purposes of the amounts paid to the foundation by the CLAT. There would be no estate tax.

Please let me know what questions you have about this plan.

Best wishes,

Daniel H. Markstein, III

/pam

MAYNARD COOPER & GALE PC
ATTORNEYS AT LAW

EXHIBIT II

MEMORANDUM

TO: File
FROM: Daniel H. Markstein, III
RE: Testamentary CLAT/Restricted Stock Senario
DATE: May 9, 2016

Facts: Owner currently owns 100% of the Company, an S corporation. Assume that he contributes 3% to a section 501(c)(3) charity during his life[1] and dies owning 49% (see below for the remaining 48%). Alternatively, he makes gifts to friends and/or relatives of 3% or more subject to the option that is described below. Also, assume that he bequeaths his stock in the Company to a charitable lead annuity trust (the "CLAT") subject to the option that is described below. The term beneficiary is a designated charity and the remainder beneficiary is President. The CLAT will last for a term of 20 years. Owner's will provides President with an option to buy the stock from Owner's estate (the "Estate") at a price equal to the fair market value of the stock at Owner's death. President exercises the option and buys the stock from the Estate in return for a promissory note equal to the fair market value of the stock. The Estate then distributes the promissory note to the CLAT. The CLAT uses the interest payments on the note to make the annuity payments to the charity. At the end of the CLAT term, the CLAT distributes its only asset, the note, to the sole remainder beneficiary, President.

Starting as soon as practical, the Company grants President restricted (non-voting) stock in the Company equal to 4.8% of Company's stock each year for ten (10) years, for a total of 48%. The stock will not be considered a second class of stock if it is non-voting because the Regulations provide that "differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock."[2] The stock converts to voting stock on a date certain. The restrictions lapse on the first business day of the year following the first to occur of (1) the date of Owner's death or (2) January 1, 2028.

Contribution of Stock – The value of the stock owned by Owner at his death will be included in Owner's estate for estate tax purposes.[3] However, his estate will be entitled to a charitable deduction with respect to the bequest of the stock to the CLAT equal to the present value (determined using the

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1 Pursuant to I.R.C. §1361(c)(6), an organization which is described in section 501(c)(3) and is exempt from taxation under section 501(a) may be a shareholder in an S corporation. However, S corporation items flow through as unrelated business taxable income (UBTI), no matter what the source or nature of the income, and gain or loss on disposition of S corporation stock is treated as UBTI. The practical effect of this rule is that the charity will be subject to tax on the income attributable to its S corporation investment. As a result, the S corporation may have to distribute money and/or property so that such an exempt organization can meet its tax obligations.

2 Treas. Reg. §1.1361-1(l)(1). If all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

3 I.R.C. §2031 provides that "the value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

applicable section 7520 rate) of the annuity payments payable to the charity over the lead term of the CLAT.[4] If the amount of the estate tax deduction allowed to Owner's estate with respect to the bequest to the CLAT is equal to the present value of the annuity payments, the estate will receive a full deduction for the value of the stock included in Owner's estate. To calculate the present value of the annuity payments, section 7520 of the Code requires the use of an interest rate assumption equal to 120% of the applicable federal mid-term rate in effect under section 1274(d) for the month in which the valuation date falls (the "§7520 rate").[5] The §7520 rate for the month in which Owner dies cannot be predicted; therefore, the amount of interest payments necessary to cover the annuity payments cannot be predicted. However, the CLAT will include a formula clause[6] which provides that the annuity payments must have a present value equal to the full value of the property transferred to the CLAT, making the value of the remainder interest zero, which will result in a charitable deduction for Owner's estate equal to the full amount contributed to the CLAT.[7]

Sale of Stock – If at the time of Owner's death he owns less than 50% of the authorized and outstanding voting stock of the Company, a minority interest discount (as well as a lack of marketability discount) should be applied in order to determine the fair market value of the stock because it does not represent a controlling interest in the Company. Therefore, the value of the stock for purposes of calculating Owner's taxable estate will reflect the minority interest and marketability discounts, so that the purchase price and the amount of the annuity payment will be reduced. The Estate will take an income tax basis in the stock equal to this discounted fair market value because the basis of property in the hands of a person acquiring property from a decedent is the fair market value of the property at the date of the decedent's death.[8]

The gain from the sale of property is the excess of the amount realized over the adjusted basis in the property.[9] When President purchases the stock from the Estate, the Estate will realize zero gain because its basis in the stock and amount realized will be equal. The Estate takes a basis equal to the discounted fair market value of the stock at the time of Owner's death. When President purchases the stock for an amount equal to the discounted fair market value of the stock at Owner's death, the Estate will have an amount realized equal to its basis in the stock, and therefore the gain will equal zero.

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4 I.R.C. §2055(a)(2) provides that "the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises or transfers…" to charity. *See also* §2055(e)(2)(B) which provides that if an interest in property passes to a person described in §2055(a), and the interest is in the form of a guaranteed annuity, a deduction will be allowed.

5 I.R.C. §7520. The taxpayer may also use the most favorable of that rate or the midterm rate for either of the two months preceding the month in which the valuation date falls.

6 S*ee* PLR 199927031 for example of a formula clause: "the Trustee shall pay such annuity amount in each taxable year of the trust to Charity, using a term of ten (10) years, that will produce a present value under section 7520 of the Internal Revenue Code for the non-charitable remainder interest related to the trust equal to, or as close as possible as equal without exceeding, [a set amount]."

7 *See* PLR 199947022, where the IRS approved of a testamentary CLAT where the decedent's will provided that the annuity amount is to be equal to that percentage of the initial net fair market value of the assets of the CLAT (a%) as shall produce a guaranteed charitable annuity interest and estate tax deduction equal (or nearly equal as possible) in value to b% of the initial fair market of the entire trust fund, and is to be determined according to the formula set forth in that paragraph. *See also* PLR 200124029; PLR 2000043029.

8 I.R.C. §1014(a)(1).

9 I.R.C. §1001.

As in the case of the inter vivos CLAT scenario, President will recognize S corporation income with respect to the Company stock that he owns. He will also be entitled to a deduction for the interest payments on the promissory note. The CLAT will recognize income on the receipt of these interest payments, but it will also enjoy an income tax charitable deduction for any payments made to charity. At the end of the CLAT lead term, the CLAT will distribute its only asset, the note, to the sole remainder beneficiary, President. Any outstanding principal balance that exists when the CLAT terminates will be forgiven (which should not cause discharge of indebtedness income), and President will own the Company free and clear.[10]

Tax Consequences of Restricted Stock to President – Section 83 provides that when property is transferred to any person in connection with the performance of services, the person who performed such services must recognize as income the value of that property when it becomes transferable or when it is no longer subject to a substantial risk of forfeiture, whichever occurs first; the owner's basis is the amount paid for the property plus the amount includible in income by the service provider; and the owner's holding period begins at that time.[11] The amount of income recognized will be the excess of the fair market value of the property, determined without regard to restrictions other than those that will never lapse, over the amount paid for such property.[12] Conversely, until the property becomes substantially vested, no taxable event occurs; the recipient of the services (the employer) is treated as the owner of the property transferred; and any income from such property (such as dividends) received by the person who performed the services (an employee) is treated as additional compensation to the transferee.[13] The entity for which the services are performed may deduct for federal income tax purposes the income recognized, at the time when it is recognized, by the service provider.[14] Property is substantially non-vested when it is subject to a substantial risk of forfeiture and is nontransferable; and property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.[15]

When a Company issues stock that is substantially non-vested property (as defined in Treas. §§ 1.83-3(b)) to an employee and the employee does NOT make an election under § 83(b) to include the value of the stock in income, the stock is not treated as outstanding stock for S corporation purposes.[16] Until the stock becomes substantially vested, the employer is regarded as the owner of the stock; and any distributions received by the employee with respect to the stock are considered additional compensation income for the employee in the year of the distribution.[17]

Based on the foregoing rules, President will not recognize income on the restricted stock until the stock becomes substantially vested. Any dividends that are distributed with respect to the stock to President will be treated as additional compensation to President, and he will include this amount in his taxable income. Once the stock becomes substantially vested, President will recognize income equal to the value of the stock when it becomes transferable minus the amount paid for the stock. President's

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10 *See* I.R.C. §102(a) and TAM 9240003.

11 I.R.C. §83(a), (f); Treas. Reg. § 1.83-4(a) and (b).

12 I.R.C. §83(a); Treas. Reg. § 1.83-1(a)(1).

13 Treas. Reg. §.183-1(a)(1).

14 I.R.C. §83(h); Treas. Reg. §1.83-6(a).

15 I.R.C. §83(c); Treas. Reg. §1.83-3(b).

16 *See* Treas. Reg. §1.1361-1(b)(3).

17 *See* Treas. Reg. §1.83-1(a)(1).

basis in the stock going forward will equal the amount paid for the stock plus the amount includible in income.

Tax Consequences to the Company – If the Company is an S Corporation for federal income tax purposes, it will deduct such year an amount equal to the distributions with respect to the stock made to President while the stock is substantially non-vested, because the distributions will be treated as compensation income rather than a dividend. Once the stock is substantially vested, the Company will be entitled to a deduction equal to the amount that President is required to include in his income. If President is the sole shareholder of the Company, this deduction flows through to him, offsetting the income that he was required to recognize on the vesting of the stock.

Tax Consequences to Owner as Non-restricted Shareholder – Substantially non-vested stock is not treated as outstanding for S corporation purposes. The holder of such restricted stock is not allocated any of the S corporation's income or loss on account of being a shareholder. This leaves all of the corporation's income and loss to be allocated to the non-restricted shareholders. Thus, in the structure that is being proposed, if the Company will have two equal (for ease of illustration) shareholders, one who owns restricted stock (President) and one who owns non-restricted stock (Owner) and if the Company has $100 of taxable income of which it distributes $60 ($30 to each shareholder), the result would be as follows: the $30 distributed to President would be deemed compensation and includible in President's taxable income. The distribution would also give rise to a matching deduction for the Company, leaving $70 of undistributed income. Owner must include the $70 of the Company's income in his taxable income, and the basis of his stock in the Company will also increase by $70.[18] If the Company has no accumulated earnings and profits, the $30 distribution will result in a decrease in the basis of Owner's stock, but S corporation distributions are non-taxable to the extent of tax basis. Any distributions received after stock basis has been exhausted are treated as capital gain. Therefore, in this simple example, Owner's basis will be $40 and he will have not have to recognize capital gain as a result of this distribution.

S Corporation Eligibility Concerns – The fact that the employer, in this case the Company, is treated as the owner of restricted stock until it is substantially vested raises the interesting technical question whether the Company shall have terminated its S status due to the presence of an ineligible shareholder. There would also be a second-class-of-stock issue if S corporation income and loss items are allocable to unrestricted stock only. Fortunately, under the Regulations, stock that is substantially non-vested under section 83 is not treated as outstanding stock for S corporation purposes (including eligibility), and the holder of the stock (the Company) is not treated as an S corporation shareholder. Further, in Ltr. Rul. 9121037, the IRS ruled that the issuance of Class A voting shares and Class B non-voting shares to an executive, both of which are subject to a substantial risk of forfeiture, does not create a second class of stock if the executive refrains from making a section 83(b) election. Therefore, under the proposed scenario, the section 83 stock should not be a concern for the Company in terms of the S corporation eligibility rules.

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18 I.R.C. §1366(a)(1): in determining the shareholder's tax, there shall be taken into account the shareholder's pro rata share of the corporation's items of income, loss, deduction, or credit and non-separately computed income or loss; §1366(a)(2): in any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

19 I.R.C. §1368(b)(1).

20 I.R.C. §1368(b)(2).

21 Treas. Reg. §1.1361-1(b)(3). *See also* PLR 200118046, where the IRS ruled that the issuance of nonvoting stock does not create a second class of stock, and that key employees receiving the stock are not considered shareholders until the end of the vesting period.

22 The restriction was that the shares will be forfeited if the executive resigns or his employment is terminated for cause before they vest. From the date of their issuance and until they vest, the shares cannot be sold, assigned, transferred, pledged or otherwise encumbered by the executive other than by will or by the law of descent and distribution.

III. NOTES ON NOT SO RECENT DEVELOPMENTS UNDER SECTION 6166

A. Rev. Rul. 2006-34

The Internal Revenue Service addressed the treatment of real property interests as interests in closely-held businesses under § 6166 in Rev. Rul. 2006-34, 2006-26 IRB (June 26, 2006). In that ruling, the Service answered the question whether in each of five separate fact situations the real estate owned by the decedent qualified as an active business for purposes of § 6166.

The context in which the issue arises is that in order to qualify to elect the extended payment of the estate tax under § 6166(a)(1), and in order to determine the closely-held business amount, the value of an interest in a business does not include the value of that portion of the interest that is attributable to passive assets held by the business. Section 6166(b)(9)(A). The term passive asset is defined as an asset other than an asset that is used in carrying on a trade or business. Section 6166(b)(9)(i). In its analysis, the Service noted that, in determining whether the activities of the decedent or an entity that the decedent owned constituted an active trade or business, the activities of agents and employees of the decedent or the entity are taken into consideration. It also recognized that third parties, such as independent contractors, conducting some of the activities will not prevent the business from qualifying as an active trade or business if the extent of the activities of the third party are not of such a nature that the activities of the decedent or the decedent's entity and their respective agents and employees are reduced to the level of merely holding investment property. It went on to observe that, if a decedent or the decedent's entity uses an unrelated property management company to perform most of the activities associated with the real estate interest, that fact suggests that an active trade or business does not exist.

The Service announced that it would employ a facts-and-circumstances test in order to determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business. In so doing, it will consider the following non-exclusive list of factors:

1. The amount of time that the decedent or the agents or employees of the decedent or his entity devoted to the trade or business.

2. Whether an office was maintained from which the activities of the decedent or his entity were conducted or coordinated and whether the decedent or the agents or employees of decedent or his entity maintained regular business hours for that purpose.

3. The extent to which the decedent or the agents and employees of the decedent or his entity was actively involved in finding new tenants and negotiating and executing leases.

4. The extent to which the decedent or the agents and employees of the decedent or his entity provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises.

5. The extent to which the decedent or the agents and employees of the decedent or his entity personally made, arranged for, performed, or supervised repairs or maintenance to the property (whether or not performed by independent contractors), including painting, carpentry, and plumbing.

6. The extent to which the decedent or the agents and employees of the decedent or his entity handled tenant repair requests and complaints.

Based on the foregoing, the Service issued the following rulings:

Situation 1. At the time of death of A, he owned a ten-store strip mall titled in his name. A personally handled the day-to-day operation, management, and maintenance of the strip mall. A also handled most repairs. When A was unable personally to perform a repair, A hired a third-party independent contractor and reviewed and approved the work performed. A's ownership of the strip mall qualified as an interest in a closely-held business for purposes of § 6166. The result would have been the same if the strip mall had been held in a single-member LLC owned by A and the LLC were a disregarded entity.

Situation 2. At the time of death of B, he owned a small office park titled in his name. The office park consisted of five separate two-storey buildings, each of which had multiple tenants. B hired a property management company in which he had no ownership interest to lease, manage, and maintain the office park; and B relied entirely on the property management company to provide all necessary services. The management company's employees performed the following duties: advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. The management company provided a monthly accounting statement to B, along with a check for the rental income, net of expenses and fees. B was not a proprietor of an active business, and his interest in the office park did not qualify as an interest in a closely-held business for purposes of § 6166.

Situation 3. The facts are the same as in Situation 2 except that C owned 20% in value of the stock of the property management company. Because C owned a significant interest in the property management company, its activities with regard to the office park allowed C's interest in the office park to qualify as an interest in a closely-held business for purposes of § 6166.

Situation 4. At the time of D's death, his assets included a 1% general partnership interest and a 20% limited partnership interest in a limited partnership. The limited partnership owned three strip malls that together constituted 85% of the value of the limited partnership's assets. Per the partnership agreement, D, as the general partner, was required to provide the limited partnership with all services necessary to operate the limited partnership's business, including daily maintenance to and repairs of the strip malls. D was paid an annual salary for his services as general partner. Either personally or with the assistance of employees or agents, D performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing, and approving the work of third-party independent contractors for such work), and making decisions regarding periodic renovations of the strip malls. Because the strip malls were used in carrying on the partnership's active trade or business, they were not passive assets under § 6166(b)(9), and their value is not excluded from the value of D's interest in the partnership for purposes of § 6166. D's interest in the limited partnership qualifies as an interest in a closely-held business for purposes of § 6166. The determination of whether the limited partnership was carrying on a trade or business for purposes of § 6166 is made with reference to the partnership's activities. By reason of the activities of D on behalf of the limited partnership, the limited partnership carried on an active trade or business. Because D owned at least 20% of the partnership, the conclusion would be the same even if D's activities were instead performed by another employee, partner, or agent of the partnership.

Situation 5. At the time of E's death, he owned 100% of the stock in a corporation that operated an automotive dealership. E made all of the decisions regarding the dealership, including the approval of advertising and marketing promotions, management and acquisition of inventory, and dealing with personnel matters. E also owned real property on which improvements were constructed for the dealership. E leased the real property to the dealership under a net lease, and the dealership's employees performed all maintenance of and repairs to the real property. The dealership corporation was conducting an active trade or business at the time of E's death. Consequently, E's 100% stock interest in the dealership corporation qualifies as an interest in a closely-held business. Additionally, the real property was used exclusively in a business of the dealership under a net lease. Because E owned a significant interest in the dealership whose activities with regard to the real property constituted active management, E's interest in the real property also qualifies as an interest in a closely-held business.

For an excellent analysis of this ruling, *see* Keith Schiller, "IRS Clarifies, Liberalizes and Pragmatically Applies § 6166 to Real Estate," 31 TAX MGM'T. EST. GIFTS & TR. J. no. 5 (Sept. 7, 2006). The ruling was applied in PLR 200842012 (July 18, 2008), in which the Service examined the breadth of § 6166 to determine whether the corporation constituted an active trade or business. In this ruling, the Decedent owned A shares of Class A voting Common Stock; B shares of Class B Nonvoting Common Stock; [and] C shares of Partially Convertible $0.10 Par Value in the corporation at issue. The corporation at issue owned, developed, managed, and leased various types of property, including commercial, office, manufacturing, light industrial, residential and storage space. The employees of the corporation handled all business aspects, including: collecting common area maintenance charges, maintaining and recording business transactions, balancing ledgers, preparing reports on the commercial properties, locating tenants, negotiating leases, and handling tenant problems and requests.

The corporation also employed a facilities team. The responsibilities for this team included day-to-day repairs, maintenance, general upkeep, functioning of the business systems, and performing or overseeing maintenance, repairs, construction, renovation, janitorial services and landscaping. Additionally, the facilities team was responsible for demolition, excavation, grading, asphalt and street repairs. The team also supervised the landscape contractor and negotiated the contract.

For the administrative duties, the corporation employed secretarial, accounting and clerical staff. This staff conducted receptionist duties, bookkeeping services, rent collection, and payment of bills. The corporation also employed a controller who oversaw the accounting functions, prepared and presented financial reports. Overseeing the general operation of the corporation were the Corporate Executive Officer and Corporate Operating Officer who both were family member shareholders, working full time for the corporation.

With the exception of the facilities personnel, all of the corporation's employees worked in the corporation's office which was open during regular business hours. The facilities personnel worked in the facilities shop and the facility manageR and coordinator split their time between the shop and the office.

Based on the facts presented, the Service found that the corporation was an active business, not just an entity managing assets. The Service found that the facts of this ruling satisfied the factors required by Rev. Rul. 2006-34; the corporation maintained a business office with regular hours, and the daily activities included negotiating leases, managing tenant requests and concerns, and maintenance of the properties are overseen or performed by corporate employees. Based upon these factors, the Service found the corporation to be actively involved in trade or business within the meaning of § 6166(b)(1)(C).

The second issue considered whether the decedent's stock in the corporation qualified as an interest in a closely held business within the meaning of § 6166 (a)(1). Upon the decedent's death, the corporation had fewer than forty-five shareholders. The stock was owned by the decedent and decedent's granddaughters, as well as various trusts. With regard to the trusts, the trust beneficiaries all had present interests in the trusts. Under section 6166(b)(2)(C), the property owned by a trust where a beneficiary has a present interest in that trust will be considered as owned by that beneficiary. Therefore, due to the actual number shareholders at the time of decedent's death, the estate qualified as closely held business under § 6166(b)(1)(C)(ii).

B. Private Rulings

Some private rulings and Chief Counsel's advice issued around the time of publication of Rev. Rul. 2006-34 addressed a late 6166 election, the acceleration of the tax by reason of the termination of the deferral, and the time within which the Service can obtain security for the payments due after a 6166 election.

1. Late Election

In the first of those, CCA 200628042 (June 15, 2006), an estate elected on its untimely-filed estate tax return to pay a portion of the estate tax in installments under § 6166. The estate had reasonable cause for its failure timely to file. It was granted a 6166 election to pay the estate tax in installments, but it failed to make the first required payment after having failed to request an extension of time under § 6161 to make the late payment. The estate appeared to have reasonable cause for not making the prescribed payment on the due date. The issues were whether there is a reasonable cause exception for denial of a § 6166 election because (1) it was made in connection with an untimely-filed estate tax return and (2) whether reasonable cause may be considered by Appeals whenever there has been a late installment payment under § 6166.

With respect to the first issue, the Chief Counsel advised that, because the tax return was not timely filed, the 6166 election was not timely made; therefore, the election was not valid. While § 6651 specifically provides a reasonable cause exception to those taxpayers who fail to pay the tax shown on the return when due, there is no similar reasonable cause exception under § 6166. Thus, there is no reasonable cause exception for the denial of a § 6166 election made in connection with an untimely-filed estate tax return.

With respect to the second issue, after noting that an extension of time to pay under § 6161(a)(1) may be authorized for an installment payment due under a § 6166 election for up to one year from the date when the tax is due and that under § 6166(a)(2) the Service may extend the time for payment of estate tax deferred under § 6166 for a reasonable period that does not exceed ten years from the date from the tax is due upon a showing of reasonable cause, the Chief Counsel concluded that in the present situation the taxpayer neither timely paid the amount due nor paid the amount within six months of the due date nor sought an extension under § 6161 of time to pay the amount due. Because § 6166 does not provide a reasonable cause exception under any circumstance, Appeals may not consider whether the taxpayer had reasonable cause for the late installment payment, and the Service was entitled to issue notice and demand to terminate the taxpayer's installment privileges. Even if the estate tax return was not timely filed, the estate may elect to pay a deficiency in installments under § 6166; if the deficiency is not due to negligence, intentional disregard of the rules and regulations, or fraud. CCA 200909047 (February 27, 2009).

Early in 2007, a private letter ruling addressed and denied a request for relief to extend the time for making a § 6166 election. In PLR 200721006 (February 14, 2007) a personal representative of an estate, under Reg. § 301.9100-3, requested an extension for filing an election under § 6166. Alternatively, the personal representative requested that the Service consider the § 6166 election a procedural directive and grant it on the basis of the substantial compliance doctrine.

The Service denied both requests. With regard to the first request, the Service noted that the election to pay estate taxes by equal installments, based on § 6166(d), must be made no later than the time prescribed by § 6075(a) of the Internal Revenue Code for filing the estate tax return. Section 6075(a) requires the returns to be filed within 9 months after the date of the decedent's death. Since a statute prescribes the due date for an election under § 6166, by definition, this election is a statutory election within the meaning of Treas. Reg. §301.9100-1 (b). Additionally, no regulations prescribe the due date for a § 6166 election.

The Service also noted that Treas. Reg. §20.6166-1(b) provides that an election under § 6166(a) is made by attaching certain information to a timely filed estate tax return. However § 6075 prescribes what makes an estate tax return timely, making the due date only determinable by reference to the statute. The mere incorporation of a statutory due date in a regulation will not change a statutory election into a regulatory election. Therefore, the Service ruled that Treas. Reg. §301-9100.3 did not apply in this case since the regulation was not applicable to statutory election, but only to certain regulatory elections.

The Service also declined to consider the § 6166 election as a procedural directive and therefore found that the 'substantial compliance' doctrine did not apply in this context.

2. Termination of Deferral

A second private letter ruling, PLR 200613020 (Dec. 14, 2005), dealt with whether a distribution of a partnership interest from a testamentary trust will terminate the § 6166 extension of time for payment of the tax. The trust was funded with an interest in a partnership which engaged in forest products ownership, harvesting, and sale; and it also invested in other real estate and securities. As permitted under the will of the decedent, the decedent's daughter had the right upon request after attaining specified ages to withdraw assets from the trust, including part of her interest in the partnership.

According to § 6166(g)(1)(A), if any portion of an interest in a closely-held business that qualifies for the § 6166(a) election is distributed, sold, exchanged, or otherwise disposed of, or money or other property attributable to such an interest is withdrawn from such trade or business and the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50% of the value of the closely-held business, then the extension of time for payment of the tax will cease to apply and the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Secretary. However, § 6166(g)(1)(D) provides that the foregoing provision does not apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive the property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent.

The Service ruled that, under § 6166(g)(1)(D) and Reg. 20.6166A-3(e)(1), transfers of property to a person entitled to receive such property under the decedent's will or a trust created by the decedent will not cause the acceleration of the deferred portion of the estate tax. Accordingly, the distribution of the trust to the beneficiary of part or all of the partnership interests held in trust in response to the beneficiary's written request did not cause the cessation of the extension of time under § 6166(a) for the payment of the estate tax.

3. Time When Security Can Be Required

In CCA 200627023 (May 19, 2006), an estate properly elected on its timely-filed estate tax return to pay a portion of the estate tax in installments under § 6166. The period of limitations on assessment had expired and the Service had issued a closing letter to the executor of the estate. The estate had not yet provided a bond under § 6165 or granted the Service a lien in lieu of bond under § 6324A. The Service had not yet granted the estate the Section 6166 election. The Service sought security for the unpaid tax. The Chief Counsel advised that:

a. There is no limitations period under the Code for obtaining security from a taxpayer who elects to pay the estate tax in installments under § 6166 as long as the assessment remains unpaid.

b. While § 6501 sets forth a three-year period of limitations on assessment of estate tax, the Service's ability to demand that the taxpayer provide security under § 6166(k)(1) with respect to the deferred payment is separate and distinct from the Service's ability to assess a tax. Thus, the Service may demand security at any time, notwithstanding, or even after, the period of limitations on assessment has expired, so long as the assessment remains unpaid.

c. Issuing a closing letter to the executor of the estate will not prevent the Service from obtaining a surety bond under § 6165 or a special lien under § 6324A from the taxpayer. Interestingly, the Chief Counsel observed:

> "We believe the Service may seek security, or additional security, for the Section 6166 election at any time, including instances where the security may no longer sufficiently secure the Service's interest. This is so because, once the Service has granted the Section 6166 election, the estate tax liability is not currently due and payable. Without security, the Service's interest in the estate tax liability would be insecure for the duration of the deferral under § 6166. Just like a lender, the Service has the ability to seek security to shelter its unprotected interest during the period of time the estate tax liability is deferred."

C. Estate of Roski

In the spring of 2007, the Tax Court decided *Estate of Edward P. Roski v. Comm'r*, 128 T.C. 113 (2007). Decedent's estate filed an estate tax return to which was attached a notice of election under § 6166. In response, the Commissioner notified the executor of the decedent's estate that because of the election the estate was required either to post a bond or in lieu thereof to elect to provide a special lien under § 6324A. The estate then requested that the Commissioner exercise his discretion not to require either the posting of a bond or the imposition of the special lien, giving as reasons the following:

1. The estate had explored the possibility of posting a bond but was unable to find a bonding company willing to underwrite the amount in question for the duration of the ten-year installment payment period; and, even if the estate were able to obtain a bond, the estate's advisors believed that the cost would be prohibitive.

2. The assets of the estate included interests in a well-established family-owned business which benefitted from continuity of management.

3. The decedent's son, who was the executor of his estate, was a highly respected businessman who at all times had fulfilled his tax obligations.

4. The government already had security for the payment of the estate's deferred taxes in the form of the general statutory estate tax lien provided for under § 6324.

5. The imposition of a special lien in lieu of a bond would adversely affect the estate's ability to carry on the closely-held businesses that ultimately would have to provide the funds from which the estate's deferred taxes would be paid.

6. The imposition of a special lien against the estate's assets would violate covenants and partnership agreements that would affect the estate's interests in those assets and could lead to litigation forcing the estate to sell its properties.

The Commissioner responded by issuing a notice of determination that the estate could not make a § 6166 election, and the attached explanation took the position that the estate had failed to fulfill the requirements for the § 6166 election in that it had failed to provide a bond or the special section 6324A lien. The estate filed a petition for declaratory judgment under § 7479, and the matter came before the court on cross motions for summary judgment. Pointing out that the Commissioner had changed his position regarding whether a bond is required for a § 6166 election four times over the prior 15 years, the court noted that the Commissioner's determination to require security for all § 6166 elections was made in response to the recommendation of the U.S. Treasury Inspector General for Tax Administration, TIGTA Rept. 2000-30-059. That report included findings that 93% of the total outstanding estate tax balances were not secured by a bond or a special lien for the full term of the agreement, that the Commissioner was attempting to collect $177,000,000 in overdue tax balances involving 187 defaulted installment agreements that had not been secured by bonds or liens, and that $50,000,000 due from 252 estates that had defaulted on installment agreements not secured by bonds or liens was no longer collectable. The TIGTA report recommended that the Commissioner secure his interest in all § 6166 deferrals with either bonds or special liens.

The court went on to hold that it had jurisdiction under § 7479 to review the Commissioner's determination that the estate did not qualify for the § 6166 election because it did not meet the Commissioner's requirement of a bond or a special lien. While the court agreed that the Commissioner should be able to consider factors such as administrative convenience and revenue collection, it also held that the Commissioner had arbitrarily failed to exercise his discretion and was not permitted to impose a bright-line bond requirement and denied both parties' motions for summary judgment.

D. Notice 2007-90

In response to the *Roski Estate* case, the Service issued Notice 2007-90, 2007-46 IRB 103 (October 29, 2007) announcing a change in policy. It noted that under § 6324(a) a general federal estate tax lien arises upon the decedent's date of death and attaches for a period of ten years to all assets of the gross estate, a lien that cannot be extended beyond the ten-year period following the date of death. Consequently, when an estate qualifies and elects under § 6166 to pay the estate tax over a period of up to 14 years, the government's interest in the deferred estate tax is secured by the general federal estate tax lien for only the first 9 years and 3 months of the installment, leaving the government's interest unsecured for the remaining 4 years and 9 months of the installment payment. It observed that in most cases approximately one-half of the total deferred estate tax still remains to be paid during that final unsecured portion of the deferral period. It went on to give notice that the Treasury Department and the Service were in the process of establishing standards to be applied on a case-by-case basis in the future to identify those estates making a § 6166 election in which the government's interest in the deferred estate tax and the interest thereon is deemed to be sufficiently at risk to justify the requirement of a bond or special lien. Finally, the Service announced that it would consider the following factors in determining whether deferral of installment payments of estate tax under § 6166 poses a sufficient credit risk to the government to justify the requirement of a bond or special lien and that it would consider all relevant facts and circumstances in addition to the following factors:

1. Duration and stability of the business.
2. Ability to pay the installments of tax and interest timely.
3. Compliance history.

The notice was made applicable to each estate (1) that timely makes a § 6166 election and that timely files a return on or after November 13, 2007, (2) whose return was being audited by the Service as of April 12, 2007, or (3) that currently was in that deferred period but that had not yet provided a bond or special lien, (a) if the general federal estate tax lien will expire within two years from November 13, 2007 or (b) the IRS reasonably believed that the government's interest in collecting the deferred tax and interest thereon in full is sufficiently at risk to require a bond or a special lien.

Comments were requested by January 14, 2008 with regard to 5 issues:

1. What factors, in addition to or in place of those stated above, should the IRS use in determining whether to require a security from an estate electing to pay the estate tax in installments under § 6166?

2. How often during the § 6166 installment payment period should the IRS re-evaluate whether the estate poses a sufficient credit risk to the government's collection of the deferred estate tax and related interest to justify the requirement of a bond or special lien?

3. What facts evident from a review of the estate tax return are likely to be reasonably accurate predictors of either a future default or a full payment of the deferred tax payments and related interest?

4. What additional financial information should the IRS require from an estate to assist in making the determination as to whether the estate poses a sufficient credit risk to the government with regard to the deferred estate tax and interest thereon to justify requiring a bond or special lien?

5. For purposes of §§ 6165 and 6166(k), should the IRS define a surety bond under § 7101 also to include other forms of security; and, if so, what other forms of security, such as certain irrevocable letters of credit from reputable financial institutions or U.S. Treasury bonds should be so included?

E. The Section of Real Property, Trust and Estate Law Comments

On January 14, 2008, the ABA Section of Real Property, Trust and Estate Law (the "Section") filed comments in response to the Notice 2007-90.

After making some legislative proposals, the Real Property, Trust and Estate Law Section offered the following replies to the questions posed in the Notice:

1. What factors, in addition to or in place of those stated in the Notice, should the Service use in determining whether to require a bond or a special lien from an estate electing to pay the tax in installments under § 6166? The Section suggested these factors:

a. Whether the estate controls the business.
b. The Executor's potential personal liability for the deferred estate tax.
c. Elections reducing the § 6166 deferral period to less than fifteen years. In this case, there should be an absolute policy of not requiring a bond or a special lien because the due date for all payments is within the period during which the § 6324 general lien is viable.

2. How often during the § 6166 installment period (or on what occurrences) should the Service re-evaluate whether the estate poses a sufficient credit risk to justify the requirement of a bond or a special lien? The Section's position is that the Service should not make such a re-evaluation until the earlier of the occurrence of a default or one year before the expiration of the general estate tax lien with the reporting of an adverse event in the annual § 6166 notification.

3. What facts evident from a review of the estate tax return are likely to be reasonably accurate predictors of either a future default or full payment of a deferred tax payment and interest? The Section places great emphasis on the appraisal that should be attached to the estate tax return. In addition, if the estate tax return is audited, information about the company and its financial data should enable the Service to make an evaluation of the business' financial stability, cash flow, tax compliance history, and ability to make the required installment payment of the tax.

4. What additional financial information should the Service require from the estate to assist in making the determination as to whether the estate poses a sufficient credit risk to justify the requirement of a bond or a special lien? Noting that the Service already has in place a procedure with respect to each installment payment date prior to each anniversary date of the regular estate tax due date to require the executor to certify that the estate tax due had not been accelerated due to distributions or dispositions under § 6166(K), the Section recommended:

a. Annual certification of non-default of other financing.
b. Providing income tax/information on the returns for the estate and the business.
c. Additional § 6166(g)(2) payments on the deferred estate tax equal to the undistributed income of the estate.

5. Should the Service define a surety bond also to include other forms of security, and, if so, what other forms should be included? The Section's position is that the Service should define a surety bond to include other forms of security, such as letters of credit from reputable financial institutions and personal guarantees from credit-worthy ultimate beneficiaries of the estate. These alternate forms of security should be alternatives that are available to the taxpayer at his election.

F. Collateral for the Special Lien

In three private rulings, the Service addressed the question where the stock in a closely-held corporation, CCA 200747019 (October 11, 2007), or an interest in an LLC, CCA 200803016 (October 11, 2007) and PLR 200845023 (August 8, 2008), should be accepted as collateral for the § 6324A special lien. In both CCAs, the Chief Counsel concluded that, if the statutory requirements were met, the collateral proffered must be accepted. In the former CCA, the Chief Counsel pointed out that § 6324A(c)(1)(A) provides that the collateral offered to secure the special lien may be an interest in real and other property, and that stock in a closely-held corporation or an interest in an LLC qualifies as such other property. Nevertheless, a prerequisite is that the three statutory requirements of §§ 6324A(b)(1) and (2) must be met:

1. The collateral must be expected to survive the deferral period.
2. The collateral must be identified in the agreement.
3. The value of the collateral must be sufficient to pay the estate tax plus the interest payable over the first five years of the deferral period.

The Chief Counsel described the first of those requirements and the underlying risk as follows:

> First, the stock in a closely-held corporation must be expected to survive the deferral period. This means that the corporation must survive the deferral period and retain value. To determine whether a corporation will survive the deferral period, the Service should first value the business, i.e., the closely-held corporation, based on the relevant financial information provided by the estate. It is incumbent upon the estate to provide the Service with all relevant financial information, including appraisals, annual reports, and any relevant financial document, in order for the Service to adequately value the closely-held business. IRM § 4.48.4. provides guidelines for valuing a business. Professional judgment should be used to select the best valuation method. Using the results from its valuation, the Service must then judge whether the business can be expected to survive the deferral period. There is a risk that the Service may err in its conclusion, but Congress intended that the Service bear such a risk. Comm. on Ways and Means, 94th Cong., Background Materials on Federal Estate and Gift Taxation 302 (Comm. print 1969). ("[T]he Government will not only permit the deferral of taxes, but will bear part of the risk that the illiquid asset may decline in value during the deferral

period"). If Congress had intended that the Service be assured payment, Congress would have required that a bond be provided to the Service for deferred estate taxes.

The Chief Counsel then stated that, if the three statutory requirements of § 6324A are met, then the special lien arises and the collateral must be accepted by the Service. He also pointed out that, by enacting § 6324A(d)(5) and giving the Service the authority to demand additional collateral when the initial collateral declines in value, Congress chose to reduce rather than eliminate the risks to the Service.

He also observed that the Service has statutory rights to require relevant financial information from the estate to continue to monitor the value of the accepted stock as collateral during the deferral period and could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period. If the estate refused the Service's request for information, the Service could require that additional collateral be posted, and if the estate refused to provide additional collateral, the Service could accelerate all deferred payments.

In short, the Chief Counsel took the position that the decision of whether to monitor and the procedure for monitoring the sufficiency of collateral is a business decision to be made by the Service. Nevertheless, he strongly recommended that the Service monitor the sufficiency of the collateral securing the special estate tax lien during the deferral period, such as, for example, requiring that the estate provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period.

Although less expansive than the former, the latter CCA reached the same conclusions. The Chief Counsel also noted that, although there was no authority for the Service to substitute the § 6324A(c) written agreement for a pledge and escrow agreement, the estate had submitted a proposed pledge and escrow agreement that reiterated the matter that would be contained in the required § 6324A(c) written agreement; but it also required the estate to provide annual reports or certified financial statements to the Service on or before April 15 of each year during the term of the agreement and required the estate to assign its interest in the LLC to the attorneys for the executors as escrow agent. The Chief Counsel went on to recommend that, in addition to filing a notice of federal tax lien with respect to the special estate tax lien on the stock, the Service take physical possession of the stock certificates and that, if only non-certificated LLC membership interests existed, they be assigned to the Service.

Similarly, in PLR 200845023, the Service ruled that the decedent's interest in an LLC qualified as an interest in a closely-held business within the meaning of § 6166(b)(1) and was not a passive asset within the meaning of § 6166(b)(9). However, it also concluded that the federal estate tax attributable to a tenant-in-common interest in real property owned by the LLC with respect to which neither the decedent nor the LLC provided any management services was a passive asset so that the federal estate tax attributable to the value of that real property could not be paid in installments. In another CCA, the Chief Counsel advised that debt incurred over 15 years by the decedent's son's company to the decedent's company for operational services, administrative support, equipment use, and services was a passive asset. CCA 200928037 (July 10, 2009).

G. Interest

In CCA 200909044 (February 27, 2009), the Chief Counsel concluded that the maximum value of required property under § 6324A always includes the amount of interest expected to become payable over the first four years of the deferral period and that, if using a flat 2% rate results in an amount that is less than or equal to 45% of the underpayment interest rate, it was legally permissible.

H. Summary

All of the foregoing public and private pronouncements are summarized in a Chief Counsel's memorandum that was issued on February 25, 2009 and designated as Program Managers Technical Advice (PMTA 2009-046). These issues are addressed in question and answer form, as follows:

1. Can the required bond or lien amount include accrued interest on the tax?

The required bond or lien amount may include accrued interest on the tax. This required amount refers to the amount of the estate tax payable in installments under § 6166. The Service, though, may request a bond in an amount of tax deferred given the Service has the authority to require a bond up to double the amount of tax due. Consequently, the value of the collateral securing the lien may equal the deferred tax and the aggregate amount of interest payable over the first 4 years of the deferral period under § 6166.

2. Can bond or lien amount be compromised?

The bond or lien amount may be compromised. The bond amount provided by a taxpayer does not need to equal twice the amount of the deferred tax. Also, the amount of the collateral securing the lien does not need to equal the deferred tax plus the first 4 years interest. Instead, the bond amount or the value of the collateral securing the lien should reflect the amount of estate tax payable in installments that is at risk of default. A case-by-case determination should be made for whether to require a bond or to accept a lien for an amount less than the total amount of the deferred tax plus the 4 years of interest. The Service should make this determination based on all of the facts and circumstances of the specific situation.

3. Can Appeals make valuation determinations with respect to the property upon which the lien will attach? Can Appeals determine whether certain types of property are adequate security for the section 6324A lien?

Appeals may make valuation determinations with respect to the property upon which the lien will attach. Delegation order 66, Treasury Regulation § 601.106, and Rev. Proc. 2005-33, 2005-24 I.R.B. 1231, allow Appeals to determine value with respect to the § 6166 lien property proffered as collateral for the special estate tax lien under § 6324A. Also, Appeals may make the determination of whether certain types of property provide adequate security which, under § 6324A, the special estate tax lien may attach.

4. With respect to Issue 3, when Appeals determines the value of the property, how should this determination be made? Must Appeals rely upon the value of the assets listed on the Form 706, or can Appeals determine value based upon other factors? For example, if property was valued under § 2032A as farm property, can it be valued as business or residential property for the lien? Or, for example, can the undiscounted value of a FLP interest be used for the lien, even though the FLP interest was discounted for Form 706 purposes?

Appeals' valuation determination should be based on the current fair market value of the § 6166 lien property on the date the § 6324A lien agreement, as defined in § 6324A(c), is signed by all interested parties. The collateral's value should be based on the property's current and anticipated use as well as any potential government interest in the property if the lien were foreclosed upon.

5. Can previously pledged or mortgaged property be used for the § 6324A lien? Should the value be used for the full value or the net equity?

A previously pledged or mortgaged property may be used as § 6166 lien property, but the mortgage, lien or any other encumbrances will be taken into account in determining the value of the property. Treas. Reg. 20.6324A-1(b)(2). Therefore, the equity in § 6166 lien property must equal the unpaid portion of the deferred tax and the required amount or, if less, the amount of security required by Appeals.

6. What format should Appeals issue its determination to the taxpayer when settling a non-docketed case and determining whether the taxpayer is entitled to the election? Also, how should Appeals notify the Service of its determination?

If Appeals settles a non-docketed case and the settlement includes a determination as to the value or adequacy of property, it is a matter of policy that should be decided by Appeals whether Appeals signs an agreement with the taxpayer or simply sends a letter to the taxpayer. If Appeals decides to issue a form signed by both Appeals and the taxpayer, Appeals will create a new form, since Form 890 and closing agreements would not adequate. Again, the format in which this decision is conveyed to Advisory is also a matter of policy to be decided by Appeals.

In short, the Service is now required to exercise its discretion in determining whether to require a bond and the value of collateral if the estate elects a special lien to secure the payment of the estate tax deferred under § 6166. In light of the Treasury Inspector General's report referred to in the *Roski Estate* case, and the positions taken by the Chief Counsel, it is likely that there will be increased requirements of either the bond or the special lien and more sophisticated monitoring of the status of a closely-held entity interests in which are posted as collateral. Even so, the Internal Revenue Service may be a more forgiving creditor than a commercial bank in light of the tribulations suffered by the banking industry over the past 15 months.