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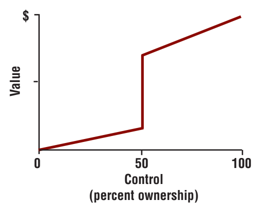
# POINTERS

### Value And Control.

It is essential for any successful business continuation or disposition plan to consider the factors of value and control. Complete control of a business with no value is worthless; and value in a business you do not control is tenuous. With most successful operating businesses, value and control are typically fixed and determined. In the small closely-held business it is generally accepted that the same individual, or group of individuals, both controls the business and owns the value. But what happens to control and value upon the death of the business owner? This is the essential question you must address in developing an effective business succession plan. By charting the interrelationship of these two factors you can better appreciate how control dictates value. Greater control means greater value – less control means less value. But the relationship is not linear! Having a controlling interest (i.e., more than 50 percent) in a closely-held corporation produces a "control premium," as can be seen from the sharp increase in value in the chart. The flip side of the control premium is the discount allowed for a minority interest (page 407).




### Continued – Sold – Liquidated.

There is no better place to begin a discussion of business succession planning than by asking the questions set forth on page 123. But before you begin the discussion, visit the chart on page 121. Where would you place your client on this chart? Just as importantly, where would your client place himself on this chart? This insight should enable you to more effectively work with your client in developing *and implementing* a business disposition plan.

### Know The Entity.

Before proceeding, it is essential to identify the type, or format, of the business: C corporation, S corporation, partnership, limited liability company, or sole proprietorship. The form of organization is an important consideration in selecting an agreement to be used if it is intended that the business will be sold (e.g., a stock redemption agreement does not work very well with a sole proprietorship). In this regard, you may wish to consult the materials on pages 184-186, 198-199, 464, 493-495, 499, 511, and 539-541. Knowing the type of business is also important when considering employee benefits (pages 292-300).

### Retain Control … Shift Value.

If your client's business is to be *continued* by a family member, there are many techniques that can be used to reduce estate taxes – while at the same time maintaining control (e.g., family limited partnerships or recapitalizations, see pages 170-177). Implementation of a specific arrangement will often depend not only upon your client's willingness to proceed, but also upon the ability of your client's professional advisors to work as a team.

### Compare The Charts.




The cross purchase agreement involves an agreement between the owners to buy and sell their respective interests. You might think of it as a horizontal obligation running from business owner to business owner. On the other hand, the entity purchase agreement, also referred to as a stock redemption agreement if used with a corporation, involves an agreement by the owners to sell their respective interests to the business. You might think of it as a vertical obligation running between the business owners and the business. However, because of changing individual and business circumstances, choosing between a cross purchase agreement and an entity purchase agreement can be difficult. To keep their options open, your clients may prefer to use the highly flexible "wait and see" buy/sell agreement. With this arrangement, the decision as to who will make the purchase is delayed until after the death of an owner. All of these agreements provide for the complete sale of a business interest, and can be used with either a corporation or a partnership, but not with a sole proprietorship. To gain a better understanding of these plans, compare the charts on pages 131, 135, and 147.

### Business Valuation Is Art … Not Science.

With the business owner the subject of business valuation is a wonderful "ice breaker." However, do not promise more than you can deliver. Business valuation is art, it is not science. The chart on page 127 provides a good place to begin, but a capitalization of earnings approach is not relevant in valuing many businesses (e.g., a medical practice or professional corporation). If appropriate, do not hesitate to advise your client to retain an accredited expert to perform a comprehensive business valuation.

### Risk Management.

You should discuss "risk management" with the business owner. As stated by Judge Staley, "The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself from the loss of its most vital assets – managerial skill and experience". The statistics on pages 187 and 188 will help you quantify this risk for your business-owner clients.

### Company Owned Life Insurance (COLI)

Employer-owned life insurance contracts must meet certain notice and consent requirements in order for the death proceeds to be excluded from taxable income. Application of a "related persons" provision, together with complicated attribution rules, will likely cast a very wide net (see discussion, pages 357-359). The general rule is that death proceeds from these contracts are taxed as ordinary income. Exceptions to this general rule are based upon the insured's status, or how death proceeds are paid or used. However, to qualify for any exception, it is essential to first meet strict notice and consent requirements. For each tax year the contract(s) is owned a reporting requirement mandates that all employers owning one or more employer-owned life insurance contracts must file Form 8529 (Report of Employer-Owned Life Insurance Contracts). *It is strongly recommended that notice be given, and consent be obtained, at the time an application is taken for virtually any life insurance contract that might conceivably fall within the scope of this law*.

### Understand The Attribution Rules.

These rules have been aptly described as "infamous and insidious." While at first they may appear esoteric and difficult, they are important to understand. In family held corporations, if stock owned by one family member is to be sold to the corporation it is extremely important to consider the effect of the attribution rules (pages 178-183). Violation of these rules means that the sale will be treated and taxed as a stock dividend.

### Reality Checks … They Are Important!

Often your business owner client will want to retain the business for the benefit of a son or daughter. Good planning will usually help this happen, but not if the child is a 2-year-old. Then there is the sole proprietor, who is convinced that his key man will take over the business and run it for the benefit of his survivors. This sounds just fine, until you discover that the "keyman" is a stock clerk hired just a year ago – but he is a "bright" young man. And then there is the physician, who is practicing as a sole proprietor, and who is convinced that his practice is easily worth five or six times annual billings, plus the book value of all the equipment he purchased a few years back. These clients will be well served if you help them perform a "reality check-up."

## DEVELOPMENT CYCLE OF A BUSINESS

This chart will help us to better understand the typical life cycle of the owner-managed business. Such businesses are usually owned by rugged individualists who were drafted into business in a variety of ways. Although the growth curve is different for each business, it can generally be separated into four distinct phases, with the first two involving a lot of hard work.

The first stage is best described as the **Wonder Stage**, because sooner or later he will wonder, "How in the world did I get into this mess?" A seven-day workweek is the norm, for which he gets *freedom*, *power*, and the *last word* on how the job is to be done. Undercapitalized and overextended, he expends maximum energy just to keep creditors at bay, avoid taxes, and end up with a profit to finance future growth. The large majority of new businesses don't survive this stage.

It is during the **Blunder Stage** that the last of the failures quit, while the survivors experience substantial growth, work 18-hour days, learn to trust no one, and become *highly secretive*. This leads to a reluctance to teach the business to others.

By the time the **Thunder Stage** is reached, the business owner has become a respected and substantial member of his community. He enjoys his success! Secrecy and a *total lack of review* of his decisions have become hallmarks of his management style. The creation of myths at this stage is commonplace. These include the notion that the business is too unusual for anyone else to run; his experience is all that counts; business practices should stay the same; the business is his to do with as he pleases; that HE is *truly immortal*.It is now that he draws the collective attention of the community's life underwriters and financial advisers. He desperately needs their services, but proves to be distrustful of advice. This dilemma could have been avoided had a relationship of trust and service been established *before* the thunder stage.

During the **Plunder Stage** the owner may tend to lose his appetite for risk, preferring instead just to keep what he has. He must learn to teach and share, not destroy on the way down what he built on the way up. Such teaching and sharing will allow for a renaissance of wonder, the opportunity for a successor's hard work and continued business growth. All too often the alternative is liquidation!

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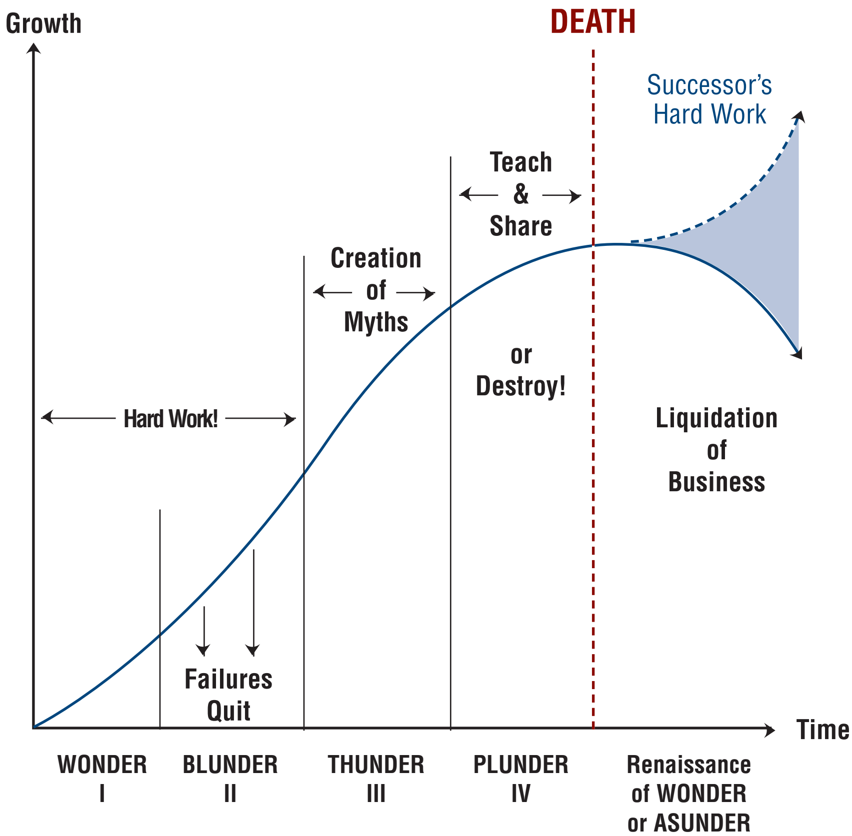



This chart and the accompanying text have been taken from Chapter Three of *Beyond Survival*, by Léon A. Danco, Ph.D., and are reprinted by permission of the publisher. This book has proven to be an invaluable guide to the advisor who desires to understand and effectively communicate with the owner of the closely held business. In addition, Dr. Danco has written *Inside The Family Business*, and *Outside Directors In The Family Owned Business*. Dr. Danco's books may be obtained by writing The Center for Family Business, P.O. Box 24268, Cleveland, Ohio 44124.

# DISPOSITION OF A BUSINESS INTEREST

For our purposes, there are essentially three risks facing the business owner: death, disability, and retirement. Likewise, upon the occurrence of one of these events, only one of three things can happen to his business: it will be continued, sold, or liquidated. The planning process should reveal the answers to these questions:

Will **SUCCESSOR MANAGEMENT** be available and willing to operate the business? Such a person could be either a family member or a key employee, but it is important to be realistic about both their abilities and commitment to staying with the business. A *yes* answer will lead to …

Would a **SATISFACTORY RETURN** on business capital be provided for the family? The decision as to what is "satisfactory" is a highly subjective determination, but it usually falls within the range of 6 to 20 percent.[1] A *yes* answer will lead to …

Could **TAX-FAVORED PROFITS** be withdrawn for the family? If the business is a corporation, then payment of a salary to the stockholder-employee is "tax-favored" as a deductible business expense. However, the same payments to a surviving spouse might be characterized as nondeductible dividends.[2]

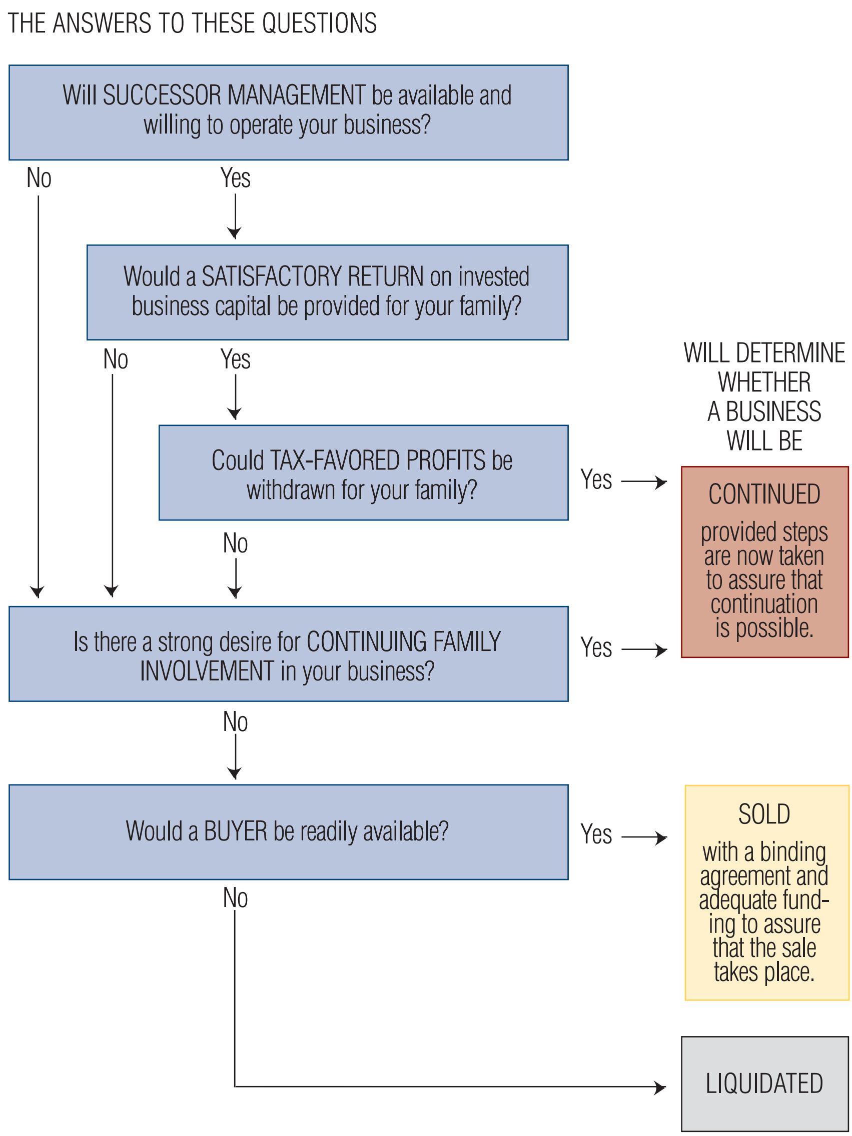
If the answers to all three of these questions are *yes*, then it is likely that the business could be successfully **continued**. However, should the answer to any one of these questions be *no*, then this would lead to …

Is there a *strong* desire for **CONTINUING FAMILY INVOLVEMENT** in the business? A *yes* answer to this question is often the result of a strong sense of family pride in the business, despite one or more "no" answers to the previous questions. Under such circumstances the business might well be **continued**, provided steps are now taken to assure that continuation is possible.[3] A *no* answer to this question will lead to …

Would a **BUYER** be readily available? If the answer is *yes*, then the business should be **sold**, with a binding agreement and adequate funding in order to assure that the sale takes place. A *no* answer to this question means that the business is likely to be **liquidated** and its assets sold for pennies on the dollar.

Footnotes on page 125

## UPON DEATH, DISABILITY OR RETIREMENT



**Disposition of a Business Interest**

## PLANNING MATRIX

| *If Business Is to Be:* | *Consider Using Chart* | *On Page* |
|---|---|---|
| CONTINUED | Installment Sale & Private Annuity | 43 |
| | Intentionally Defective Trust | 67 |
| | Partial Stock Redemption | 155 |
| | Key Person Insurance | 163 |
| | Reverse Key Person Insurance | 167 |
| | Family Limited Partnership | 171 |
| | Recapitalization | 175 |
| SOLD | Business Valuation | 127 |
| | Entity Purchase Agreement | 131 |
| | Cross Purchase Agreement | 135 |
| | Trusteed Cross Purchase Agreement | 139 |
| | "Wait And See" Buy/Sell Agreement | 147 |
| | Key Person Buy-Out Agreement | 151 |
| | Split-Dollar Funding Cross Purchase | 229 |
| LIQUIDATED | Key Person Insurance | 163 |
| (To replace lost | Reverse Key Person Insurance | 167 |
| business value) | Group Insurance | 209 |
| | Executive Equity | 217 |
| | Split-Dollar Insurance | 225 |

## Footnotes

[1] A determination of business value would be a starting point for deciding what would be a "satisfactory" return on business capital. For example, $10,000 of annual income from a business worth $500,000 would probably not be satisfactory. If the business could be sold for $400,000, and the funds invested at 8 percent, the resulting before-tax income would be $32,000 per year, more than three times that provided if the business were retained.

[2] There are numerous cases that have held that payments to stockholder-heirs are not deductible to the corporation. In the case of *The Barbourville Brick Company v. Commissioner*, 37 T.C. 7 (1961), the United States Tax Court held that payments to the surviving widow were dividends. Judge Brown, concurring in the denial of any income tax deduction to the corporation, considered the payments nondeductible as not a "reasonable business expense." In his written opinion, Judge Brown observed that:

> "[A]pparently there were no employees, stockholders, or members of [the decedent's] family, qualified to take over the management of petitioner's business. There is neither claim nor evidence that the widow performed any services for [the business]. Finally there is neither claim nor showing that the payments in question were in the nature of extra compensation for past services rendered by petitioner's deceased president … income tax deductions are a matter of legislative grace … and are to be justified as ordinary and necessary expenses of carrying on a trade or business."

[3] The "steps" relate to preparing for the eventual transfer of a healthy business to other family members or key employees. In this regard, the business planning charts on the following pages demonstrate techniques that will assist in providing the plans and funds for such a smooth transfer of the business. A comparison of life insurance and other sources of estate settlement costs is set forth on page 80.

# BUSINESS VALUATION

There are many reasons why the owner of a closely held business must have some idea of the value of his business:

- When *obtaining loans* a higher, yet realistic, value could result in increased credit.
- If the *reasonableness of compensation* to an employee-stockholder is challenged by the IRS, knowing the value of the business will be helpful.[1]
- In *determining a price* for the business when it is sold upon death, disability, or retirement.[2]
- For *estate planning* purposes, the higher the value, the greater the potential estate tax.[3]

**Valuation is an art; it is not a science**.[4] With the closely held business, the concept of valuation is often elusive. Pat answers rarely exist. However, with many businesses, "capitalizing" expected earnings can be a useful starting point for determining fair market value.

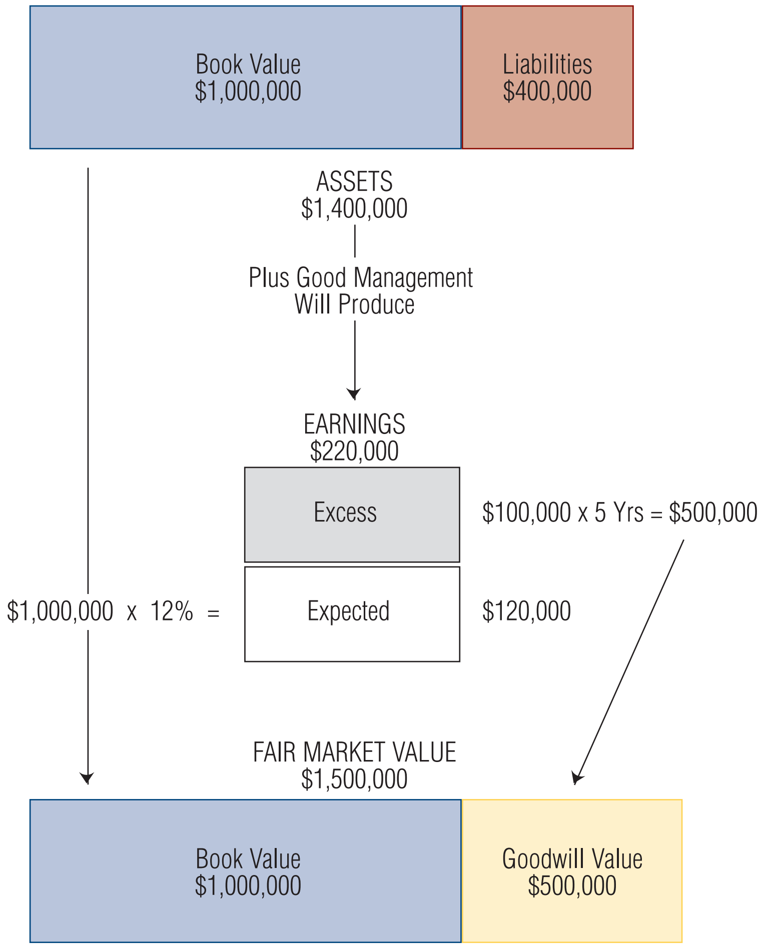
For example, we know that assets, plus the talents of good management, are expected to produce earnings. Assume that a business had assets of $1,400,000 and liabilities of $400,000. By subtracting liabilities from assets, we can determine that book value is $1,000,000.[5] This is the net worth of the business, which is often referred to as stockholder's equity. Also assume that the business has earnings of $220,000.

The first step in capitalizing expected earnings is to determine what rate of return an outside purchaser would expect on his investment. Assume that, after a careful consideration of the risks inherent in this particular business, the *expected* rate of return is determined to be 12 percent.[6] If the sales price were set at book value, or only $1,000,000, expected earnings would then be $120,000. This means that there are *excess* earnings of $100,000, which should be reflected in the sales price as goodwill.

Goodwill is determined by deciding how much a purchaser should pay for these excess earnings, which are the product of such intangibles as reputation and market position. A careful consideration of both the age of the business and the likelihood of continuing excess earnings might reveal that the purchaser should pay for five years of excess earnings, or $500,000. By adding this $500,000 of goodwill to the $1,000,000 of book value, we get a fair market value for the business of $1,500,000.[7]

Footnotes on page 129

## CAPITALIZING EXPECTED EARNINGS



### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of business.
2. Form of organization (C corporation, S corporation, partnership *or* sole proprietorship).
3. Nature of business.
4. Book value (assets minus liabilities).
5. Average earnings (after-tax).
6. Number of years business has been in existence.
7. Salaries of principals in excess of replacement salaries.

*Note*: Whenever possible, at least a 3-year average of earnings and book value should be used. The salaries of principals in excess of salaries that would be paid to replacements is typically added to average earnings. The nature of the business is relevant to determining the appropriate *expected rate of return* ("12%" in the chart). The number of years the business has been in existence, and thus its stability, reputation and market position, is relevant to determining the appropriate *capitalization of earnings* factor ("5" in the chart). For a further discussion of these rates, see footnote 6, page 129.

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

**Q 305-Q 306**. Valuation of closely held business interest for federal estate tax purposes.
**Q 312**. An agreement restricting the lifetime sale of a business interest may be considered for gift tax purposes.
**Q 770**. Valuation of investment property for federal estate tax purposes.
**Q 777**. Chapter 14 valuation rules generally.
**Q 785**. Impact of Chapter 14 rules on buy/sell agreements.

## Footnotes

[1] Knowing the value of the business will help defend the reasonableness of salary and other fringe benefits. In this regard, see the expanded discussion of Unreasonable Compensation on page 581.

[2] Common means of selling businesses are set forth in the Entity Purchase Agreement chart on page 131 and the Cross Purchase Agreement chart on page 135.

[3] Under the Chapter 14 special valuation provisions, the value of property for gift and estate tax purposes is determined without regard to any agreement to acquire the property at less than fair market value. However, this rule does not apply if the agreement is: (1) a *bona fide* business arrangement; (2) not a *device* to transfer the property to members of the decedent's family for less than full and adequate consideration; and (3) in its terms, *comparable* to similar arrangements entered into by persons in an arm's length transaction. All three of these tests are presumed to be met if the agreement is between unrelated individuals (i.e., an agreement exclusively among persons who are not the natural objects of each others' bounty).

In agreements between related individuals maintenance of family ownership and control could be a *bona fide* reason for using a particular business value, thereby satisfying the first test. But the stipulated value will not be controlling for estate tax purposes unless the agreement also meets the *device* and *comparable* tests. In order to satisfy all three of these requirements in family held businesses there is likely to be an increased utilization of both *appraisal* and generally accepted *formula* methods of business valuation (see pages 402-403).

For estate tax purposes, the executor of an estate may elect special methods for valuing *real property* used in a farm, trade, or business. A discussion of the strict qualifications and restrictions imposed appears on pages 525-526.

[4] When valuation is left to chance, it opens the door to litigation with the Internal Revenue Service. The table of Contested Business Valuations (pages 191-196) contains a listing of specific types of businesses which ended up being the subjects of extensive litigation when the owners failed to properly plan for their estate tax valuation. The state of the art is at best uncertain for those who fail to "peg" properly the value of their business interests. It is also important to recognize that valuation may mean different things to different people, depending upon the purpose of the valuation. However, as far as the Internal Revenue Service is concerned, it is based upon a consideration of *all relevant facts*, and in particular those eight factors set forth in the expanded discussion of Fair Market Value on page 407. Financial ratio analysis provides another means of determining business value (see page 190).

[5] In using this approach to business valuation, care must be taken to assure that Book Value accurately reflects the true value of business assets (see page 337).

[6] Selection of appropriate expected *rate of return* and *capitalization of earning* factors is very subjective. Nevertheless, the following may provide some idea of the ranges used:

| Expected rate of return | | Capitalization of earnings | |
|---|---|---|---|
| 8-11% | safe business | 1-3 | volatile earnings |
| 12-17% | average business | 4-6 | average, variable earnings |
| 18-22% | speculative business | 7-9 | stable earnings |

[7] This chart demonstrates an application of what has come to be known as the "ARM 34" formula. It is most appropriately used with manufacturing firms involving substantial investments of both plant and equipment. The letters "ARM" stand for "Committee on Appeals and Review Memorandum." This committee no longer exists under the present judicial system. Another, more direct, method of capitalizing earnings is sometimes referred to as the "straight capitalization method" and is best demonstrated by the following question: "If a buyer expects to make 12 percent on his investment, and the business is producing earnings of $220,000 per year, what would the buyer be willing to pay for the business?" The calculation required to answer this question produces a substantially higher valuation than the ARM 34 formula shown in the chart:

$$\text{Value} \times .12 = \$220{,}000 \quad \textit{or} \quad \text{Value} = \$220{,}000 \div .12 = \$1{,}833{,}333$$

# ENTITY PURCHASE AGREEMENT

The entity purchase agreement is another means of providing for the complete disposition of a business interest. Under such an arrangement the contract is with the business rather than with the other owners.[1]

**DURING LIFETIME.** To illustrate how it works, assume that we have a corporation that is owned equally by A and B.[2] They would each enter into an agreement with the business for the purchase and sale of their respective interests. Typically, this agreement is *binding*, in that it obligates both A and B, and their estates, to sell, and the business to buy, upon the death, disability, or retirement of either one of them.[3]

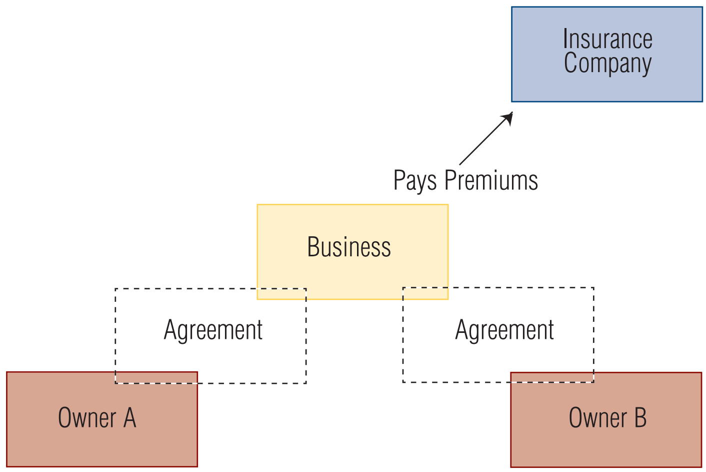
Rather than relying on its ability to accumulate or borrow sufficient funds to meet its obligations to purchase these interests, the business obtains separate life insurance contracts insuring A and B.[4] The business pays the premiums and is owner and beneficiary of the contracts. In this manner, the business pre-funds its obligations with life insurance. With the use of life insurance to fund an entity purchase agreement the business is in effect *amortizing* the cost of the purchase over the lifetime of the insured.[5]

**UPON DEATH.** Should A die first, his stock interest passes to his family or estate. At the same time, the insurance company pays a potentially tax-free death benefit to the business as beneficiary of the contract insuring A's life.[6]

Pursuant to the agreement, in return for cash, A's family, or estate, will then transfer A's *entire interest* to the business.[7] In this way a fully funded agreement *guarantees* that the surviving family will receive a fair price for A's interest.[8] If A's estate is subject to estate taxes, the agreement can also serve to help "peg," or establish, the value of the stock for estate tax purposes, thereby avoiding the extensive negotiations and potential litigation with the Internal Revenue Service that may occur when valuation is left to chance.[9]

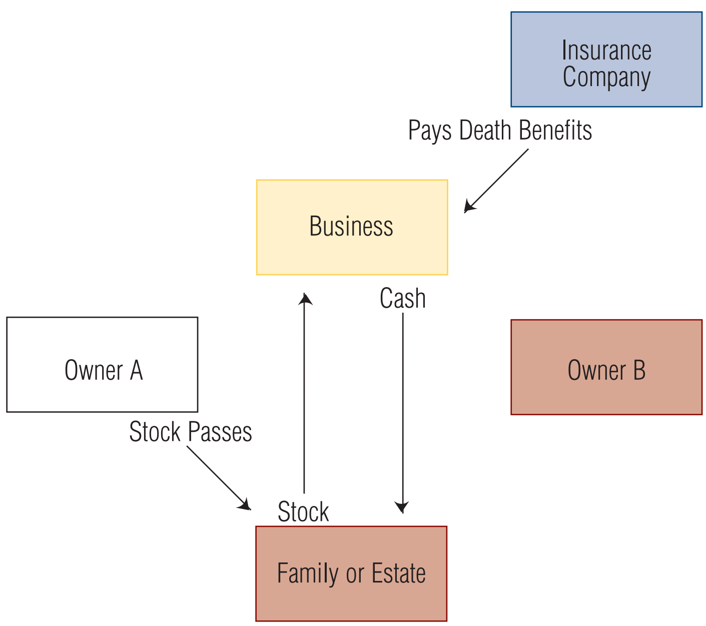
Footnotes on page 133

## DURING LIFETIME




The Business Obtains Life Insurance On Each Owner

## UPON DEATH



## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of owner to be insured.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.
5. Value of ownership interest.
6. Form of organization (C corporation, S corporation or partnership).

## CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 263**. When death benefits of business life insurance are exempt from income tax.

*Corporation*

**Q 246**. Premiums paid on business life insurance not usually taxable to insured employee.
**Q 247**. Premiums paid by corporation on policies insuring the life of a stockholder or employee usually not deductible.
**Q 251**. Premiums paid by corporation to fund stock redemption not taxable to insured stockholder.
**Q 285**. Amount paid by corporation for decedent's entire stock interest generally not dividend to estate, provided no attribution problems.
**Q 286-Q 287**. Avoiding attribution of stock ownership.
**Q 290**. Usually no capital gain to deceased stockholder's estate.
**Q 291**. Amount paid by corporation for stock usually not taxable as constructive dividend to surviving stockholder(s).
**Q 292**. Income tax results of funding stock redemption agreement with life insurance.
**Q 295**. Taxation of payments when redemption by S corporation.
**Q 300**. Treatment of corporate owned life insurance for purpose of alternative minimum tax.

*Partnership*

**Q 257**. Premiums paid by partnership are not deductible.
**Q 296**. Income tax results when deceased partner's interest is sold or liquidated under a business purchase agreement.
**Q 299**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

*Estate Tax*

**Q 304**. Life insurance proceeds not directly included in insured owner's estate when partnership or corporation is owner and beneficiary.

## Footnotes

[1] Note that in contrast to the cross purchase agreement, the entity agreement requires that the *business* purchase the interest, not the other owners (compare entity purchase agreement with cross purchase agreement using the materials on page 198). The entity agreement can be used by either a partnership or a corporation with more than one stockholder. It is often the preferred method with *multiple* stockholders or partners, since only one policy on the life of each owner is required (but see, First-to-Die Insurance, page 411, which can be used to fund multiple-owner cross purchase agreements). An entity purchase agreement cannot be used by a corporation with only one stockholder or a sole proprietorship, since the corporation cannot own itself and the sole proprietorship is not a separate entity that can make the purchase. When used to fund the purchase of corporate stock, it is usually referred to as a "stock redemption" or "section 302(b)(3) stock redemption" agreement (see footnote 8, page 157). In this sense, the terms "entity purchase" and "stock redemption" are interchangeable.

[2] It is also assumed that A and B are *not* related to each other. If they were, and the business was a corporation, then the attribution rules would have to be considered (attribution is more fully explained on pages 178-183).

[3] If the agreement is binding upon disability as well as death, consideration should also be given to funding the agreement with disability buy-out insurance (see expanded discussion on page 376-377). The tax treatment of various disability income arrangements is set forth on page 326.

[4] Employer-owned life insurance must meet strict notice and consent requirements if the death benefits are to be received free of income taxes (see Company Owned Life Insurance (COLI), pages 357-359).

[5] By having the corporation purchase and pay the insurance premiums, it is often possible to utilize after-tax "enhanced dollars." Even if the corporation is not in a lower tax bracket than its stockholders, the entity purchase may still be the preferred method, since the corporate check is usually far easier to obtain for premium payments than a client's personal check. The likelihood that life insurance will be used can be estimated by referring to the Odds of Death tables on pages 187-188. Corporate borrowing as an alternative to life insurance funding is usually unattractive, as can be seen from the Cost of Borrowed Dollars table on page 190.

[6] Under some circumstances a portion of annual cash value increases and death proceeds could be subject to the Corporate Alternative Minimum Tax, as discussed on pages 363-365.

[7] Note that B is now the sole owner of the business. However, B's cost basis for purposes of income taxes has not been increased, because the business, not B, purchased A's interest. If the business were subsequently sold by B, he would have substantially more gain than would have been the case had B previously purchased A's interest under a cross purchase agreement at A's death. With regard to a corporation, once an entity purchase agreement has been funded with life insurance, it *is generally not* possible to use the same policies when changing to a cross purchase agreement. This is because of the Transfer For Value rule, as more fully explained on pages 573-574.

[8] Various means can be used in the agreement to determine the purchase price. A *fixed price* could be established, with a further provision providing for periodic review and redetermination between the business and the owners. Alternatively, a *formula method* could be used, under which specific factors would be employed to calculate a value. For an example of a *capitalization formula*, see the Business Valuation chart on page 127. Another approach to determining a price is to provide for an *appraisal* at the time of sale (i.e., after the first owner's death, or earlier if a lifetime sale is contemplated).

[9] To help "peg" the value of the business for estate tax purposes, the parties must be required to sell during lifetime for the same price as provided for a sale at death. Also, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129). The listing of Contested Business Valuations on pages 191-196 provides specific examples of what can happen when there is a failure to properly "peg" the value of stock in a closely held corporation. The cases on page 197 demonstrate that a buy/sell agreement really does help fix the value.

# CROSS PURCHASE AGREEMENT

The cross purchase agreement is one means of providing for the complete disposition of a business interest.[1] Under this arrangement the owners agree, among themselves, to buy and sell their respective interests.[2]

**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation equally owned by two individuals, A and B. They enter into an agreement providing for the purchase and sale of their respective interests. Typically, this agreement is *binding* and obligates both parties, or their representatives, to either buy or sell upon the death, disability, or retirement of either A or B.[3]

Rather than trying to accumulate or borrow sufficient funds to buy B's interest, A obtains a life insurance contract insuring B. A applies for this coverage, pays the premiums, and is both owner and beneficiary of the contract. Likewise, B applies for a life insurance contract insuring A, pays the premiums, and is both owner and beneficiary.[4] By this means, A and B can use life insurance to *fully* fund their mutual obligations to each other.[5]

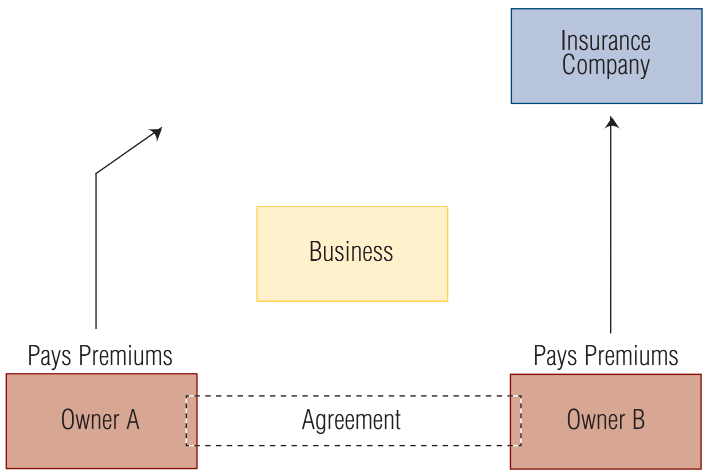
**UPON DEATH.** Assuming that A dies first, his stock interest would then pass to his family or estate. At the same time, the insurance company pays a death benefit to B, as beneficiary of the contract insuring A's life. B receives these funds free of all income taxes, since they are received as the death benefit of a life insurance contract.[6]

Pursuant to the agreement, A's family, or estate, transfers A's entire stock interest in the corporation to B, in return for which B pays the cash received from the insurance company.

The fully funded agreement will *assure* that A's surviving family receives a fair price for his interest in the business. But such an agreement can also serve another very important function. If the estate had been subject to estate taxes, it is possible that extensive negotiations and even litigation could result if the estate tax value of the business had been left to chance. These problems of delay and litigation can be avoided by having a cross purchase agreement which helps establish, or "peg," the value of the stock.[7]

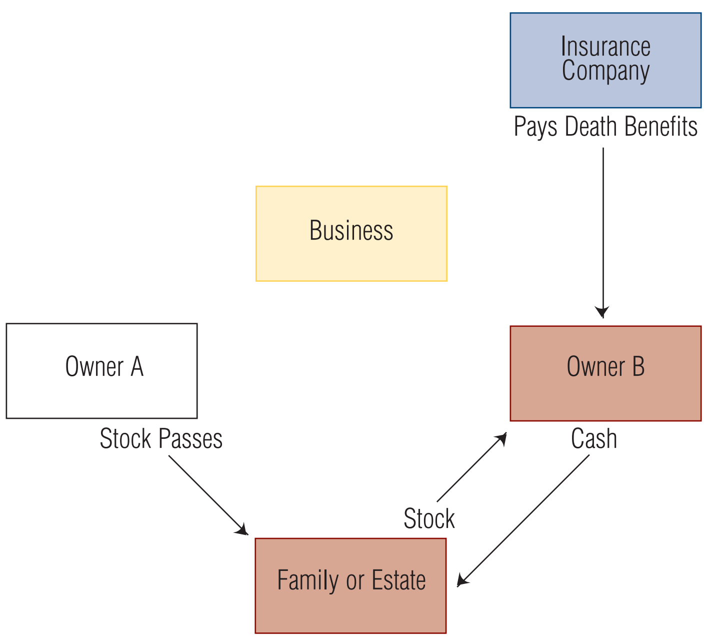
Footnotes on page 137

## DURING LIFETIME




Each Owner Obtains Life Insurance On The Other

## UPON DEATH



## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Names of owners to be insured.
2. Sex.
3. Dates of birth.
4. Smoker/nonsmoker.
5. Value of ownership interests.
6. Form of organization (C corporation, S corporation, partnership, or sole proprietorship).
7. Identity of purchaser (stockholder or partner).

## CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 64**. For death proceeds to be excludable from income, a life insurance policy must meet certain requirements.

*Corporation*

**Q 249**. Stockholder cannot deduct premiums paid on policy purchased on life of another stockholder.

**Q 254**. Premiums paid by corporation on policies owned by stockholders are taxable income to stockholders.

**Q 283**. Sale of deceased's stock will usually not result in income tax liability to deceased's estate.

**Q 284**. Income tax effects of funding stock purchase agreement with life insurance.

*Partnership*

**Q 257**. Premiums paid by partner for insurance on life of copartner are not deductible.

**Q 258**. Premiums paid by partner for insurance on his own life are not deductible by him if proceeds payable to copartner.

**Q 296**. Income tax results when deceased partner's interest sold or liquidated under a business purchase agreement.

**Q 299**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

*Sole Proprietorship*

**Q 260**. Premiums paid by key employee for insurance on life of sole proprietor are not deductible.

*Estate Tax*

**Q 303**. Life insurance proceeds not included in insured's estate when partners or stockholders purchase insurance on lives of each other.

## Footnotes

[1] Compare the cross purchase agreement with the entity purchase agreement using the materials on page 198. The cross purchase agreement can be used with either a corporation or a partnership. With a sole proprietorship, a similar arrangement could be established between the sole proprietor and a key employee (chart, page 151. However, since the key employee has no ownership interest, there are no reciprocal obligations to buy and sell. The sole proprietor would merely be obligated to sell and the key employee obligated to buy. Life insurance funding involves the key employee purchasing a contract on the life of the sole proprietor in order to fund his obligation to purchase. This purchase could be assisted by the split-dollar technique (chart, page 229).

[2] Various means can be used in the agreement to determine a purchase price. A *fixed price* could be established, with a further provision providing for periodic review and redetermination by mutual agreement among the owners. Alternatively, a *formula method* could be employed, under which specific factors would be used to calculate a value. For an example of a *capitalization* formula, refer to the valuation chart on page 127. Another approach to determining a price is to provide for an *appraisal* at the time of sale (i.e., after the first owner's death, or earlier if a lifetime sale is contemplated).

[3] A cross purchase agreement will avoid the attribution problems that can occur in a family held corporation (attribution is more fully explained on pages 178-183). However, a cross purchase agreement with *multiple* stockholders can be cumbersome when the agreement is to be funded with life insurance. For example, with three stockholders, six policies would be required because each stockholder would have to be the owner and beneficiary of a policy on each of the other stockholders. If there were four stockholders, twelve policies would be required. To avoid the problem of multiple policies, preference is often given to using an entity purchase agreement (chart, page 131) or a trusteed cross purchase agreement (chart, page 139 and comparison page 199). However, the death of one owner could create a transfer for value problem with respect to remaining policies insuring the surviving owners (pages 573-574). Funding with first-to-die insurance should avoid these problems (page 411).

[4] In a family-owned business the attribution rules under Code section 101(j) *may* treat these policies as "employer-owned." This would subject the death benefits to income taxation. To assure the proceeds are received free of income taxes, appropriate notice and consents should be obtained (see Company Owned Life Insurance (COLI) pages 357-359).

[5] When the obligation is not fully funded, borrowing as an alternative to life insurance is usually unattractive. The real risk of a death among multiple owners of a business can be estimated by using the Odds Of Death figures on pages 187-188. Executive equity or split-dollar could be used to assist A and B in purchasing the life insurance (see charts, pages 217 and 229).

[6] Receipt of the death proceeds allows B to purchase A's business interest *and* obtain an income tax cost basis equal to the purchase price. To illustrate, assume that both A and B originally paid $100,000 for each of their 50 percent stock interests which are now each worth $750,000 (for a total corporate value of $1,500,000). If A dies and the corporation buys A's stock for $750,000, B is then left as the sole stockholder of a corporation valued at $1,500,000. If B then subsequently sells the corporation, his gain on the sale would be $1,400,000 (the $1,500,000 sales price less the $100,000 he originally paid for his stock). However, if upon A's death B had purchased A's stock under a cross purchase agreement, B's basis in his corporate stock would be increased by $750,000. Under these circumstances, B's gain on a later sale of the corporation would be only $650,000 (the $1,500,000 sales price less his basis of $850,000, which includes the $100,000 he paid for his original stock plus the $750,000 he paid for A's shares).

[7] To help "peg" the value, the parties must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129 and pages 402-403). The table of Contested Business Valuations on pages 183-188 provides specific examples of what happens when there is a failure to properly "peg" the value of stock in a closely held corporation. The cases on page 197 demonstrate that buy/sell agreements really do help fix the value.

# TRUSTEED CROSS PURCHASE AGREEMENT

The trusteed cross purchase agreement is one means of providing for the complete disposition of a business interest.[1] Under this arrangement the owners use a third party to carry out their cross purchase agreement.[2] Although sometimes referred to as a "trustee," this individual is not acting as a trustee in a formal trust sense. Rather, the trusteed cross purchase agreement more closely resembles an escrow arrangement, under which an escrow agent acts as agent for the owners in carrying out their mutual obligations to each other.

**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation owned by four stockholders, A, B, C, and D. They enter into an agreement providing for the purchase and sale of their respective interests.[3] Typically, this agreement is *binding* and obligates all stockholders, or their representatives, to either buy or sell upon their death, disability, or retirement.

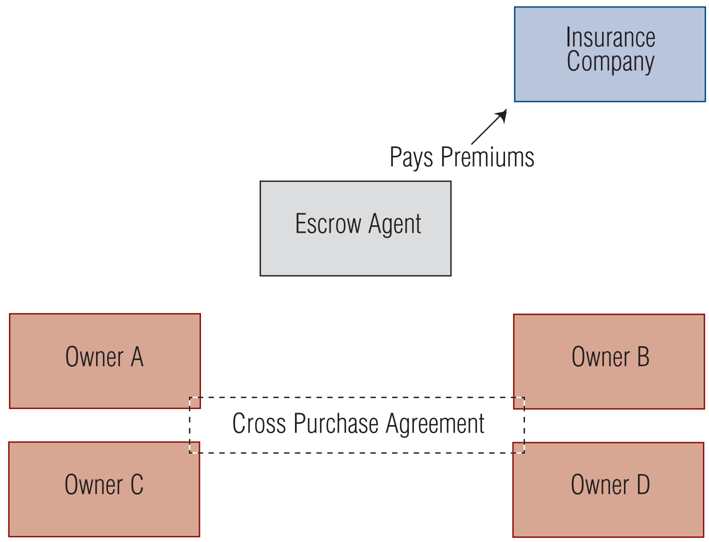
To implement the agreement the stockholders transfer their stock certificates to the escrow agent, and further have the escrow agent purchase life insurance on each stockholder.[4] The escrow agent is both owner and beneficiary of these contracts and pays any required premiums.[5] By this means the stockholders can use life insurance to *fully* fund their agreement, while having the assurance that their mutual obligations to each other will be carried out by the escrow agent.[6] Use of an escrow agent can substantially reduce the number of policies required to fund the agreement.[7]

**UPON DEATH.** Assuming that A dies first, the insurance company pays a death benefit to the escrow agent, as beneficiary of the contract insuring A's life. The escrow agent receives these funds free of all income taxes, since they are received as the death benefit of a life insurance contract. Pursuant to the agreement, the escrow agent then transfers A's entire stock interest in the corporation to the surviving stockholders, in return for which the escrow agent pays the cash received from the insurance company to A's family.[8]

The fully funded agreement will *assure* that A's surviving family receives a fair price for his interest in the business. But such an agreement can also serve another very important function. If the estate had been subject to estate taxes, it is possible that extensive negotiations and even litigation could result if the estate tax value of the business had been left to chance. These problems of delay and litigation can be avoided by having a trusteed cross purchase agreement which helps establish, or "peg," the value of the stock.[9]

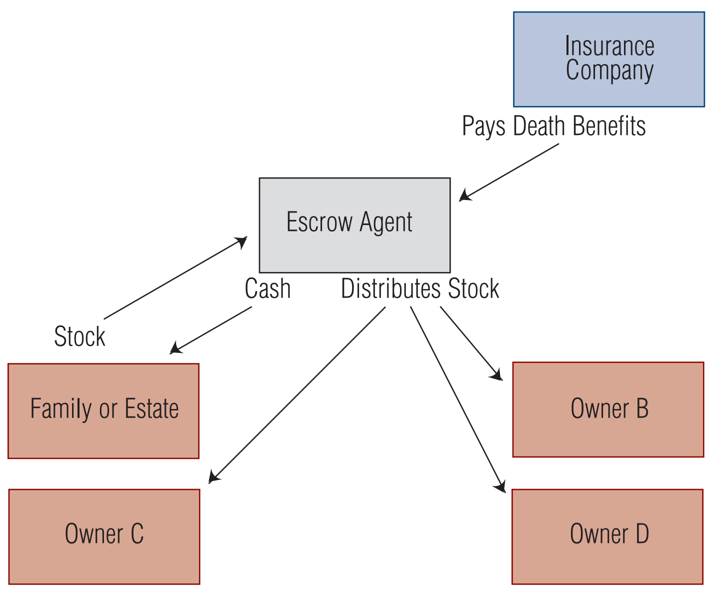
Footnotes on page 141

## DURING LIFETIME




The Escrow Agent Obtains Life Insurance On Each Owner

## UPON DEATH



## Trusteed Cross Purchase Agreement

### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Names of owners to be insured.
2. Sex.
3. Dates of birth.
4. Smoker/nonsmoker.
5. Value of ownership interests.
6. Form of organization (C corporation, S corporation, partnership, or sole proprietorship).
7. Identity of purchaser (stockholder or partner).
8. Identity of escrow agent.

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 64**. For death proceeds to be excludable from income, a life insurance policy must meet certain requirements.

*Corporation*

**Q 249**. Stockholder cannot deduct premiums paid on policy purchased on life of another stockholder.

**Q 254**. Premiums paid by corporation on policies owned by stockholders are taxable income to stockholders.

**Q 283**. Sale of deceased's stock will usually not result in income tax liability to deceased's estate.

**Q 284**. Income tax effects of funding stock purchase agreement with life insurance.

*Partnership*

**Q 257**. Premiums paid by partner for insurance on life of copartner are not deductible.

**Q 258**. Premiums paid by partner for insurance on his own life are not deductible by him if proceeds payable to copartner.

**Q 296**. Income tax results when deceased partner's interest sold or liquidated under a business purchase agreement.

**Q 299**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

*Sole Proprietorship*

**Q 260**. Premiums paid by key employee for insurance on life of sole proprietor are not deductible.

*Estate Tax*

**Q 303**. Life insurance proceeds not included in insured's estate when partners or stockholders purchase insurance on lives of each other.

## Footnotes

[1] Trusteed cross purchase agreements are also known as "custodian" or "escrowed" agreements. The provisions for an escrow agent can be part of the cross purchase agreement, or provided for in a separate agreement. The trusteed cross purchase agreement can be used with either a corporation or a partnership. With a sole proprietorship, a similar escrowed arrangement could be established between the sole proprietor and a key employee (chart, page 151). However, since the key employee has no ownership interest, there are no reciprocal obligations to buy and sell. The sole proprietor would merely be obligated to sell and the key employee obligated to buy.

[2] In recent years there has been a substantial increase in the use of cross purchase agreements (as opposed to entity purchase agreements). The factors contributing to this include: (1) the introduction of the corporate alternative minimum tax that may claim up to 15 percent of the death proceeds paid to a C corporation (see pages 363-365); (2) the avoidance of the attribution rules with a family-held corporation (see pages 178-183); (3) the increase of cost basis for the surviving stockholders, (see footnote 6, page 137); and (4) the ability to convert to a entity purchase agreement using the same policies without running afoul of the transfer for value rules (see page 573-574).

[3] See footnote 2, page 137, for an explanation of the various means that can be used in the agreement to determine a purchase price.

[4] In a family-owned business the attribution rules under new Code section 101(j) *may* treat these policies as "employer-owned." This would subject the death benefits to income taxation. To assure the proceeds are received free of income taxes, appropriate notice and consents should be obtained (see Company Owned Life Insurance (COLI) pages 357-359).

[5] Since the escrow agent pays the premiums on behalf of the owners he obtains the funds from the owners (e.g., B, C and D benefit from and therefore must pay the premiums for the policy insuring A). Although the premiums are not tax-deductible, split-dollar plans could be used to assist the owners in paying for the life insurance (chart, page 229). As an alternative, consider Executive Equity (chart, page 217).

[6] When the obligation is not fully funded, borrowing as an alternative to life insurance is usually unattractive. The real risk of a death among multiple owners of a business can be estimated by using the Odds Of Death figures on pages 187-188.

[7] With multiple stockholders the typical cross purchase agreement has the disadvantage of requiring that each stockholder be the owner and beneficiary of a policy on each of the other stockholders. Example 1, below, requires twelve policies to fund a cross purchase agreement involving just four stockholders (i.e., A must own policies insuring B, C, and D, etc.). Example 2 uses an escrow agent under a *trusteed* cross purchase agreement to reduce the number of policies to the number of insured stockholders.

| | | | | | |
|---|---|---|---|---|---|
| EXAMPLE 1 | Owner → | A | B | C | D |
| | 12 policies insuring | B C D | A C D | A B D | A B C |
| EXAMPLE 2 | Owner → | ESCROW AGENT | | | |
| | 4 policies insuring | A | B | C | D |

[8] After the first death there is a potential transfer for value problem upon the transfer of the deceased stockholder's ownership interests in the remaining policies insuring the surviving stockholders (pages 573-574). It has been suggested that this problem could be avoided by using a first-to-die policy (see page 411).

[9] To help "peg" the value, the parties must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129 and pages 402-403).

# CROSS ENDORSEMENT BUY-SELL AGREEMENT

The trusteed cross purchase agreement is one flexible means of providing for the complete disposition of a business interest.[1] However, the cross endorsement buy-sell agreement is an alternative which can provide the benefit of basis-step up typically found in a cross purchase agreement with the simplicity and flexibility of individual policy ownership by the insured shareholders. Unlike the trusteed cross purchase agreement and the escrow and partnership ~~versions~~ of that structure, each shareholder simply purchases a permanent policy on his or her own life.[2] No third party is required to own or facilitate the arrangement.

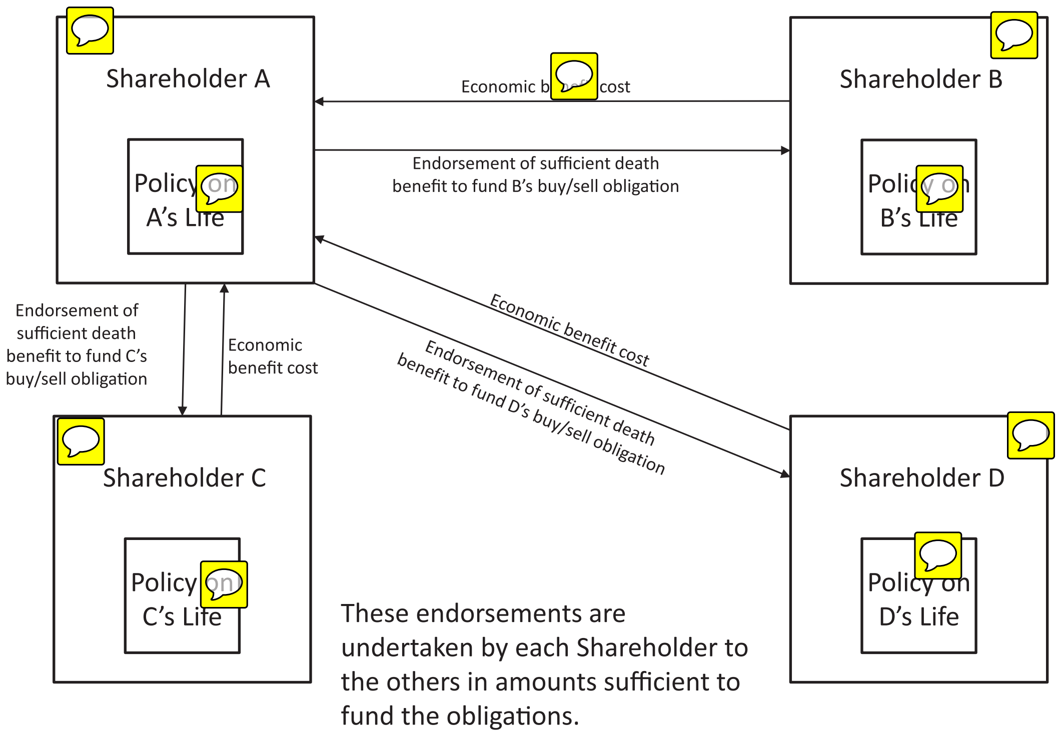
**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation owned by four stockholders, A, B, C, and D. They enter into a buy-sell agreement providing for the purchase and sale of their respective interests.[3] Typically, this agreement is *binding* and obligates all stockholders, or their representatives, to either buy or sell upon their death, disability, or retirement.

To fund the agreement the stockholders simply endorse some or all of the death benefit on a policy (or policies) insuring their own life to the other shareholders. For example, A would endorse a portion of the death benefit on his or her life insurance policy (equal to the purchase obligation of that shareholder) to each of B, C, and D.[4] Likewise, B would endorse his or her death benefit to A, C, and D. C and D would do the same with the result that each of A, B, C, and D could own a single permanent policy on his or her life that would be partially endorsed to each of the other three shareholders. A, B, C, and D can continue to own their own life insurance policy and their own shares of stock without the need to make a transfer. Like a trusteed cross purchase agreement, a cross-endorsement arrangement can substantially reduce the number of policies required to fund a cross-purchase buy-sell agreement.[5]

**UPON DEATH.** Assuming that A dies first, the insurance company pays the death benefit to the shareholders as provided for under the split dollar endorsement agreements. Assuming A, B, C, and D were equal shareholders – the death benefit would be paid (tax-free) one-third to each of B, C, and D.[6] Pursuant to the buy-sell agreement, A's estate would transfer A's entire stock interest (one-third each) to B, C, and D in exchange for the cash received from the insurance company.[7] The fully funded agreement can *assure* that A's surviving family receives a fair price for his or her interest in the business. But such an agreement can also serve to establish, or "peg," the value of the stock.[8] Most importantly, under this structure, if the business is sold or otherwise terminated during the insureds' lifetimes, the life insurance policies are owned by the individual insured. All that is required is that the parties cease the annual rental of the death benefit under the endorsement split dollar arrangement.[9]

Footnotes on page 145

**Cross-Endorsement Buy/Sell Funding**



### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Names of owners to be insured.
2. Sex.
3. Dates of birth.
4. Smoker/nonsmoker.
5. Value of ownership interests.
6. Form of organization (C corporation, S corporation, partnership, or sole proprietorship).
7. Identity of purchaser.
8. Identity of policyowner (insured or an entity created by insured such as an ILIT).

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 64**. For death proceeds to be excludable from income, a life insurance policy must meet certain requirements.

*Corporation*

**Q 249**. Stockholder cannot deduct premiums paid on policy purchased on life of another stockholder.

**Q 254**. Premiums paid by corporation on policies owned by stockholders are taxable income to stockholders.

**Q 283**. Sale of deceased's stock will usually not result in income tax liability to deceased's estate.

**Q 284**. Income tax effects of funding stock purchase agreement with life insurance.

*Partnership*

**Q 258**. Premiums paid by partner for insurance on his own life are not deductible by him if proceeds payable to copartner.

**Q 296**. Income tax results when deceased partner's interest sold or liquidated under a business purchase agreement.

**Q 299**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

## Footnotes

[1] See discussion of the Trusteed Cross Purchase Agreement on pages 138-141. A common alternative to the Trusteed Cross Purchase Agreement is the Partnership Cross Purchase Agreement in which a partnership is used rather than a trust or escrow arrangement. The partnership arrangement is used to void what some tax professionals consider a possible transfer for value issue created when beneficial ownership of the policies is transferred in the Trusteed Cross Purchase Agreement structure. See a discussion of Transfer for Value on pages 573-574.

[2] Sometimes the policy is owned by a trust created by the insured rather than by the insured individually. Use of a trust brings with it the advantages and disadvantages of trust ownership discussed in various places throughout the text including pages 50-53.

[3] See footnote 2, page 137, for an explanation of the various means that can be used in the agreement to determine a purchase price.

[4] The arrangement between the shareholders is a simple endorsement split dollar agreement whereby the policy owner simply "rents" the death benefit to the other shareholders using the IRS 2001-10 rates or the carrier cost of term insurance. See a discussion of endorsement split dollar at pages 224-227.

[5] With multiple stockholders the typical cross purchase agreement has the disadvantage of requiring that each stockholder be the owner and beneficiary of a policy on each of the other stockholders. Example 1, below, requires twelve policies to fund a cross purchase agreement involving just four stockholders (i.e., A must own policies insuring B, C, and D, etc.). Example 2 uses a cross-endorsement arrangement to reduce the number of policies to the number of insured stockholders.

| | | | | | |
|---|---|---|---|---|---|
| EXAMPLE 1 | Owner → | A | B | C | D |
| | 12 policies insuring | B C D | A C D | A B D | A B C |
| EXAMPLE 2 | Owner → | INDIVIDUAL INSURED | | | |
| | 4 policies insuring | A | B | C | D |

[6] Each of B, C, and D would receive the death benefit free of all income taxes since they are received as the death benefit of a life insurance contract.

[7] With a trusteed buy-sell agreement there is a potential transfer for value problem after the first death upon the transfer of the deceased stockholder's ownership interests in the remaining policies insuring the surviving stockholders (pages 574-575). With the cross-endorsement arrangement no such problem exists at that time since no policy is transferred. Rather, the endorsement split dollar agreement in future years is merely modified to accommodate the new ownership percentages. Some tax advisors have expressed concern that the cross-endorsement itself is a transfer for value. To avoid this concern, a common strategy is to create a partnership between the partners to hold a piece of business property such as land, building, or vehicles.

[8] To help "peg" the value, the parties must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129 and pages 402-403).

[9] This avoids potential conflict among shareholders upon sale or liquidation of the business. In most instances, once the business is sold or terminated, the parties to the buy-sell arrangement want to acquire the policies on their own life. Traditional entity purchase, cross purchase, and trusteed cross purchase arrangements require complicated planning to insure that this can be done and that a fair price for the policy is set. With the cross-endorsement buy sell arrangement no transfer is required. Each surviving shareholder simply stops endorsing his or her policy to the other shareholders when the buy-sell agreement ceases to exist.

# "WAIT AND SEE" BUY/SELL AGREEMENT

Choosing between a cross purchase and entity purchase agreement is often made difficult because of changing individual and business circumstances, as well as the inevitable "reforms" to our tax laws. One solution to this dilemma is the highly flexible "wait and see" buy/sell agreement, under which the owners agree among themselves, and with the business, to buy and sell their respective interests.[1]

**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation which is owned equally by A and B.[2] As with both cross and entity purchase agreements, the "wait and see" agreement provides for valuation of their interests, sale upon death, disability, or retirement, and the specific terms of payment.[3] However, unlike cross and entity purchase agreements, the "wait and see" buy/sell agreement does not specifically identify the purchaser. The purchaser and amounts of purchase are not determined until after the death of either A or B.

Life insurance funding of the agreement can be accomplished in a number of ways.[4] A and B could purchase life insurance contracts on each other (as with cross purchase agreements). Alternatively, the business could purchase life insurance contracts on both A and B (as with entity purchase agreements). A third alternative involves a combination of the first two methods.[5] Our example assumes that A and B purchase life insurance contracts on each other, are the policy owners, premium payors, and beneficiaries.[6]

**UPON DEATH.** Should A die first, his stock passes to his family or estate. At the same time, the insurance company pays a tax-free death benefit to B, as beneficiary of the contract insuring A's life. Pursuant to the agreement the following steps are implemented:

**1st** - The business has a *first option to purchase* A's stock.[7]

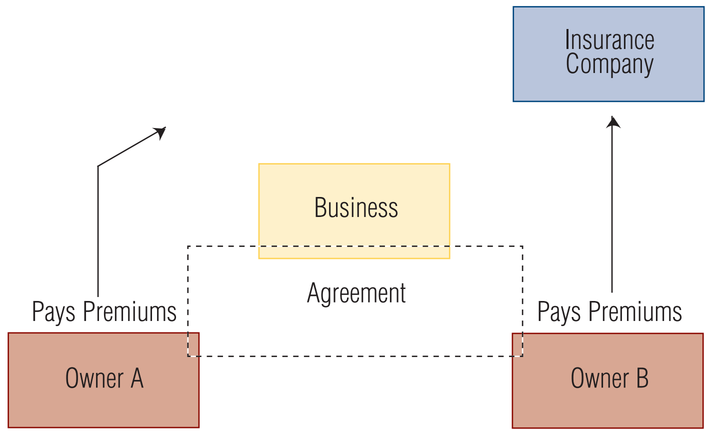
**2nd** - If the business does not exercise its option, or purchases less than all of A's stock, B has a *second option to purchase* A's stock.[8]

**3rd** - The business *is required to purchase* any of A's stock not previously purchased by either the business or B.[9]

Under the first and third steps the business could obtain funds for purchasing A's stock by borrowing the death proceeds received by B.[10] As with cross and entity purchase agreements, the "wait and see" buy/sell agreement can also serve to help "peg," or establish, the value of the stock for estate tax purposes.[11]

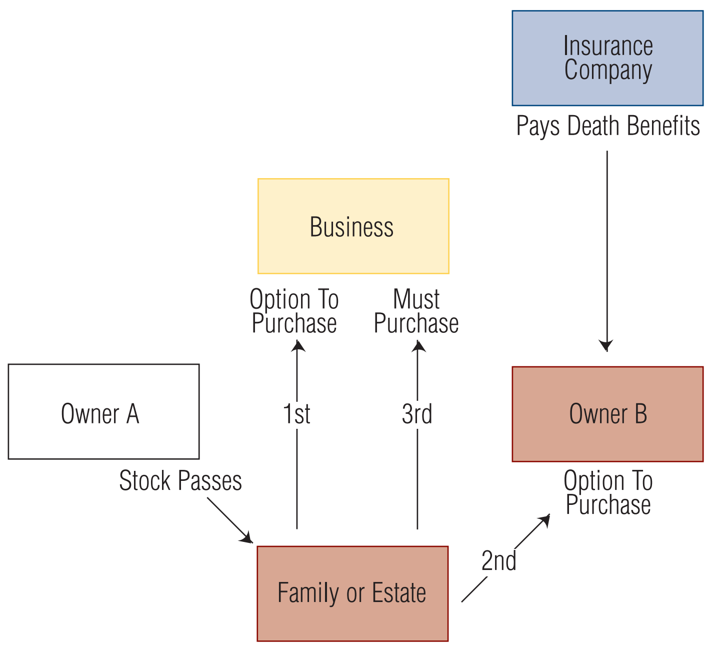
Footnotes on page 149

## DURING LIFETIME




Each Owner Obtains Life Insurance On The Other

## UPON DEATH



## "Wait and See" Buy/sell Agreement

### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Names of owners to be insured.
2. Sex.
3. Dates of birth.
4. Smoker/nonsmoker.
5. Value of ownership interests.
6. Form of organization (C corporation, S corporation, or partnership).
7. Identity of purchaser of insurance.

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 263**. When death benefits of business life insurance are exempt from income tax.

*Corporation*

**Q 246**. Premiums paid on business life insurance not usually taxable to insured employee.
**Q 247**. Premiums paid by corporation on policies insuring the life of a stockholder or employee usually not deductible.
**Q 251**. Premiums paid by corporation to fund stock redemption not taxable to insured stockholder.
**Q 283-Q 290**. Usually no capital gain to deceased stockholder's estate.
**Q 284-Q 292**. Income tax results of funding agreement with life insurance.
**Q 285**. Amount paid by corporation for decedent's entire stock interest generally not dividend to estate, provided no attribution problems.
**Q 286 and Q 287**. Avoiding attribution of stock ownership.
**Q 291**. Amount paid by corporation for stock usually not taxable as constructive dividend to surviving stockholder(s).
**Q 295**. Taxation of payments when redemption by S corporation.
**Q 300**. Treatment of corporate owned life insurance for purpose of alternative minimum tax.

*Partnership*

**Q 257**. Premiums paid are not deductible.
**Q 296**. Income tax results when deceased partner's interest is sold or liquidated under a business purchase agreement.
**Q 299**. Tax treatment of life insurance purchased to fund partnership business purchase agreement.

*Estate Tax*

**Q 304**. Life insurance proceeds not directly included in insured owner's estate when partnership or corporation is owner and beneficiary.

## Footnotes

[1] The "wait and see" buy/sell agreement is also referred to as the "option" or "flexible" buy/sell. The agreement is not appropriate when a corporation has only one stockholder, or with a sole proprietorship, since the corporation cannot own itself and the sole proprietorship is not a separate entity that can make the purchase.

[2] It is also assumed that A and B are *not* related to each other. If they were, and the business were a corporation, then the attribution rules would have to be considered if there is a purchase of stock by the business under either the 1st or 3rd step (attribution is more fully explained on pages 178-183).

[3] Various means can be used in the agreement to determine the purchase price. A *fixed price* could be established, with a further provision providing for periodic review and redetermination between the business and the owners. Alternatively, a *formula method* could be used, under which specific factors would be employed to calculate a value. For an example of a *capitalization formula*, see the Business Valuation chart on page 127. Another approach to determining a price is to provide for an *appraisal* at the time of sale (i.e., after the first owner's death, or earlier if a lifetime sale is contemplated).

[4] If the agreement is binding upon disability as well as death, consideration should also be given to funding the agreement with disability buy-out insurance. Such coverage will generally provide a lump-sum payment after a stated period of total and permanent disability. The premiums are nondeductible and the benefits are received free of income taxes. An expanded discussion of disability buy-out insurance is on page 376-377.

[5] No matter which method is chosen, to assure the death proceeds are received free of income taxes, appropriate notice and consents should be obtained (see Company Owned Life Insurance (COLI), pages 357-359).

[6] Funding of the life insurance owned by A and B could be accomplished with split-dollar (chart, page 229) or executive equity (chart, page 217). Having the stockholders as owners and beneficiaries of the policies avoids any potential corporate alternative minimum tax problem, as discussed on pages 363-365. This also allows the survivor to obtain a stepped-up basis by purchasing some or all of the deceased's stock at the 2nd step (i.e., a cross purchase agreement). The survivor would not have received an increased cost basis if the corporation purchases all of the deceased's stock at the 1st step (i.e., an entity purchase agreement).

[7] Typically the corporation would have from 30 to 90 days to exercise its option at the 1st step. If the corporation purchases all of A's stock the result would be an entity purchase agreement (chart, page 131).

[8] If the corporation does not purchase all of the stock at the 1st step, and B purchases all of A's stock at the 2nd step, the result is a cross purchase agreement (see chart, page 135). Typically B would have from 30 to 90 days to exercise his option. Note that it is important for the surviving stockholder to have an *option*, but not an *obligation*, to purchase stock at the 2nd step. If B had a legal obligation to purchase A's stock, and failed to do so, then the corporation's purchase of stock at the 3rd step would be treated as a dividend to B (i.e., the corporation would be considered as having discharged B's legal obligation).

[9] Note that despite the options involved in the 1st and 2nd steps, the mandatory purchase by the corporation in the 3rd step provides the *binding* agreement that assures A's stock will be sold for the benefit of his family (see footnote 11, below).

[10] Alternatively, the corporation could borrow funds from other sources, or B could make a capital contribution to the corporation, thereby increasing his cost basis in his stock. This also has the advantage of avoiding any problems with the corporate alternative minimum tax, which could occur if the corporation received the death proceeds (see pages 363-365).

[11] To help "peg" the value of the business for estate tax purposes, the parties must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129).

# KEY PERSON BUY-OUT AGREEMENT

The key person buy-out agreement is one means of providing for the complete disposition of a business interest.[1] Under this arrangement the owner agrees to sell all of his business interest to a key person.[2]

**DURING LIFETIME.** To illustrate how this works, assume that we have a corporation owned by A. A would enter into an agreement providing for the sale to B, a key person in the business. Typically, this agreement is *binding* and obligates both parties, or their representatives, upon the death, disability, or retirement of A.

Rather than trying to accumulate or borrow sufficient funds to buy A's interest, B obtains a life insurance contract insuring A. B applies for this coverage, pays the premiums, and is both owner and beneficiary of the contract.[3] By this means, B can use life insurance to *fully* fund his obligation to A.[4]

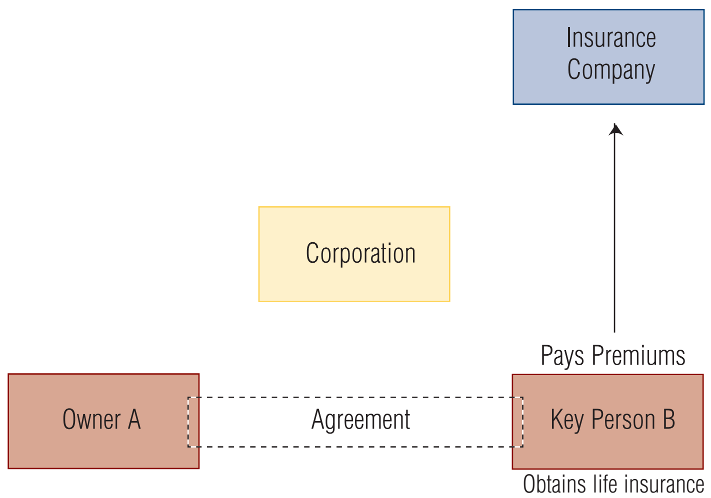
**UPON DEATH.** Assuming that A dies first, his stock would then pass to his family or estate. At the same time, the insurance company pays a death benefit to B, as beneficiary of the contract insuring A's life. B receives these funds free of all income taxes, since they are received as the death benefit of a life insurance contract.[5]

Pursuant to the agreement, A's family, or estate, transfers A's stock interest in the business to B, in return for which B pays the cash received from the insurance company.

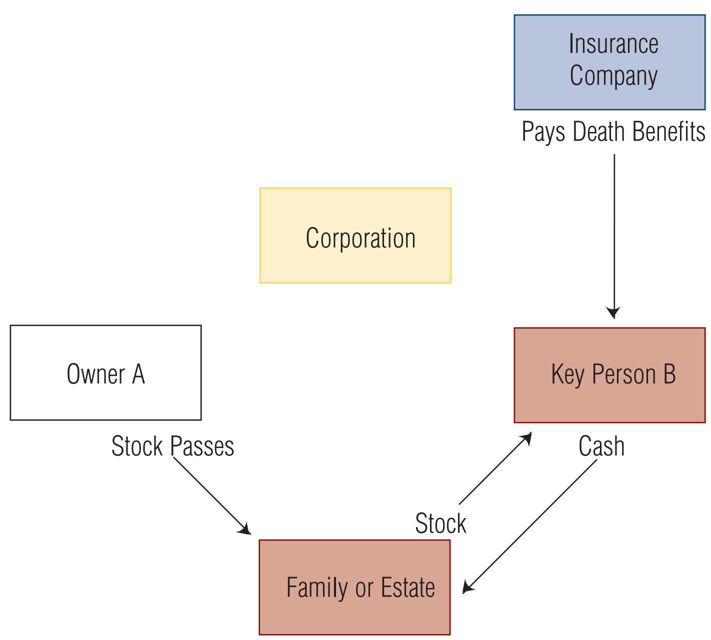
The fully funded agreement will *assure* that A's surviving family receives a fair price for his interest in the business. But such an agreement can also serve another very important function. If the estate had been subject to estate taxes, it is possible that extensive negotiations and even litigation could result if the estate tax value of the business had been left to chance. These problems of delay and litigation can be avoided by having an agreement that helps establish, or "peg," the value of the stock.[6]

Footnotes on page 153

## DURING LIFETIME




## UPON DEATH



## Key Person Buy-Out Agreement

### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of owner to be insured.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.
5. Value of ownership interest.
6. Form of organization (C corporation, S corporation, partnership, or sole proprietorship).
7. Identity of key employee.

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 64**. For death proceeds to be excludable from income, a life insurance policy must meet certain requirements.

*Corporation*

**Q 283**. Sale of deceased's stock will usually not result in income tax liability to deceased's estate.

**Q 284**. Income tax effects of funding stock purchase agreement with life insurance.

*Sole Proprietorship*

**Q 260**. Premiums paid by key employee for insurance on life of sole proprietor are not deductible.

*Estate Tax*

**Q 303**. Life insurance proceeds not included in insured's estate when partners or stockholders purchase insurance on lives of each other.

## Footnotes

[1] Such an agreement can be used with a corporation, a partnership, or a sole proprietorship. Since the key employee has no ownership interest, unlike the cross purchase agreement on page 135, there are no reciprocal obligations to buy and sell. The owner is merely obligated to sell and the key employee obligated to buy. A trusteed key person buy-out agreement might also be considered similar to the trusteed cross purchase agreement (chart, page 139).

[2] Various means can be used in the agreement to determine a purchase price. A *fixed price* could be established, with a further provision providing for periodic review and redetermination by mutual agreement among the owners. Alternatively, a *formula method* could be employed, under which specific factors would be used to calculate a value. For an example of a *capitalization* formula, refer to the valuation chart on page 127. Another approach to determining a price is to provide for an *appraisal* at the time of sale (i.e., after the owner's death, or earlier if a lifetime sale is contemplated).

[3] In a family-owned business it is possible that the reach of the attribution rules under Code section 101(j) *might* treat this policy as "employer-owned." This would subject the death benefit to income taxation. To assure the proceeds are received free of income taxes, appropriate notice and consent should be obtained (see Company Owned Life Insurance (COLI) pages 357-359).

[4] When the obligation is not fully funded, borrowing as an alternative to life insurance is usually unattractive, as can be appreciated. Although the premiums paid for this coverage are not tax-deductible, a split-dollar plan could be used to assist B in purchasing the life insurance (chart, page 229). As an alternative, consider Executive Equity (chart, page 217).

[5] Receipt of the death proceeds allows B to purchase A's business interest *and* obtain an income tax cost basis equal to the purchase price. Assume that A originally paid $100,000 for his stock interest that is now worth $750,000. If A dies and B purchases A's stock under a key person buy-out agreement, B's basis in the stock would be equal to the $750,000 purchase price. B's gain on a later sale of the stock would be equal to the amount by which the sales price exceeds $750,000.

[6] To help "peg" the value, A must be required to sell during lifetime for the same price as provided for a sale at death. In addition, the agreement must specifically *bind* A's estate or family and further comply with the Chapter 14 requirements (see footnote 3, page 129 and pages 402-403). The table of Contested Business Valuations on pages 183-188 provides specific examples of what happens when there is a failure to properly "peg" the value of stock in a closely held corporation. The cases on page 197 demonstrate that buy/sell agreements really do help fix the value.

# PARTIAL STOCK REDEMPTION

A partial stock redemption under Section 303 offers a very attractive way of paying estate settlement costs, particularly for a corporation that will be continued by the surviving family.[1]

Under most circumstances, a stockholder who has the corporation redeem less than his entire stock interest will be fully taxed on the proceeds as ordinary income. However, under the special provisions of Section 303, his surviving family can do after death what the stockholder generally cannot do during his lifetime … namely, sell only a *portion* of his stock interest to the corporation, and have the sale treated as a capital transaction rather than as a dividend.

**DURING LIFETIME.** If the stock interest will be *more than* 35 percent of the stockholder's adjusted gross estate, then his stock will qualify under Section 303 for a partial redemption at his death.[2] The *amount* of stock which can be purchased is limited to the sum of all federal and state death taxes, funeral, and administrative expenses. The purchase must also be made from whoever has the obligation to pay these costs, usually the family or estate.[3]

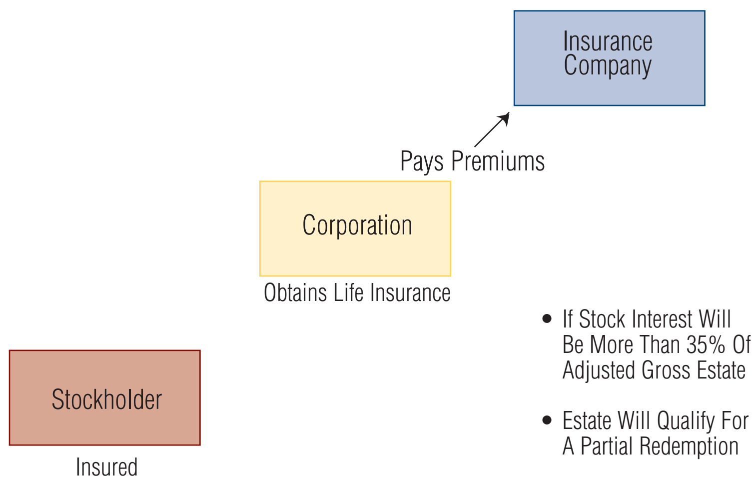
Since few corporations can be expected to accumulate sufficient cash for such a purchase, typically the corporation obtains a life insurance contract insuring the stockholder in his capacity as an employee. The corporation pays the premiums and is both owner and beneficiary of the contract.[4] This is generally a much better solution to the funding problem than attempting to accumulate large cash reserves over a period of time, borrowing at high interest rates, or selling corporate assets.[5]

**UPON DEATH,** the stock passes to the family or estate. At the same time, the insurance company pays a death benefit to the corporation.[6] This money is usually received free of all income taxes.[7] The corporation can then use the cash to purchase *some* of the stock from the family or estate.

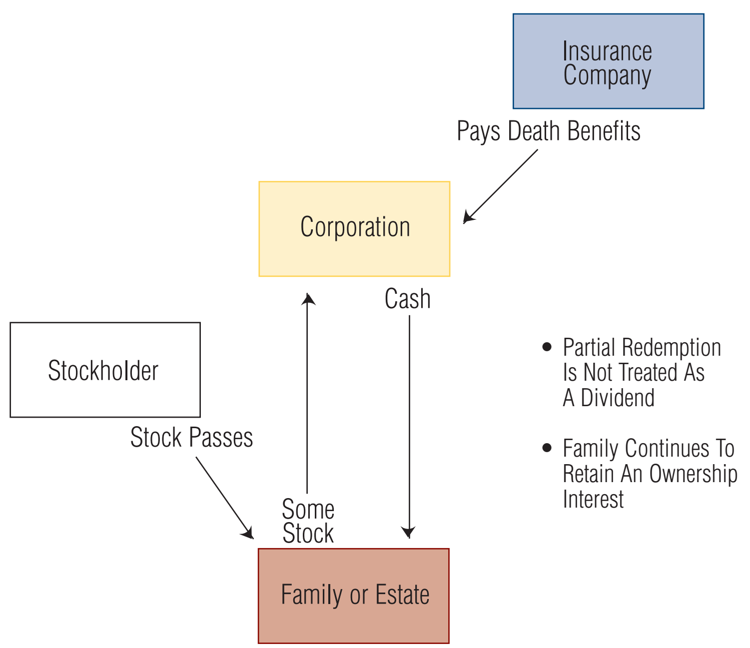
The tax-favored treatment under Section 303 has been made available to the family-owned corporation in order to protect it from being sold or liquidated to pay death taxes and other estate settlement costs. When a corporate interest is the bulk of an estate, it only makes sense to use corporate dollars to provide the necessary cash to pay these costs.[8]

Footnotes on page 157

## DURING LIFETIME




## UPON DEATH



### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of owner to be insured.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.
5. Value of ownership interest.
6. Value of adjusted gross estate (see calculation steps, page 87).
7. Form of organization (C corporation or S corporation).

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 138**. Income taxation of life insurance policy that insures more than one life.
**Q 245**. Premiums paid not deductible.
**Q 247**. Premium paid by corporation on policies insuring the life of a stockholder or employee usually not deductible as business expense.
**Q 251**. Premium paid by corporation to fund stock redemption not taxable to insured stockholder.
**Q 263**. When death benefits of business life insurance are exempt from income tax.
**Q 288**. Requirements for a Section 303 stock redemption.
**Q 290**. Usually no capital gain to deceased stockholder's estate caused by a redemption.
**Q 291**. Amount paid by corporation for stock usually not taxable as constructive dividend to surviving stockholder(s).
**Q 292**. Income tax results of funding stock redemption agreement with life insurance.
**Q 293**. Accumulated earnings tax and purchase of business life insurance.
**Q 295**. Taxation of payments when redemption by S corporation.
**Q 300**. Treatment of corporate owned life insurance for purposes of alternative minimum tax.

*Estate Tax*

**Q 194**. Estate taxation of life insurance policy that insures more than one life.
**Q 304**. Life insurance proceeds not directly included in insured stockholder's estate when corporation is owner and beneficiary.

## Footnotes

[1] Partial stock redemptions are also referred to as "Section 303 Redemptions." Code section 303 authorizes a redemption of less than the entire stock interest of the decedent to be treated as a *sale* of stock, as opposed to a *dividend*. Because of the step-up in basis at death, a sale of stock will generally result in little, if any, taxable gain, since under a capital transaction the seller is not taxed on the basis of the property sold. In contrast, a dividend would be fully taxable as ordinary income (see Stepped-Up Basis, on page 561).

[2] The adjusted gross estate is determined by subtracting debts, funeral, and administrative expenses from the gross estate. This requirement provides you with the opportunity to conduct an estate analysis involving a full review of a client's assets. Without this information, it is not possible to determine whether an estate would qualify for a partial stock redemption (see page 12). If a client has more than one corporation, the stock of two or more corporations may be combined to meet the 35 percent test, provided the stockholder owns 20 percent or more of the value of each corporation, and the stock of the corporation is included in his gross estate. Even though an estate may *presently* be expected to qualify for a partial stock redemption, it is important to monitor estate assets to assure that there is not a subsequent disqualification. For example, the corporate stock could become 35 percent or less of the adjusted gross estate if: (1) other estate assets appreciate more than the stock interests; (2) the stock interests decline in value; (3) stock is either sold or given away.

[3] The redemption can be made only by that party having liability for the federal and state death taxes, funeral, and administrative expenses. It must usually be made within 3 years and 90 days after the estate tax return is filed (the estate tax return must be filed within 9 months after death). The effectiveness of a Section 303 redemption is limited when the unlimited marital deduction is used. See discussion on page 544.

[4] Employer-owned life insurance must meet strict notice and consent requirements if the death benefits are to be received free of income taxes (see Company Owned Life Insurance (COLI), pages 357-359).

[5] It is questionable whether many corporations could accumulate sufficiently large cash reserves for effective partial stock redemptions without running afoul of the prohibition against the unreasonable accumulation of earnings (see Accumulated Earnings Tax on page 332). With the purchase of life insurance to fund a partial stock redemption, the corporation is in effect amortizing the cost of the redemption over the lifetime of the insured stockholder. The insurance carried is similar to key person insurance as shown in the chart on page 163. If the corporation is in a relatively low tax bracket, the required premium payments can be made with enhanced dollars. Another variation of insurance ownership and beneficiary designation is shown in the Reverse Section 303 stock redemption chart, on page 159. Funding a partial stock redemption with survivorship life insurance can be particularly attractive when the unlimited marital deduction is used at the first death, since it provides death proceeds at the second death, when the estate taxes can no longer be deferred.

[6] This death benefit will *increase* the value of the decedent's stock in his gross estate in proportion to the decedent's interest in the corporation. For example, if the decedent owned 100 percent of the stock, a $100,000 death benefit might increase the value of the stock in the estate by $100,000. However, if the decedent owned only 40 percent of the stock, a $100,000 death benefit might increase the value of the stock in the estate by only $40,000. It could always be argued that there was a loss of corporate value caused by the death of a key employee that offsets some or all of the increase in stock value.

[7] Under some circumstances a portion of annual cash value increases and death proceeds could be subject to the Corporate Alternative Minimum Tax, as discussed on pages 363-365.

[8] In this chart, only *some* stock is redeemed, whereas a redemption of *all* stock is referred to as a "Section 302(b)(3) redemption." Section 302(b)(3) is that section of the Code that enables the redemption, or sale to the corporation, of the *entire* stock interest of a stockholder to be treated as a *sale* of stock, as opposed to a *dividend*. The Entity Purchase Agreement chart, on page 131, explains the Section 302(b)(3) redemption. Unlike the entity purchase agreement, in a family held corporation a partial stock redemption does not cause potential attribution problems (see pages 178-183).

# REVERSE SECTION 303

A reverse stock redemption under Section 303 offers a very attractive way of paying estate settlement costs by having an entity other than the corporation purchase insurance to fund the redemption.[1]

**DURING LIFETIME.** If the stock interest will be *more than* 35 percent of the stockholder's adjusted gross estate, then his stock will qualify under Section 303 for a partial redemption at his death.[2] The *amount* of stock that can be purchased is limited to the sum of all federal and state death taxes, funeral, and administrative expenses.[3] However, the purchase must be made from whoever has the obligation to pay these costs, usually the family or estate.

One way to implement a reverse Section 303 is for the stockholder to establish a life insurance trust.[4] A life insurance contract insuring the stockholder is then obtained by the trust.[5] The trust pays the premiums and is both owner and beneficiary of the contract.[6]

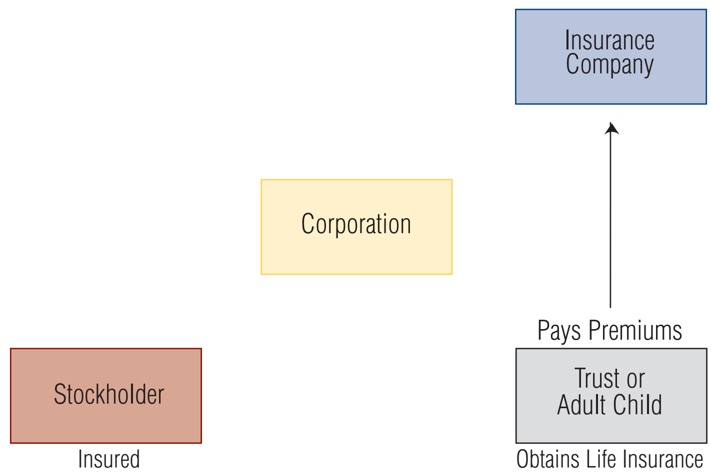
**UPON DEATH.** The stock passes to the family or estate. At the same time, the insurance company pays a death benefit to the trust, which is received free of all income taxes.[7] The trust then loans the money to the corporation, which uses it to purchase *some*, but not all, of the stock from the family or estate.

In repaying this loan the corporation can make tax-deductible interest payments to the trust. Although these interest payments would be taxable income to the trust, repayments of the loan principal would be received by the trust free of income taxes. By this means the family can continue to retain ownership and control of the corporation, while at the same time receiving, as trust beneficiaries, the benefits of the untaxed repayment of loan principal.

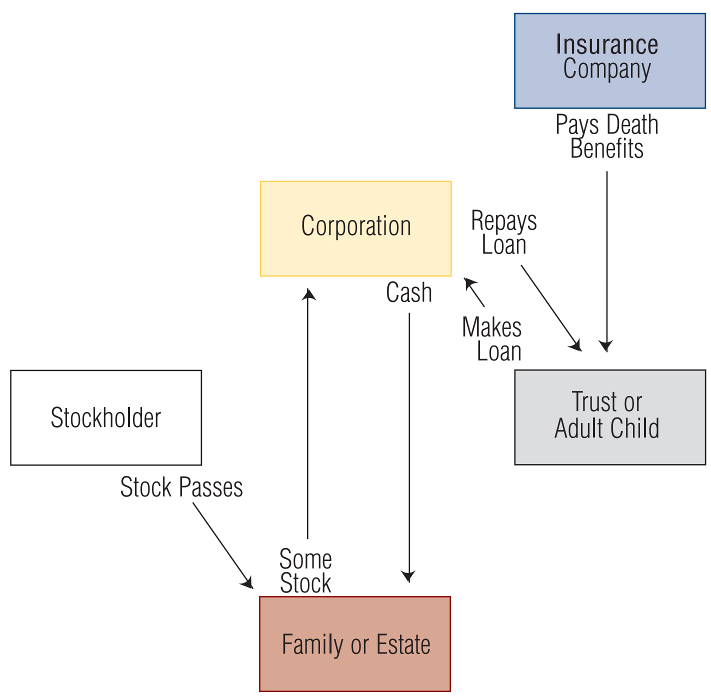
Of course, it is not necessary for a trust to be established. Anyone who has substantial funds can loan them to the corporation for the purpose of a partial stock redemption. For example, a son or daughter of the stockholder could be owner and beneficiary of life insurance contracts insuring the parent. After receipt of the death benefit, the proceeds could be loaned by the children to the corporation, which would then repay the loan together with interest.[8]

Footnotes on page 161

## DURING LIFETIME




## UPON DEATH



## Reverse Section 303

### INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of owner to be insured.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.
5. Value of ownership interest.
6. Value of adjusted gross estate (see calculation steps, page 87).
7. Form of organization (C corporation *or* S corporation).

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

**Q 2**. Premiums paid on life insurance generally not deductible.
**Q 138.** Income taxation of life insurance policy that insures more than one life.
**Q 194.** Estate taxation of life insurance policy that insures more than one life.
**Q 288**. Requirements for a Section 303 stock redemption.
**Q 290**. Usually no capital gain to deceased stockholder's estate.
**Q 291**. Amount paid by corporation for stock usually not taxable as constructive dividend to surviving stockholder(s).
**Q 295**. Taxation of payments when redemption by S corporation.

## Footnotes

[1] Section 303 is that section of the Code that authorizes a redemption of less than the entire stock interest of the decedent to be treated as a *sale* of stock, as opposed to a *dividend*. Because of the step-up in basis at death, a sale of stock will generally result in little, if any, taxable gain, since under a capital transaction the seller is not taxed on the basis of the property sold. In contrast, a dividend would be fully taxable as ordinary income (see Stepped-Up Basis, on page 561).

[2] The adjusted gross estate is determined by subtracting debts, funeral, and administrative expenses from the gross estate. This requirement provides you with an opportunity for an estate analysis involving a full review of a client's assets (see page 12). Without this information, it is not possible to determine whether an estate will qualify for a partial stock redemption. If a client has more than one corporation, the stock of two or more corporations may be combined to meet the 35 percent test, provided the stockholder owns 20 percent or more of the value of each corporation, and the stock of the corporation is included in his gross estate. Even though an estate may *presently* be expected to qualify for a Section 303 redemption, it is important to monitor estate assets in order to assure that the estate continues to qualify. For example, the corporate stock could become 35 percent or less of the adjusted gross estate if: (1) other estate assets appreciate more than the stock interests; (2) the stock interests decline in value; (3) some of the stock is either sold or given away.

[3] The permanent reduction of the federal estate tax under the American Taxpayer Relief Act of 2012 reduced the utility of a Reverse Section 303.

[4] The details of establishing a life insurance trust are set forth in the chart on page 51.

[5] In a family-owned business it is possible that the reach of the attribution rules under Code section 101(j) *might* treat this policy as "employer-owned." This would subject the death benefit to income taxation. To assure the proceeds are received free of income taxes, appropriate notice and consent should be obtained (see Company Owned Life Insurance (COLI) pages 357-359). Funding a reverse Section 303 stock redemption with survivorship life insurance can be particularly attractive when the unlimited marital deduction is used at the first death, since it provides death proceeds at the second death, when the estate taxes can no longer be deferred. If survivorship life insurance is used, then appropriate notice and consents should be obtained from *both* insureds.

[6] Since premiums must come from after-tax dollars, having someone other than the corporation own the insurance contract and pay the premiums could take advantage of a lower tax bracket.

[7] Use of a reverse Section 303 may be advisable when there is a concern regarding the Corporate Alternative Minimum Tax (see pages 363-365). With the usual Section 303 redemption, as shown in the chart on page 155, the payment of the death benefit to the corporation exposes the corporation to the alternative minimum tax. With a reverse Section 303 redemption the death benefit is paid outside the corporation, meaning that there is no increase in adjusted current earnings, and thus no exposure to the alternative minimum tax.

[8] When the insurance is owned by and payable to either children or a trust, the reverse 303 technique avoids the problem of increasing the value of the deceased's taxable estate, as occurs when death proceeds are paid to a corporation under the usual Section 303 arrangement (see the chart on page 155, and footnote 6 on page 157).

# KEY PERSON INSURANCE

Multipurpose key person insurance protects a business from the financial losses that can occur when a key employee dies. Such a key employee could be the owner of the business, or a non-owner employee whose very specialized abilities are critical to the operation of the business and difficult or costly to replace.[1] Adequate amounts of key person insurance are essential in any risk management program. Since the existence of business debt "signals a need for insurance," key person insurance can function as a form of commercial loan protection, as well as provide needed funds when a business is to be continued, sold, or liquidated.[2]

**DURING LIFETIME.** This protection is provided by having the business obtain insurance on the life of the key employee.[3] As both owner and beneficiary of the contract, the business pays the premiums directly to the insurance company.[4] The contract's cash values are carried as a business asset, and are available as collateral for securing commercial loans, or for direct borrowing from the insurance company at generally favorable interest rates.[5]

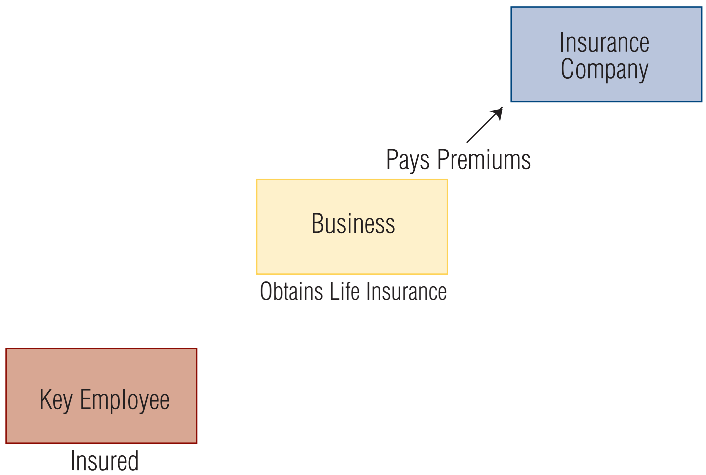
Many guidelines are used in estimating the *dollar value* of a particular key employee. However, the value can be most easily estimated by using a factor of three to ten times the employee's salary. Other guidelines that have been employed involve either a determination of the employee's replacement cost, or an estimation of lost profits or credit.[6]

**UPON DEATH** of the key employee the insurance company pays the death benefit directly to the business. The funds are treated as an addition to surplus and are received free of any direct income taxes.[7]

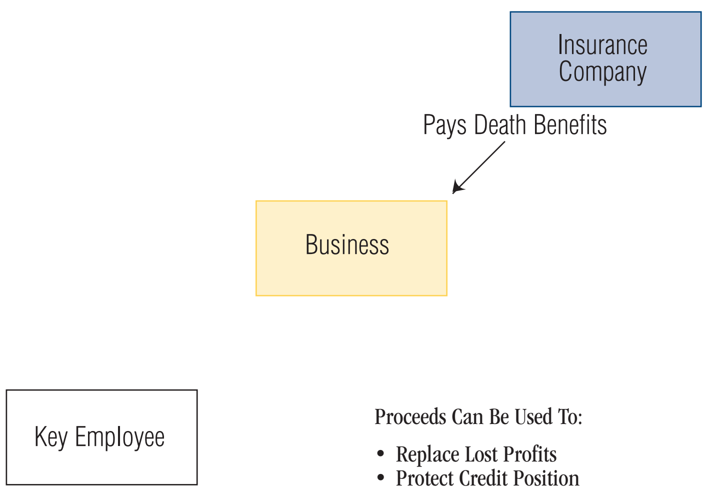
The proceeds can then be used for various purposes. Should it be determined that the business will be *continued*, these can be used to obtain a qualified replacement, replace lost profits, protect its credit position, provide a financial cushion, fund a partial stock redemption or make survivor income payments. If the business is to be *sold*, then there is money available to fund a full stock redemption. In case of *liquidation*, the cash will benefit the surviving family by offsetting lost business value.[8]

Footnotes on page 165

## DURING LIFETIME




## UPON DEATH




Proceeds Can Be Used To:

- Replace Lost Profits
- Protect Credit Position
- Provide Financial Cushion
- Offset Lost Business Value
- Obtain Qualified Replacement
- Make Survivor Income Payments
- Fund Entity Purchase Agreement (Sec. 302)
- Fund Partial Stock Redemption (Sec. 303)

## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of employee.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.

*To Determine Amount of Coverage*

5. Salary of employee.
6. Position of employee in business.

## CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*General Rules*

**Q 3**. Deduction of interest on indebtedness incurred to purchase or carry life insurance contract.
**Q 13**. Taxation of distributions from policies classified as modified endowment contracts.
**Q 29**. Taxability of policy loans.
**Q 30**. Deduction of interest on policy loans.
**Q 245**. Premiums paid usually not deductible as business expense.
**Q 246**. Premiums paid usually not taxable to insured employee.

*Corporation*

**Q 223**. Tax consequences of attaching disability income rider to key person life insurance policy.
**Q 247.** Premiums paid by corporation on policies insuring the life of a stockholder or employee usually not deductible as business expense.
**Q 250**. Premiums paid by corporation not taxable to insured employee.
**Q 300**. Treatment of corporate owned life insurance for purposes of alternative minimum tax.

*Partnership*

**Q 257**. Premiums paid by partnership are not deductible.
**Q 258**. Premiums paid by partner for insurance on his own life not deductible by him if proceeds payable to partnership.

*Estate Tax*

**Q 301**. Life insurance payable to partnership generally not includible in insured partner's estate (but included as part of partnership interest).
**Q 302**. Life insurance payable to corporation generally not includible in insured's estate, provided insured had no "incidents of ownership" in policy (but included in valuing corporate stock).

## Footnotes

[1] The classic statement regarding the need for key person insurance was made by the U.S. Court of Appeals, 3rd Circuit (1951), in the case of *The Emeloid Co., Inc. v. Commissioner*:

> "What corporate purpose could be more essential then key [person] insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets – managerial skill and experience."

[2] Key person insurance can also be thought of as a "line of credit." As such, it will assure that money is available when needed, without any repayment of the debt, i.e., a forgiveness of the "loan." Relying on borrowed funds may be ill advised.

[3] Employer-owned life insurance must meet strict notice and consent requirements if the death benefits are to be received free of income taxes (see Company Owned Life Insurance (COLI), pages 357-359).

[4] The "cost" of key person insurance is sometimes measured as the difference between the premium paid and the cash value increase. This view tends to argue in favor of permanent insurance with cash values, as opposed to term insurance with no cash values (but such an approach ignores the time value of money, as discussed in Interest Adjusted Net Cost on page 427). It should also be recognized that the cash values of permanent insurance, carried for a bona fide business purpose, are not subject to the unreasonable accumulation of earnings tax. An expanded discussion of this subject is contained on page 332. If cash values are borrowed, it would be to the business's advantage to be sure it could deduct interest paid on the borrowed funds (see Minimum Deposit Insurance, on page 481). If borrowing of cash values is contemplated, then it is important to avoid having the policy classified as a Modified Endowment Contract (see expanded discussion on pages 438-439).

[5] Under some circumstances a portion of annual cash value increases and death proceeds could be subject to the Corporate Alternative Minimum Tax, as discussed on pages 363-365. However, this problem is not present in an S corporation, since it is not subject to the alternative minimum tax adjusted current earnings adjustment. In fact, key person insurance in an S corporation may be particularly attractive in view of the opportunity to make tax-free withdrawals of the death proceeds where the S corporation has no accumulated earnings and profits (see S Corporation, pages 539-541). With a C corporation the alternative minimum tax problem can be avoided by using the Reverse Key Person Insurance technique (see chart, page 167).

[6] See page 189 for various formulas used to value a key person. Another approach to the valuation of a key person is to discount all future salary payments to normal retirement age. For example, referring to the Present Value Table on page 601, it can be determined that, using a time value of money assumption of 8 percent, a 45-year-old employee earning $50,000 per year, who is expected to retire in 20 years (age 65), has a present value of $490,900 ($50,000 × 9.818 = $490,900). No matter which approach is used, valuation of a key person is much like valuation of a business, the process may be more art than science. However, application of these guidelines will provide a useful starting point for determining a key person's value to a business.

[7] An explanation and illustration of proper accounting entries for policy premiums and values is set forth in Accounting For Business Life Insurance on pages 330-331.

[8] Whether a business is likely to be continued, sold, or liquidated upon the death of a key employee, will depend upon answers to the questions set forth in the Disposition Of A Business Interest chart on page 123.

# REVERSE KEY PERSON INSURANCE

Reverse key person insurance offers an alternative means of providing key employee insurance by having someone other than the business purchase insurance on the life of the key employee. It is particularly useful with C corporations, where the corporate alternative minimum tax can reduce by up to 15 percent the death benefit received by the corporation.[1] With reverse key person insurance there is no exposure to the alternative minimum tax, because the death benefit is not paid to the corporation. If the key employee is also a stockholder, payment of the death benefit outside the corporation also avoids increasing the value of the deceased's stock and thereby avoids any increase in estate taxes.[2]

**DURING LIFETIME.** Such a program can be established by having the trustee of an irrevocable life insurance trust purchase insurance on the key employee.[3] As both owner and beneficiary of the contract, the trustee pays the premiums directly to the insurance company.[4]

Many guidelines are used in estimating the dollar value of a particular key employee. However, the value can be most easily estimated by using a factor of three to ten times the employee's salary. Other guidelines that have been employed involve either a determination of the employee's replacement cost, or an estimation of lost profits or credit.

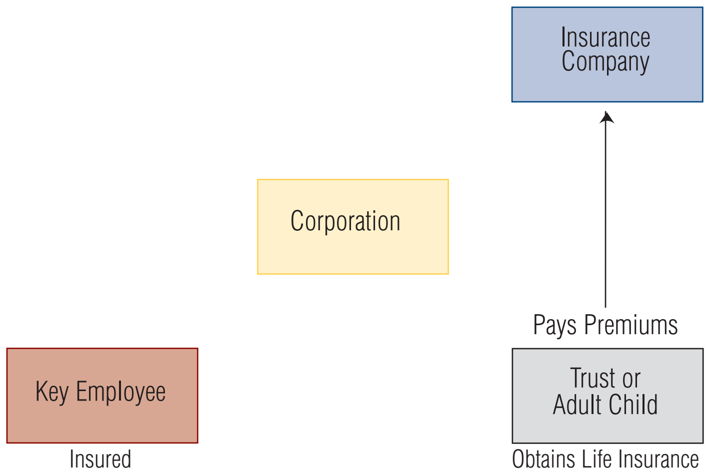
**UPON DEATH** of the key employee the insurance company pays the death benefit directly to the trustee of the trust.[5] The proceeds are received free of income taxes as the death benefit of a life insurance contract.

The funds can then be loaned by the trustee to the corporation.[6] In repaying this loan the corporation makes tax-deductible interest payments to the trust.[7] Although these interest payments are taxable income to the trust, repayments of the loan principal are received by the trust free of income taxes.

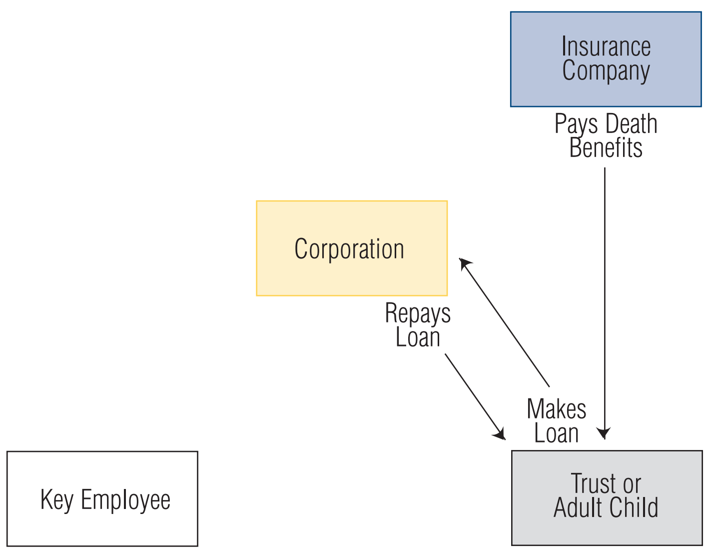
Of course, it is not necessary for a trust to be established. Anyone who has the funds can loan them to the corporation for the purpose of key person insurance. For example, an adult child could be the owner and beneficiary of a life insurance contract insuring his parent. After receipt of the death benefit, the child could loan the proceeds to the corporation, which would then repay the loan together with interest.[8]

Footnotes on page 169

## DURING LIFETIME




## UPON DEATH



## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Name of employee.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.

*To Determine Amount of Coverage*

5. Salary of employee.
6. Position of employee in business.

*To Determine Party Who Will Own Insurance Contract*

7. Availability of irrevocable life insurance trust (including trust language authorizing loan to corporation).
8. Names and ages of children.
9. Degree of involvement of children in business.

## CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

*Income Tax*

**Q 145**. When income taxable to trust or to trust beneficiaries.
**Q 148**. Death proceeds received by trust free of income taxes.
**Q 300**. Treatment of corporate owned life insurance for purposes of alternative minimum tax.

*Estate Tax*

**Q 78**. Circumstances under which life insurance proceeds are includable in insured's gross estate even though insured has no incident of ownership in policy and proceeds are not payable to estate.
**Q 177**. Insurance proceeds included in insured's estate when trustee *required* to pay estate debts and taxes.

## Footnotes

[1] This reduction is only likely with a C corporation; there is no exposure with an S corporation or a partnership. With Key Person Insurance, as shown in the chart on page 163, the death benefit paid to a C corporation is included in adjusted current earnings as part of the alternative minimum tax calculations. The larger the death benefit relative to anticipated corporate earnings, the greater the likelihood that the corporate alternative minimum tax will reduce the death benefit. Alternatively, the smaller the death benefit relative to anticipated corporate earnings, the lesser the likelihood of a reduction in death benefits on account of the alternative minimum tax. A more detailed explanation of the Corporate Alternative Minimum Tax is contained on pages 363-365. The table on page 365 provides examples of the relationship between the amount of the death benefit and anticipated corporate earnings.

[2] When the insurance is owned by and payable to either a trust or an adult child, the Reverse Key Person Insurance technique also avoids the problem of increasing the value of the deceased's estate, as can occur when death proceeds are paid to a corporation under the typical Key Person Insurance arrangement (see the chart on page 163, and footnote 6 on page 157). In this regard, note the similarity between Reverse Key Person Insurance and Reverse Section 303 (see chart, page 159).

[3] In a family-owned business it is possible that the reach of the attribution rules under new Code section 101(j) *might* treat this policy as "employer-owned." This would subject the death benefit to income taxation. To assure the proceeds are received free of income taxes, appropriate notice and consent should be obtained (see Company Owned Life Insurance (COLI) pages 357-359).

[4] The details of establishing and administering an irrevocable life insurance trust are set forth on pages 50-53.

[5] When considering Reverse Key Person Insurance it is important to determine how the premiums will be paid. With Key Person Insurance the premium is an obligation of the corporation as owner of the insurance contract. In contrast, with *Reverse* Key Person Insurance the contract is owned by a trustee, or an adult child, who has the obligation to make the premium payments. Corporate funds could be used to assist in paying the premiums using either Executive Equity, chart page 217, or Split-Dollar Insurance, chart page 225.

[6] The trustee must have authority to make a loan to the corporation. Although many irrevocable life insurance trusts will give the trustee broad authority to purchase assets and make loans to the estate and others, it would be prudent to give the trustee specific authority to make loans at prevailing interest rates to the corporation. However, the trust language *should not* require the trustee to make such loans, as this would likely cause the death proceeds to be included in the insured's estate. Although the trustee cannot be required to make the loan, preserving the family business for the trust beneficiaries would likely motivate the trustee to make the loan, particularly if the trustee was also responsible for maintaining and preserving the business (see footnote 6, page 53).

[7] Interest payments are deductible by the corporation but taxable to the trust unless distributed and taxed to the trust beneficiaries. Distribution of trust income may be advisable in view of the very high income tax rates applicable to trusts (e.g., the table on page 585 indicates that in 2015 income in excess of $12,300 is subject to a 39.6 percent tax rate). On the other hand, creation of a debt from the corporation to the trustee, or an adult child, offers the advantage of being able to subsequently withdraw the loan principal from the corporation free of income taxes. This is similar to the same advantage offered by the Reverse Section 303 (see chart, page 159).

[8] Because it is not possible to obligate the adult child to loan the death proceeds to the corporation, it is extremely important to be sure the child will be highly motivated to make such a loan (e.g., the child is the "heir apparent" to the business and would suffer financially should the corporation fail to continue operations).

# FAMILY LIMITED PARTNERSHIP

The family limited partnership (FLP) is a valuable planning technique offering numerous advantages to the owners of a closely held business.[1] With this technique, business interests and other assets can be transferred to family members at reduced values while maintaining indirect yet effective control.[2]

**ESTABLISHING PARTNERSHIP.** The FLP is established by an agreement setting forth the partnership's operating rules and the filing of a certificate of limited partnership with state authorities.[3] The typical FLP agreement places restrictions and limitations on ownership of partnership interests, and cannot be changed or terminated for a specified number of years without the concurrence of all partners.[4]

Once the agreement is drawn, the parents then contribute assets to the FLP, which in turn issues both *general* and *limited* partnership interests.[5] Thereafter, the parents make gifts of the limited partnership interests to their children. These gifts can be structured to fall within the gift tax annual exclusion, or the $5,000,000 ($5,430,000 as indexed in 2015) estate tax exclusion amount and used to immediately transfer large amounts of limited partnership interests.[6]

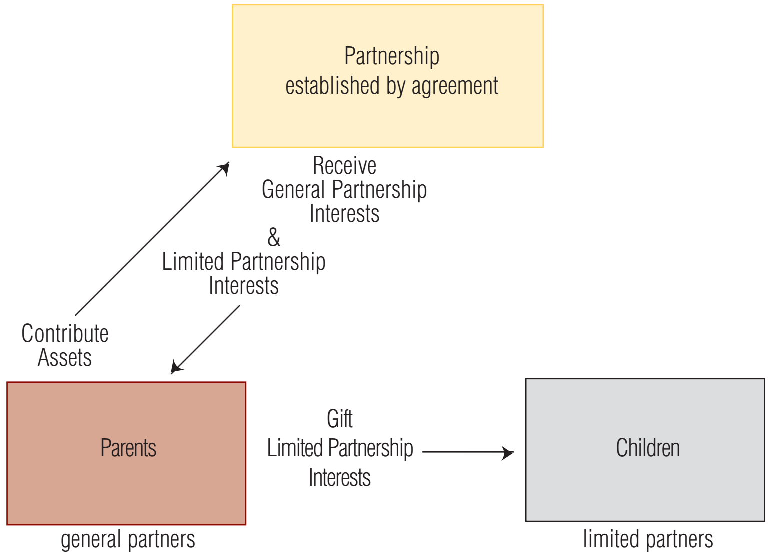
**ADVANTAGES OF PARTNERSHIP.** The principal advantages of the FLP are both *control* and *flexibility*.[7] As general partners, the parents have complete power and authority to manage the partnership.[8] As limited partners, the children have no say in the management of the partnership, no liability for partnership debts, and a priority over the general partners in the event of a liquidation.

With a FLP, gifts can be made of assets that are otherwise not easily divisible (e.g., the family farm). Transferring real estate located in another state to the partnership can avoid ancillary probate. Income can be shifted to children in lower income tax brackets.[9] Periodic gifts of limited partnership interests can reduce the parent's taxable estate.[10] Gifts of limited partnership interests are subject to valuation discounts for both minority interests and lack of marketability. Such valuation discounts, which can often range up to 30 percent and more, offer the opportunity to "leverage" these tax-free gifts.[11]

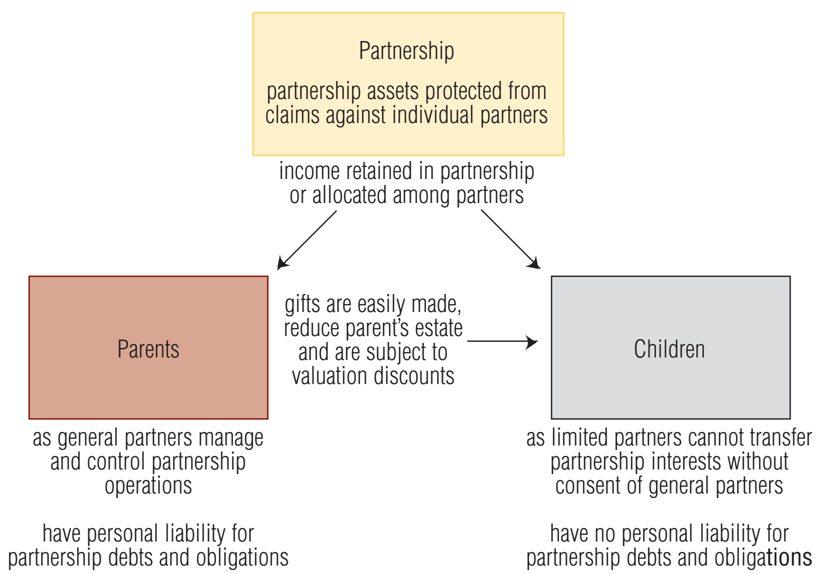
Because the children cannot transfer their limited partnership interests without the consent of all other partners, partnership assets are protected from claims against the individual partners (including those arising out of a divorce). Although creditors might succeed in obtaining a right to partnership distributions, the general partners have the power to withhold distributions by retaining income within the partnership.[12]

Footnotes on page 173

## ESTABLISHING PARTNERSHIP




## ADVANTAGES OF PARTNERSHIP
Control and Flexibility



## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

1. Nature of family business.
2. Other assets in estate (particularly real estate).
3. Value of assets to be contributed to partnership.
4. Marital status.
5. Names and ages of donee(s).
6. Relationship of donee(s) to donor(s).
7. Attitude toward making gifts to family members.
8. Prior gifts made and prior use of unified credit.

## CROSS REFERENCE TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

**Q 296**. The income tax results when a deceased partner's interest is sold under a business purchase agreement.

**Q 301**. If a partnership is both policy owner and beneficiary, insurance proceeds are not includable in the insured's estate (but are included in determining the value of the deceased's partnership interest).

**Q 303**. Proceeds from a policy purchased by a partner on the life of another partner to fund a cross purchase agreement are not included in the insured partner's gross estate.

**Q 304**. Proceeds from a policy purchased by a partnership on the life of a partner to fund the purchase of the insured partner's interest are not included in the insured's gross estate.

**Q 305-Q 306**. How a closely held business interest is valued for federal estate tax purposes.

**Q 673**. When a limited liability company is treated as a partnership.

**Q 674**. How the income of a partnership is taxed.

## Footnotes

[1] Partnerships are also used as an alternative to the irrevocable life insurance trust and to avoid transfer for value rules, but the latter use appears very aggressive (see page 495).

[2] Although the family limited partnership is an innovative use of existing laws regarding limited partnerships, it should always be established for legitimate business and non-tax estate planning purposes.

[3] The principal requirements for a family limited partnership are: (1) capital must be a material income-producing factor, meaning that a personal service business where income consists primarily of fees or commissions would not qualify for operation as a family limited partnership (i.e., lawyer, doctor, photographer, plumber, etc.); (2) if the partnership has been created by gift, the donor (parent) must be given a reasonable salary for services rendered to the partnership before profits can be allocated among the partners (the concept of "gift" also includes intra-family sales); (3) profits of the partnership must be allocated, or divided, in proportion to each partner's capital investment; and (4) all partners must actually own a "capital interest" (i.e., an interest in partnership assets which is distributable to the partner upon his withdrawal from the partnership or upon partnership liquidation).

[4] Generally, the partnership agreement will limit ownership of partnership interests to family members. The agreement is also likely to contain provisions for settling disputes.

[5] Transfer of assets to the partnership is generally done without recognition of either gain or loss. Alternatively, the parents could make a gift of assets to the children who will then contribute these assets to the family limited partnership in return for limited partnership interests.

[6] Often the ultimate goal is for the parents to eventually own only modest partnership interests, with the bulk of the family limited partnership being held by other family members. Although this example assumes that both parents will be general partners, family limited partnerships are often established with only one spouse as the general partner and the other spouse as a limited partner.

[7] Some disadvantages of the family limited partnership include: (1) the traditional partnership freeze is subject to the impact of the Chapter 14 valuation rules, see pages 402-403 (however, most of the techniques used to reduce the effect of, or to avoid, these rules with respect to recapitalizations will also work with partnerships); (2) much of the ability to reduce taxes by shifting income from parent to younger children has been curtailed by the "kiddie tax" (see discussion on page 580); (3) there are additional expenses associated with establishing and accounting for a FLP (e.g., an information tax return must be filed); (4) gifts do not receive a step-up in income tax basis; and (5) retained partnership interests continue to appreciate in the parent's estate until they are transferred during lifetime or at death.

[8] The general partners also have liability for all partnership debts and obligations.

[9] Effective income shifting requires that the partnership be one in which capital is a material income-producing factor (see also item (2) in footnote 7, above).

[10] These gifts could be made in trust for minor children (see page 576).

[11] Lack of marketability can be established by prohibitions in the partnership agreement against terminating the partnership without the concurrence of all partners (usually limited to 40 years or less). Although valuation discounts of up to 70 percent have been claimed, such overly aggressive discounts are likely to be challenged by the IRS.

[12] The right to partnership distributions is secured by obtaining a charging order. However, because the general partners have the ability to retain profits, the flow-through nature of partnership income taxation gives them the ability to create a tax liability without making cash distributions for tax payments (i.e., an "ugly" asset).

# RECAPITALIZATION

A recapitalization through a preferred stock redemption can offer an effective and versatile estate planning technique for corporate stockholders. For example, when combined with a subsequent gifting program, it can:

- Shift substantial future appreciation to children.
- Retain control of the corporation.
- Freeze the value of stock for estate tax purposes.
- Provide an ongoing income stream for retirement.
- Transfer corporate control when, and if, appropriate.
- Motivate younger employees.
- Facilitate distribution of stock at death.

**PREFERRED STOCK REDEMPTION.** The design of stock to be received in a recapitalization can take many forms. For example, a parent might make a tax-free exchange of *all* his original common stock for a combination of voting cumulative preferred stock and nonvoting common stock.[1] Income would be provided by requiring annual dividends from the preferred stock at a fixed rate.

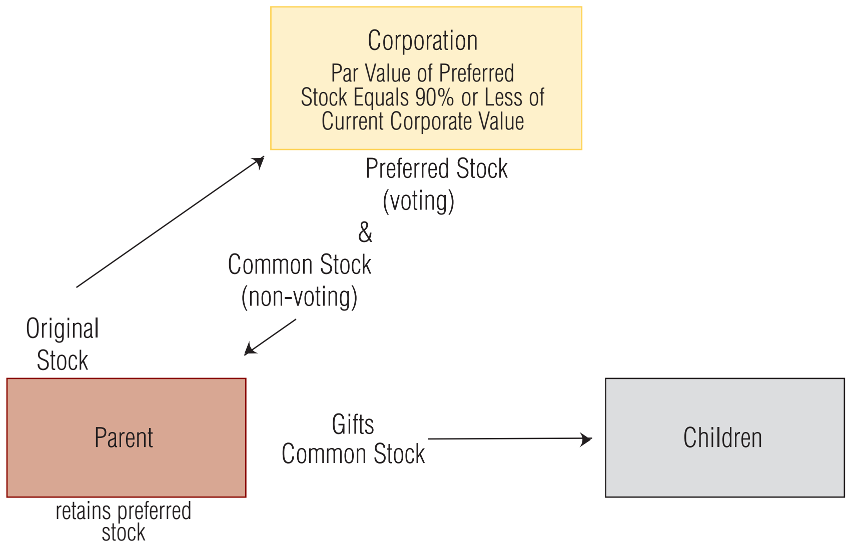
The parent retains the voting preferred stock in order to maintain control of the corporation, and the nonvoting common stock is given to the children, or other donees. As long as the retained preferred stock is entitled to dividends, it will be considered to have a value generally equal to the present value of the right to future payments. Because the value of the common stock is determined by subtracting the value of the preferred stock from the total corporate value, the preferred stock's value has the effect of *decreasing* the value of the common stock, thereby lessening exposure to gift taxes when the common stock is given to the children.[2] However, in order to obtain this increase in value of the retained preferred stock it may be necessary to obligate the corporation to pay substantial cumulative preferred stock dividends.[3]

**EFFECT OF SUBSEQUENT APPRECIATION.** The prior "freezing" of the value of the preferred stock means that most, if not all, future appreciation is shifted to the common stock owned by the children.[4]

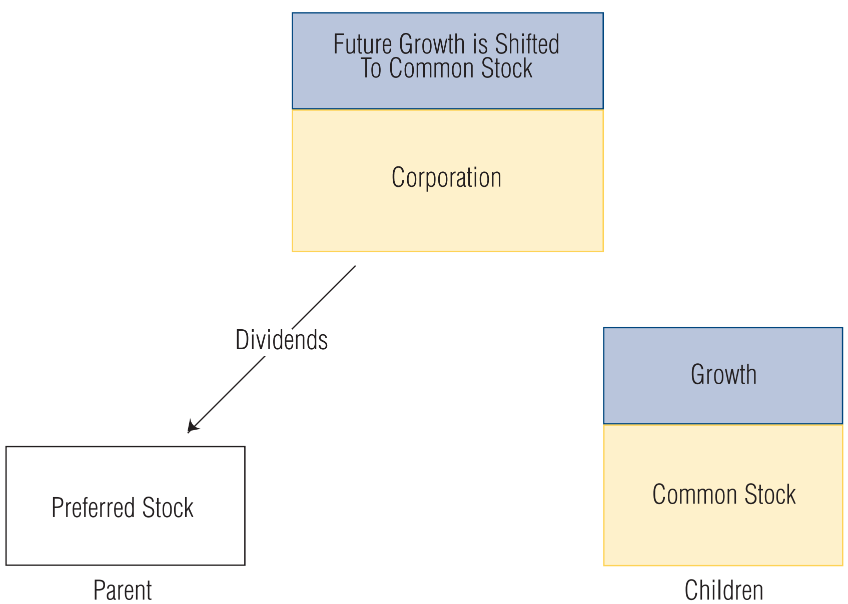
Recapitalizations can be an effective estate planning technique for corporate stockholders who desire to make gifts of stock to children or other heirs.[5] However, they should be undertaken only with the assistance of competent tax counsel.[6]

Footnotes on page 177

## PREFERRED STOCK REDEMPTION




## EFFECT OF SUBSEQUENT APPRECIATION



## INFORMATION REQUIRED FOR ANALYSIS & PROPOSAL

*To Propose Insurance on Life of Donor or Donee*

1. Name.
2. Sex.
3. Date of birth.
4. Smoker/nonsmoker.

*Attorney Must Also Know*

5. Fair market value of corporation performed by qualified appraiser.
6. Capital structure of corporation (type of stock authorized, number of shares outstanding).
7. Number of shares of stock owned by client and value of his holdings.
8. Number of shares of stock owned by client's brothers, sisters, and lineal descendants, and value of their holdings (in order to determine "control" and impact of special valuation rules).
9. Number of people who will be given stock, their ages, relationship to the client, and position in business, if any.

## CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

**Q 778**. Effect of Chapter 14 valuation rules on recapitalization.

## Footnotes

[1] This chart does not demonstrate a "true" recapitalization in which there is an exchange of *all* of a stockholder's stock (usually common) for a different class of stock (usually preferred). What is demonstrated is essentially a "preferred stock" distribution, under which the stockholder receives another class of stock (the voting preferred) without actually giving up his common stock that represents the future equity growth of the corporation. Although this receipt of preferred stock is non-taxable, it is essentially equivalent to a stock dividend and will likely be considered "Section 306 stock" (see discussion, page 545). If it were then subsequently sold, the proceeds would be treated as ordinary income, not capital gain (capital gains are discussed on pages 340-341).

[2] Because of the special valuation provisions of Chapter 14 all common stock must be given a value of at least 10 percent of the total value of the corporation (e.g., if the corporation had a value of $1,000,000, the common stock value must be at least $100,000, meaning that the retained preferred stock could, at most, be valued at $900,000). For this purpose the total value of the corporation includes the amount of all corporate indebtedness to the transferor and family members (see discussion on pages 402-403). Obtaining an accurate fair market value of the corporation at the time of recapitalization can also avoid unexpected tax problems. For example, if the value placed on the new preferred stock is *greater than* the original common stock, the stockholder may be considered as having received a dividend from the corporation. On the other hand, when a second stockholder exists at the time of the recapitalization, undervaluing the new preferred can lead to either income or gift tax liabilities. If the value placed on the new preferred is *less than* the original common stock the amount of the undervaluation might be treated as taxable income to the co-stockholder (either salary, or worse yet, a nondeductible corporate dividend). It could be treated as a gift if the co-stockholder were a family member.

[3] Under Chapter 14 these cumulative dividends *must actually be paid*, or there will be exposure to *future* gift or estate taxes. If the retained preferred stock is to have a value greater than zero the stock dividend rights must constitute "qualified payments" (i.e., dividends payable on a periodic basis and at a fixed rate or at a variable rate with a fixed relationship to market value). See the expanded discussion of qualified payments on pages 402-403. In the desire to have the retained preferred stock highly valued in order to reduce the exposure to gift taxes when the common is given to children, care must be taken not to obligate the corporation to unrealistic and onerous preferred stock dividends, which are not deductible to the corporation.

[4] Because *future* appreciation is being shifted out of the estate, a recapitalization will generally not reduce *present* estate settlement costs. The value of the stock retained by the donor will still be included in his gross estate. A partial stock redemption under Section 303 can provide an effective means of paying these costs, particularly when funded with life insurance. Dividends paid on the stock transferred by gift can be used by the donee to pay for insurance on the life of the donor using the reverse section 303 technique described in the chart on page 159. However, because of the grantor trust rules, the donee should be an individual, not a trust. Since there is some possibility that the donee will predecease the donor, the donor may wish to insure the donee in order to purchase stock from the donee's estate.

[5] A recapitalization can also be an effective way to accomplish the non-tax objectives of transferring growth and control to one child while providing income for another child. For example, assume that both nonvoting preferred and voting common were issued pursuant to a recapitalization. If Child A were not involved in the business he could be given the *nonvoting* preferred stock (with an income stream provided by dividends). Child B, who is working in the business, might then be given the voting common stock (with both its control and potential for future appreciation).

[6] These less restrictive anti-freeze provisions in the form of special valuation rules are contained in Chapter 14 of the Code.

# ATTRIBUTION

When it is intended that continued ownership would be held within a family, it is extremely important to consider the effect of the attribution rules when planning for the sale of stock to a corporation. Unfortunately, all too often the operation of these rules is poorly understood, and the adverse tax consequences can be disastrous (they have been aptly described as "infamous and insidious").

The basic problem arises under Section 302(b)(3) of the Code, that requires that to qualify as a "capital transaction" the sale of stock to a corporation must result in a *complete* disposition of the stockholder's interest (both actually owned and constructively owned). If there is a redemption of *less* than the stockholder's entire interest, then the transaction is likely to be treated and taxed as a stock dividend. However, merely selling all directly owned stock to the corporation, may not satisfy this requirement if stock owned by others is attributed to the selling stockholder or his estate. There are two types of attribution, family attribution and entity attribution. Whereas family attribution can be waived (charts, pages 182-183), entity attribution cannot be waived (charts, page 181). To summarize the rules of family attribution:

1. An individual is deemed (i.e., considered) to own any stock owned directly or *indirectly* by his:
   a. parents
   b. spouse
   c. children
   d. grandchildren

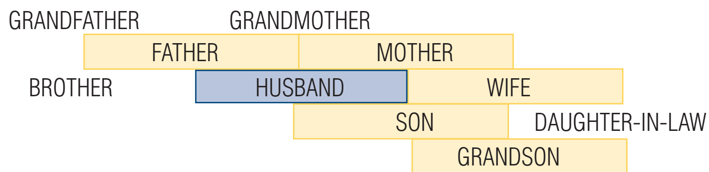
2. There is *no* family attribution with respect to one's grandparent, brother, sister, uncle, aunt, nephew, cousin, or in-law.

3. There is no "secondary" attribution under the family attribution rules (e.g., stock attributed from daughter-in-law to son cannot then be again attributed from the son to his parents).

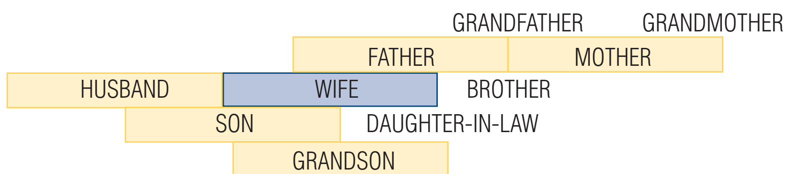
Depending upon the particular family relationship, an individual may, or may not, be considered to own the stock of other members of his family. For example, assume we have an extended family composed of a husband, his wife, his grandfather, grandmother, father, mother, and brother; as well as his son, daughter-in-law, and grandson. In this family the **husband** is considered as owning the stock of *his* father, mother, wife, son and grandson. On the other hand, his **wife** will be considered as owning the stock of only *her* father, mother, husband, son, and grandson.

# FAMILY ATTRIBUTION

Husband is considered to own the stock of *his* Father,
Mother, Wife, Son and Grandson.

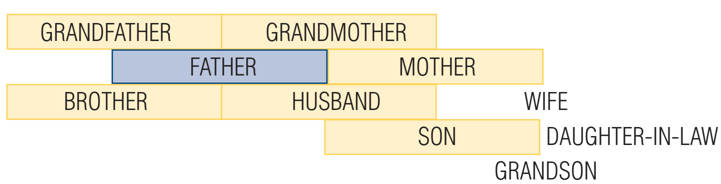



Wife is considered to own the stock of *her* Father,
Mother, Husband, Son and Grandson.




## Moving Up One Generation

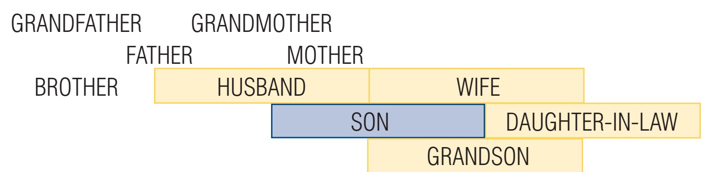
Father is considered to own the stock of
Grandfather, Grandmother, Mother, Brother, Husband, and Son
(i.e., of *his* father, mother, wife, sons, and grandson).



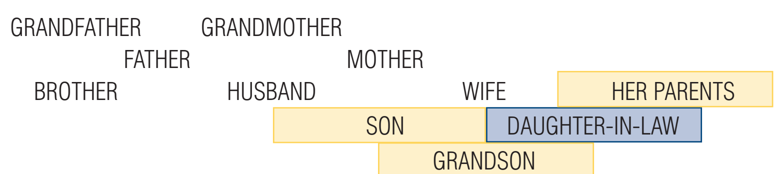
# FAMILY ATTRIBUTION

## Moving Down One Generation

Son is considered to own the stock of
Husband, Wife, Daughter-in-law, and Grandson
(i.e., of his father, mother, wife, and son).




Daughter-in-law is considered to own the stock of
Her Parents, Son and Grandson
(i.e., of her parents, husband and son).



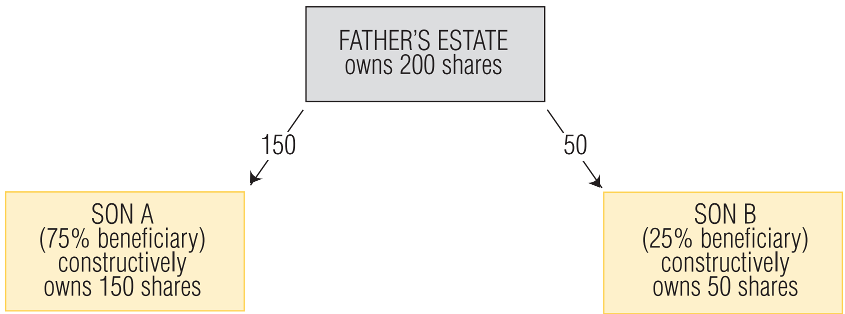

### CROSS REFERENCES TO TAX FACTS ON INSURANCE & EMPLOYEE BENEFITS, VOL. 1 (2015)

**Q 285.** Amount paid by corporation for decedent's entire stock interest generally not dividend to estate, provided no attribution problems.
**Q 286.** Avoiding attribution of stock ownership among family members.
**Q 287.** Avoiding attribution of stock ownership from estate beneficiary to estate.

# ENTITY ATTRIBUTION

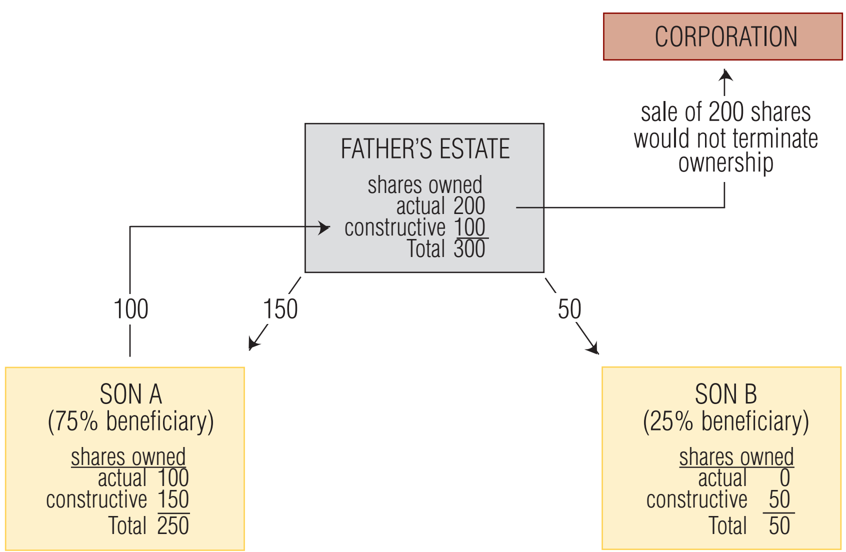
## Attribution From An Estate

Stock owned by an Estate is attributed to the Beneficiaries in proportion to their interests in the estate.



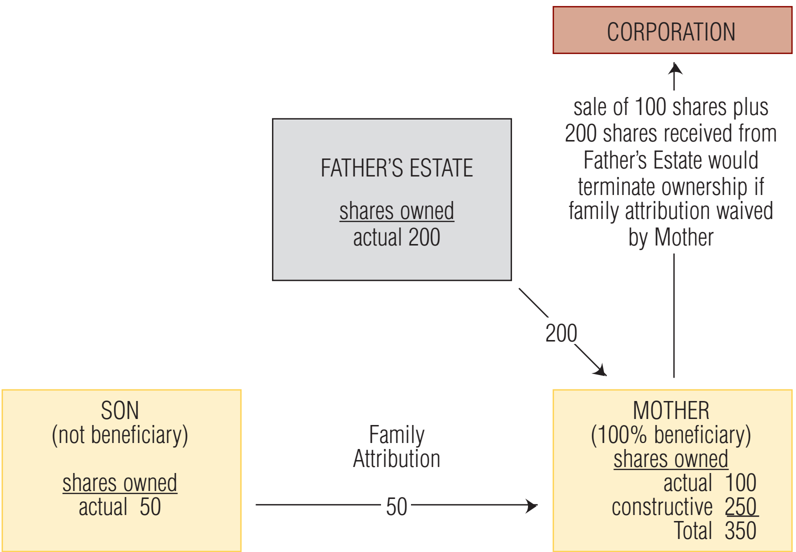

## Attribution To An Estate

Stock actually or constructively owned by a beneficiary is attributed in full to the estate, without regard for the beneficiaries' percentage of interest in the estate (the attribution of Son A's 100 shares to the estate cannot be waived).



# FAMILY & ENTITY ATTRIBUTION

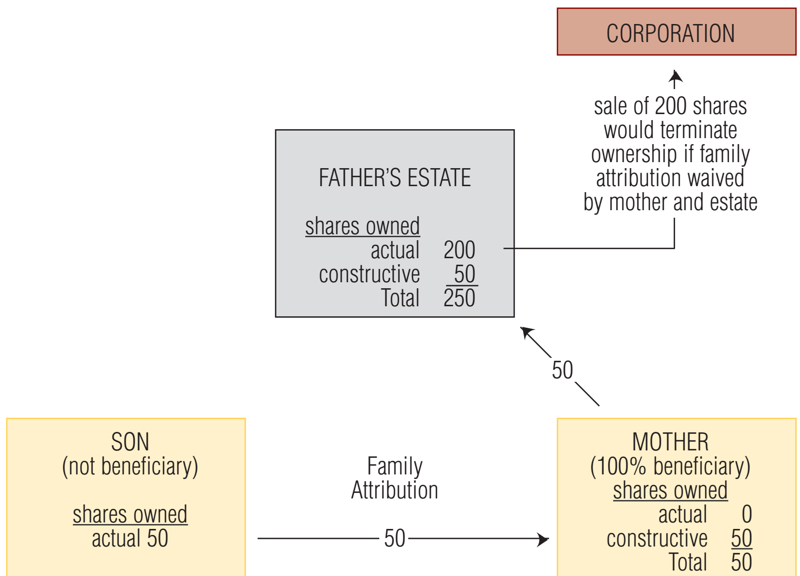
## Waiver Of Family Attribution
### Sale by Mother




*Note*: Mother can *waive family attribution* of Son's 50 shares provided she: (1) has no interest in the corporation following the redemption (i.e., as an officer, director, or employee); (2) does not reacquire an interest within 10 years; and (3) agrees to notify the IRS if she does reacquire an interest. Note also the secondary attribution of the Estate's 200 shares through Mother to the Son (i.e., entity attribution followed by family attribution). However, you cannot have entity attribution to the estate from Mother followed by another entity attribution from the Estate to another estate beneficiary.

# FAMILY & ENTITY ATTRIBUTION

## Waiver Of Family Attribution
### Sale by Estate




*Note*: Even though an entity, Father's Estate can *waive* family attribution of Son's 50 shares to Mother. This breaks the chain of secondary attribution from Son to Mother to Father's Estate (i.e., family attribution followed by entity attribution). The waiver by the estate is dependent upon both the entity (i.e., the estate) and those through whom ownership is attributed (i.e., the mother) agreeing to join in the waiver. Both the entity and the beneficiary must hold no interest in the corporation, cannot acquire an interest within 10 years of the redemption, and must agree to notify the Internal Revenue Service should an interest be acquired. If Son predeceased Mother, as an estate beneficiary Son's 50 shares would be attributed in full to the estate (see bottom chart, page 181). There can be no waiver of entity attribution.

## BUSINESS COMPARISON

| Question | Unincorporated | Incorporated |
|---|---|---|
| What is the extent of liability for: | | |
| Contract? | To all business and personal assets of each individual owner. | Usually limited to business assets in most states. |
| Negligence of owner-employees? | To all business and personal assets of each individual owner. | Generally limited to business assets except professional liability. |
| Negligence of employees? | To all business and personal assets of each individual owner. | Limited to business assets. |
| Business debts? | To all business and personal assets of each individual owner (but see discussion of Limited Liability Company, page 464). | Limited to business assets except where owners have personally guaranteed loan by endorsement or otherwise. |
| To whom are profits taxed? | Individual owners. | To the corporation if retained as earnings. To owner-employees if paid out as reasonable compensation or dividends (page 581). |
| Can a small portion of the ownership interest have full control? | Not in any practical way (but see Family Limited Partnership chart, page 171). | Yes – by use of voting preferred and non-voting stock (page 174). |
| Can the business interest be easily transferred to one or more purchasers or recipients? | No – transfer of individual assets or creation of new entity can result in complications. | Yes – stock may be easily transferred to either the corporation, other stockholders, key persons, or outsiders (pages 130, 134, and 150). |
| Who pays income taxes on dollars used to pay for life insurance funding a buy/sell agreement? | Individual owners. | Choice of corporation or stockholder-employee. |
| Can the business purchase a portion of a deceased owner's interest on a tax-favored basis? | No | Yes – under Code section 303 the corporation can purchase some stock, while allowing the surviving family to retain an ownership interest (page 154). |

*Note*: "Unincorporated" refers to sole proprietorships and partnerships, but not to limited partners; "incorporated" refers to C corporations, but not to S corporations.

| Question | Unincorporated | Incorporated |
|---|---|---|
| Does the business entity enjoy any tax-favored investment advantages? | No | Yes – under Code section 243 a corporation can deduct from 70% to 100% of the dividends received from domestic corporations. |
| Can the business have a different fiscal year than the owners? | Not in any practical way. | Yes |
| What is the annual cost of Social Security for each owner-employee? | In 2015 12.40% OASDI tax on first $118,500 of self-employment income and 2.90% hospital insurance tax without limit, all paid by the individual owner. | In 2015 6.20% OASDI tax on first $118,500 of income and 1.45% hospital insurance tax without limit, paid by the owner-employee. Equal amounts of tax are also paid by the corporation, but deductible as a business expense. |
| What is the cost of unemployment taxes for each owner-employee? | None | In 2015 both state and federal (FUTA) taxes will be a maximum $42 per employee, i.e., 6.2% of first $7,000 in wages. |
| What is the cost of worker's compensation? | None | If set by state law, can often be exempt from coverage. If paid, it is considered a deductible business expense. |
| Is there any extra cost for franchise fees and bookkeeping? | – | A small annual franchise fee is usually payable. Corporate minutes must be kept on an annual basis. Bookkeeping costs may be somewhat higher. |
| Is there any extra cost to prepare a corporate tax return? | – | Preparation of corporate return can cost more, but usually not much greater than Schedule C (Profit or Loss From Business or Profession) or Form 1065 (U.S. Partnership Return of Income). |
| Could there be a problem with unreasonable compensation to owner-employees? | No | Yes – under Code section 162 only a reasonable allowance for compensation can be deducted. This is usually not a serious problem, but should be considered (page 581). |

*Note*: "Unincorporated" refers to sole proprietorships and partnerships, but not to limited partners; "incorporated" refers to C corporations, but not to S corporations.

## References

| Question | Unincorporated | Incorporated |
|---|---|---|
| Is there a potential for double taxation? | No | Yes – if not properly planned there could be a corporate income tax, plus a personal income tax on dividends received. |
| Could a personal holding company penalty tax of 15% be levied? | No | Yes – a penalty tax could be applied if 60% of income is essentially passive, such as dividends, rents and royalties. |
| Can individual owner-employees have deferred compensation? | No | Yes – Income may be deferred (Deferred Compensation, page 240). |
| Can the business pay premiums for personal life insurance, and have the premiums paid tax-free for owner-employees? | No | Yes – up to $50,000 of group insurance is available under Code section 79 (Group Insurance, page 208). |
| Are tax-favored personal life insurance programs available to owner-employees? | No | Yes – individual plans can be established (Executive Equity, page 216, and Split-Dollar Insurance, page 224). |
| Is a qualified retirement program available? | Yes – HR-10 permits sole proprietors and partners to be covered under qualified plans. | Yes – under qualified plan rules (Qualified Retirement Plans, pages 264, 344, 374, 542, 554, 562, and 567). |
| Are other tax deductible benefits available to owner-employees, such as: | | |
| Disability income plans? | No | Yes – under Code sections 105 and 106 (Disability Income Plan, page 248). |
| Medical and dental expense reimbursement arrangements? | Not generally, but limited deduction available (footnote 2, page 255). | Yes – under Code sections 105 and 106 (Health Reimbursement Arrangements, page 252). |
| Survivor income plans? | No | Yes – as a form of salary continuation death benefit (Survivor Income, page 236). |

*Note*: "Unincorporated" refers to sole proprietorships and partnerships, but not to limited partners; "incorporated" refers to C corporations, but not to S corporations.

## ODDS OF DEATH BEFORE AGE 65

When a business has two or more owners, the odds of at least one death before age 65 increase dramatically. *The risk is not remote*. Proper planning calls for making provisions for the continuation of the business as well as providing support for the surviving family.

### One-Owner Business

| Ages | Odds of Death Male | Odds of Death Female | Ages | Odds of Death Male | Odds of Death Female |
|---|---|---|---|---|---|
| 30 | 14.9% | 11.8% | 45 | 13.0% | 10.3% |
| 35 | 14.4 | 11.5 | 50 | 11.6 | 9.3 |
| 40 | 13.8 | 11.0 | 55 | 9.6 | 7.6 |

### Two-Owner Business

| Ages | Odds Of One Death Male | Odds Of One Death Female | Ages | Odds Of One Death Male | Odds Of One Death Female |
|---|---|---|---|---|---|
| 30-30 | 27.6% | 22.3% | 45-45 | 24.2% | 19.6% |
| 30-35 | 27.2 | 22.0 | 45-50 | 23.1 | 18.7 |
| 30-40 | 26.7 | 21.6 | 45-55 | 21.3 | 17.1 |
| 35-35 | 26.7 | 21.7 | 50-50 | 21.8 | 17.8 |
| 35-40 | 26.2 | 21.3 | 50-55 | 20.0 | 16.2 |
| 35-45 | 25.5 | 20.7 | 50-60 | 16.9 | 13.5 |
| 40-40 | 25.7 | 20.8 | 55-55 | 18.2 | 14.5 |
| 40-45 | 25.0 | 20.2 | 55-60 | 15.0 | 11.8 |
| 40-50 | 23.8 | 19.3 | 60-60 | 11.7 | 9.0 |

### Three-Owner Business

| Ages | Odds Of One Death Male | Odds Of One Death Female | Ages | Odds Of One Death Male | Odds Of One Death Female |
|---|---|---|---|---|---|
| 30-30-30 | 38.4% | 31.5% | 40-45-50 | 33.7% | 27.7% |
| 30-35-40 | 37.2 | 30.6 | 40-50-60 | 28.4 | 23.0 |
| 30-40-50 | 35.2 | 28.9 | 45-45-45 | 34.1 | 27.9 |
| 35-35-35 | 37.3 | 30.7 | 45-50-55 | 30.4 | 24.8 |
| 35-40-45 | 35.8 | 29.4 | 50-50-50 | 30.9 | 25.4 |
| 35-45-55 | 32.6 | 26.7 | 50-55-60 | 24.9 | 20.1 |
| 40-40-40 | 36.0 | 29.5 | 55-55-55 | 26.0 | 21.0 |

Using the following percentages, it is possible to calculate the odds of at least one death before age 65 for any particular group of owners. After multiplying the percent for each owner by the percent for each other owner, subtract the results from 1. For example, the calculations for the odds of at least one death for three male owners, ages 40, 45, and 50: $1 - (.8617 \times .8703 \times .8840) = 1 - .6630 = 33.7\%$.

| Age | Living To Age 65 Male | Living To Age 65 Female | Age | Living To Age 65 Male | Living To Age 65 Female | Age | Living To Age 65 Male | Living To Age 65 Female | Age | Living To Age 65 Male | Living To Age 65 Female |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 30 | 85.10% | 88.15% | 38 | 85.92% | 88.77% | 46 | 87.27% | 89.82% | 54 | 89.94% | 92.01% |
| 31 | 85.20 | 88.21 | 39 | 86.04 | 88.87 | 47 | 87.52 | 90.00 | 55 | 90.44 | 92.44 |
| 32 | 85.29 | 88.28 | 40 | 86.17 | 88.98 | 48 | 87.80 | 90.21 | 56 | 91.00 | 92.91 |
| 33 | 85.39 | 88.34 | 41 | 86.32 | 89.10 | 49 | 88.09 | 90.43 | 57 | 91.63 | 93.44 |
| 34 | 85.49 | 88.42 | 42 | 86.47 | 89.22 | 50 | 88.40 | 90.69 | 58 | 92.34 | 94.02 |
| 35 | 85.59 | 88.49 | 43 | 86.64 | 89.35 | 51 | 88.74 | 90.97 | 59 | 93.11 | 94.67 |
| 36 | 85.69 | 88.58 | 44 | 86.83 | 89.50 | 52 | 89.10 | 91.28 | 60 | 93.95 | 95.37 |
| 37 | 85.80 | 88.67 | 45 | 87.03 | 89.65 | 53 | 89.50 | 91.63 | | | |

*Source:* Commissioners 2001 Standard Ordinary Mortality Table.

# ODDS OF DEATH WITHIN 10 AND 20 YEARS

When a business has two or more owners, the odds of at least one death within any given period of time increase dramatically. *The risk is not remote*. Proper planning calls for making provisions for the continuation of the business.

## One-Owner Business – MALE

Odds Of Death Within

| Age | 10 Years | 20 Years |
|---|---|---|
| 30 | 1.2% | 3.7% |
| 35 | 1.7 | 5.4 |
| 40 | 2.5 | 8.3 |
| 45 | 3.8 | 13.0 |
| 50 | 5.9 | 20.2 |
| 55 | 9.6 | 30.4 |

## One-Owner Business – FEMALE

Odds Of Death Within

| Age | 10 Years | 20 Years |
|---|---|---|
| 30 | 0.9% | 2.8% |
| 35 | 1.3 | 4.3 |
| 40 | 1.9 | 6.7 |
| 45 | 3.0 | 10.3 |
| 50 | 4.9 | 15.5 |
| 55 | 7.6 | 22.7 |

## Two-Owner Business – MALE

Odds Of One Death Within

| Ages | 10 Years | 20 Years |
|---|---|---|
| 30-30 | 2.5% | 7.3% |
| 30-35 | 2.9 | 8.9 |
| 30-40 | 3.7 | 11.7 |
| 35-35 | 3.3 | 10.4 |
| 35-40 | 4.1 | 13.2 |
| 35-45 | 5.4 | 17.6 |
| 40-40 | 5.0 | 15.9 |
| 40-45 | 6.2 | 20.2 |
| 40-50 | 8.3 | 26.8 |
| 45-45 | 7.4 | 24.2 |
| 45-50 | 9.4 | 30.5 |
| 45-55 | 13.0 | 39.5 |
| 50-50 | 11.5 | 36.3 |
| 50-55 | 14.9 | 44.5 |
| 50-60 | 20.2 | 55.8 |
| 55-55 | 18.2 | 51.6 |
| 55-60 | 23.3 | 61.5 |
| 55-65 | 30.4 | 74.0 |

## Two-Owner Business – FEMALE

Odds Of One Death Within

| Ages | 10 Years | 20 Years |
|---|---|---|
| 30-30 | 1.9% | 5.5% |
| 30-35 | 2.2 | 6.9 |
| 30-40 | 2.8 | 9.3 |
| 35-35 | 2.6 | 8.4 |
| 35-40 | 3.1 | 10.7 |
| 35-45 | 4.3 | 14.2 |
| 40-40 | 3.7 | 12.9 |
| 40-45 | 4.8 | 16.4 |
| 40-50 | 6.7 | 21.1 |
| 45-45 | 5.9 | 19.6 |
| 45-50 | 7.8 | 24.2 |
| 45-55 | 10.3 | 30.7 |
| 50-50 | 9.6 | 28.6 |
| 50-55 | 12.1 | 34.7 |
| 50-60 | 15.5 | 43.2 |
| 55-55 | 14.5 | 40.3 |
| 55-60 | 17.8 | 48.1 |
| 55-65 | 22.7 | 59.0 |

## Three-Owner Business – MALE

Odds Of One Death Within

| Ages | 10 Years | 20 Years |
|---|---|---|
| 30-30-30 | 3.7% | 10.8% |
| 30-35-40 | 5.3 | 16.4 |
| 30-40-50 | 9.4 | 29.5 |
| 35-35-35 | 4.9 | 15.2 |
| 35-40-45 | 7.8 | 24.5 |
| 35-45-55 | 14.4 | 42.7 |
| 40-40-40 | 7.4 | 22.8 |
| 40-45-50 | 11.7 | 36.3 |
| 40-50-60 | 22.2 | 59.4 |
| 45-45-45 | 10.9 | 34.1 |
| 45-50-55 | 18.1 | 51.7 |
| 50-50-50 | 16.7 | 49.1 |
| 50-55-60 | 27.8 | 69.2 |
| 55-55-55 | 26.0 | 66.3 |
| 50-60-70 | 47.9 | 91.6 |

## Three-Owner Business – FEMALE

Odds Of One Death Within

| Ages | 10 Years | 20 Years |
|---|---|---|
| 30-30-30 | 2.8% | 8.2% |
| 30-35-40 | 4.0 | 13.2 |
| 30-40-50 | 7.6 | 23.4 |
| 35-35-35 | 3.8 | 12.3 |
| 35-40-45 | 6.1 | 19.9 |
| 35-45-55 | 11.5 | 33.7 |
| 40-40-40 | 5.5 | 18.8 |
| 40-45-50 | 9.5 | 29.3 |
| 40-50-60 | 17.1 | 47.0 |
| 45-45-45 | 8.8 | 27.9 |
| 45-50-55 | 14.8 | 41.4 |
| 50-50-50 | 14.0 | 39.6 |
| 50-55-60 | 21.9 | 56.1 |
| 55-55-55 | 21.0 | 53.8 |
| 50-60-70 | 36.1 | 80.1 |

*Source:* Commissioners 2001 Standard Ordinary Mortality Table.

## KEY PERSON VALUATION FORMULAS

No single formula is accepted for valuing a key person or employee. In fact, valuing a key person is much like valuing a business, it is more art than science. Much depends upon the characteristics of the key person (e.g., a sales manager who has a substantial impact upon sales or a financial officer who has access to credit). However, there is little doubt that key persons can have considerable value; and their death or disability can cause substantial financial losses, or even failure of a business. One or more of the following formulas should provide a useful starting point for determining value.

**Contribution To Profits**. This method evaluates the key person's contributions to profits and then capitalizes this amount to determine value. For example, assume the business has a book value of $500,000, an expected rate of return on book value for this particular type of business is 8 percent and average profits are $120,000. The excess earnings are $80,000 ($500,000 x .08 = $40,000; $120,000 - $40,000 = $80,000). Assuming the key person's contribution to excess earnings is 50 percent, capitalization of the key person's contribution at 12 percent yields a value of $333,200 (.50 x $80,000 = $40,000; 100 ÷ 12 = 8.33 x $40,000 = $333,200). Note that a similar capitalization approach to valuing a business is discussed on page 126. A variation on the contributions to profits method does not capitalize the contribution, but rather reduces the key person's annual contribution as a replacement is recruited, trained, and becomes fully effective. Using this variation, the key person's value would be $120,000, assuming annual contributions to profits of $40,000 and 5 years to complete the replacement. The basic method and the variation are calculated as follows:

| | | Variation | |
|---|---|---|---|
| Average Profits | $120,000 | | |
| Book Value At 8% | 40,000 | Year 1 | $40,000 |
| Excess Earnings | $80,000 | Year 2 | 32,000 |
| Percent Of Contribution | 50 | Year 3 | 24,000 |
| Key Person's Contribution | $40,000 | Year 4 | 16,000 |
| Capitalization Factor | 8.33 | Year 5 | 8,000 |
| Key Person Value | $333,200 | Key Person Value | $120,000 |

**Business Life Value**. This is a variation of the method commonly used to determine human life value. The business estimates its annual loss of earnings if the key person were to die, multiplies that amount by the number of working years to retirement, and then discounts the results by an appropriate interest rate. Assuming annual loss of earnings of $40,000, 15 years to retirement, and 12 percent interest, the value would be calculated as follows:

| | | |
|---|---|---|
| Loss Of Earnings | $40,000 | |
| Present Value Factor | 6.811 | (from table on page 601) |
| Key Person Value | $272,440 | |

**Multiple Of Salary**. This method recognizes that the salaries paid to key persons are an indication of their value. Typically a factor of from 3 to 10 times annual salary is used. Assuming an annual salary of $75,000 and a factor of 5, the value would be calculated as follows:

| | |
|---|---|
| Annual Salary | $75,000 |
| Factor | 5 |
| Key Person Value | $375,000 |

**Discount Of Business**. This method simply discounts the value of the business to reflect the loss of the key person. Assuming a business value of $900,000 and a discount of 20 percent, the value would be calculated as follows:

| | |
|---|---|
| Value Of Business | $900,000 |
| Discount | .20 |
| Key Person Value | $180,000 |

## FINANCIAL RATIOS

| Ratio | Formula | Description |
|---|---|---|
| Current Ratio = | Total Current Assets / Total Current Liabilities | Also called the “working capital” ratio. The question addressed by this ratio: “Does the business have enough current assets to meet the payment schedule of its current debts with a margin of safety for possible losses in current assets?” A 2 to 1 ratio is generally acceptable. |
| Quick Ratio = | Cash + Gov’t Securities + Receivables / Total Current Liabilities | Also called the “acid-test” ratio and “quick current” test. The question addressed by this ratio: “If all sales revenues disappeared, could the business meet its current obligations with the readily convertible ‘quick’ funds at hand?” An acid-test of 1 to 1 is typical. Quick funds are current assets minus inventory. |
| Working Capital = | Total Current Assets - Total Current Liabilities | A measure of cash flow. Considered an indication of the ability to withstand financial crises. |
| Debt/Worth Ratio = | Total Liabilities / Net Worth | Indicates the extent to which the business is reliant on debt financing. |
| Gross Margin Ratio = | Gross Profit / Net Sales | Gross profit equals net sales minus cost of goods sold. This ratio measures the percentage of sales dollars remaining to pay overhead expenses. |
| Net Profit Margin Ratio = | Net Profit Before Tax / Net Sales | This ratio measures “return on sales” and can be used to evaluate performance in comparison with similar businesses. |
| Inventory Turnover = | Net Sales / Average Inventory At Cost | Measures how well inventory is managed. The more inventory is turned in a given operating cycle, the greater is the profit. |
| Return On Assets Ratio = | Net Profit Before Tax / Total Assets | Measures how efficiently profits are being generated from the assets employed in the business when compared with ratios of similar firms. A comparatively low ratio indicates an inefficient use of business assets. |
| Return On Investment = | Net Profit Before Tax / Net Worth | A measure of the percentage of return on funds invested in the business. A very important ratio. If the ROI is less than the rate of return on an alternative, risk-free investment, the owner may wish to sell and invest elsewhere. |

*Note*: Current Ratio, Quick Ratio, and Working Capital are **liquidity** ratios which indicate the ease of turning assets into cash. Debt/Worth Ratio is a **leverage** ratio which measures how dependant the business is on debt financing. Gross Margin Ratio and Net Profit Margin Ratio are **profitability** ratios. Inventory Turnover, Return On Assets Ratio, and Return On Investment are **management** ratios.

## CONTESTED BUSINESS VALUATIONS

The Higher The Value – The Greater The Tax

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| advertising agency | Katz, Estate of Sidney L. 27 T.C.M. 825 | $ 290.00 | $ 600.00 | $ 300.00 | 6 yrs | 11 mo | 11 days |
| automobile dealer | Leyman, Estate of Harry S. 40 T.C. 100 | 536.00 | 700.00 | 630.00 | 8 yrs | 11 mo | 0 days |
| bank | Davis, Estate of John F. 78,069 P-H Memo T.C. | 36.00 | 75.00 | 45.00 | 5 yrs | 11 mo | 0 days |
| brewery | Baltimore National Bank v. U.S. 136 F. Supp. 642 | 1,542.50 | 2,500.00 | 2,300.00 | 8 yrs | 5 mo | 19 days |
| brewery equipment manufacturer | Korslin v. U.S. 31 AFTR 2d 1390 | 25.67 | 36.72 | 66.19 | 6 yrs | 11 mo | 9 days |
| carpet manufacturer | Ewing, Estate of Anna C. 9 T.C.M. 1096 | 2,400.00 | 6,530.00 | 4,750.00 | 7 yrs | 6 mo | 24 days |
| citrus grower | Maxcy, Estate of Gregg 28 T.C.M. 783 | 10,593.79 | 12,463.28 | 10,593.79 | 8 yrs | 11 mo | 21 days |

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| cleaning products manufacturer | Louis v. U.S. 369 F. 2d 263 | $ 3.25 | $ 20.00 | $ 5.34 | 7 yrs | 8 mo | 27 days |
| cold storage | Sundquist et al. v. U.S. 74-2 USTC 13,035 | 270.00 | 500.00 | 270.00 | 7 yrs | 9 mo | 18 days |
| construction & paving | Tully, Estate of Edward A. v. U.S. 78-1 USTC 13,228 | 100.00 | 344.00 | 164.77 | 13 yrs | 10 mo | 18 days |
| crude oil processing | Vandenhoeck, Estate of Paul M. 4 T.C. 125 | 14.00 | 85.00 | 40.00 | 5 yrs | 6 mo | 9 days |
| department store | Holmes, Estate of Sue E. 22 B.T.A. 757 | 160.00 | 400.00 | 245.00 | 4 yrs | 10 mo | 17 days |
| dry goods wholesaler | Fitts' Estate v. Commissioner 237 F. 2d 729 | 150.00 | 600.00 | 375.00 | 7 yrs | 9 mo | 23 days |
| electrical parts supplier | Goodall, Estate of Robert A. 24 T.C.M. 807 | 7.44 | 10.30 | 10.30 | 11 yrs | 7 mo | 13 days |
| electric systems manufacturer | Damon, Estate of Robert H. 46 T.C. 108 | 3.00 | 6.00 | 3.75 | 7 yrs | 10 mo | 11 days |
| elevator manufacturer | Heinold, Estate of Matthew I. 24 T.C.M. 26, aff'd 363 F. 2d 329 | 3.17 | 10.00 | 8.00 | 7 yrs | 9 mo | 4 days |
| embalming fluid manufacturer | Yeazel v. Coyle, Jr. 21 AFTR 2d 1681 | 304.01 | 450.00 | 400.00 | 8 yrs | 11 mo | 15 days |

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | IRS Challenge | Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| farmer | Wilson, Estate of S.A. Regenold 51,247 P-H Memo T.C. | $ 353.92 | $ 753.05 | $ 395.00 | 8 yrs | 1 mo | 23 days |
| fertilizer manufacturer | Bradley, Estate of Mrs. Sarah H. 2 T.C.M. 609 | 200.00 | 430.00 | 275.00 | 6 yrs | 7 mo | 7 days |
| flour & grain milling | Gwinn, Estate of D. Byrd 25 T.C. 31 | 40.00 | 195.00 | 60.00 | 4 yrs | 9 mo | 3 days |
| furniture sales | Helmers, Estate of George J. 9 T.C.M. 524 | 500.00 | 1,000.00 | 900.00 | 5 yrs | 4 mo | 0 days |
| games manufacturer | Richter v. U.S. 27 AFTR 2d 1691 | 424.90 | 1,000.00 | 700.00 | 9 yrs | 10 mo | 23 days |
| gas company | McIlhenny, Estate of John D. 22 B.T.A. 1093 | 46.66 | 62.50 | 50.00 | 5 yrs | 4 mo | 16 days |
| glass container manufacturer | Hazelton, Estate of Ben F. Jr. 2 T.C.M. 450 | 41.25 | 46.25 | 43.00 | 3 yrs | 5 mo | 11 days |
| grain feed storage | Bader v. U.S. 172 F. Supp. 833 | 521.83 | 1,250.00 | 642.00 | 7 yrs | 9 mo | 24 days |
| grocery wholesaler | Pendleton, Estate of A. S. 20 B.T.A. 618 | 150.00 | 400.00 | 400.00 | 5 yrs | 4 mo | 14 days |
| hair shampoo manufacturer | Goar, Estate of Joseph E. 9 T.C.M. 854 | 200.00 | 447.31 | 275.00 | 3 yrs | 7 mo | 8 days |

## References

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| hardware store | Anderson, Estate of J. Macfie<br>72,125 P-H Memo T.C. | $ 2,500.00 | $ 3,000.00 | $ 3,000.00 | 5 yrs | 9 mo | 30 days |
| holding company | Smith, Estate of Loyd R.<br>9 T.C.M. 907 | 3,350.00 | 7,317.28 | 5,700.00 | 5 yrs | 9 mo | 24 days |
| hotel | McDermott, Estate of James D.<br>12 T.C.M. 481 | 50.00 | 150.00 | 50.00 | 6 yrs | 0 mo | 8 days |
| insurance company | Maxwell, Estate of William<br>3 T.C.M. 1207 | 49.00 | 52.75 | 52.75 | 5 yrs | 3 mo | 7 days |
| intercom systems installer | Sobel, Estate of Ephraim F.<br>10 T.C.M. 613 | 55.83 | 187.35 | 65.00 | 5 yrs | 0 mo | 1 day |
| kitchen appliance manufacturer | Johnson, Estate of Herbert L.<br>2 T.C.M. 299 | 31.00 | 50.00 | 36.00 | 5 yrs | 5 mo | 1 day |
| laundry supply company | Hogan, Estate of James<br>3 T.C.M. 315 | 1,125.00 | 2,100.00 | 1,459.00 | 3 yrs | 10 mo | 11 days |
| loading equipment manufacturer | Houghton v. U.S.<br>15 AFTR 2d 1359 | 195.00 | 450.00 | 375.00 | 8 yrs | 11 mo | 25 days |
| logging company | Garrett, Estate of Jessie R.<br>12 T.C.M. 1142 | 50.39 | 285.65 | 285.65 | 6 yrs | 6 mo | 15 days |
| meat packing company | Russell v. U.S.<br>18 AFTR 2d 6278 | 1,360.00 | 2,100.00 | 2,100.00 | 6 yrs | 6 mo | 27 days |

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| mining equipment manufacturer | Schneider-Pass, Est. of Alfred J. 28 T.C.M. 81 | $ 4,761.90 | $ 38,500.00 | $ 23,809.00 | 11 yrs | 1 mo | 19 days |
| motel & restaurant | Wallace Estate v. U.S. 31 AFTR 2d 1395 | 64.23 | 147.00 | 91.50 | 8 yrs | 7 mo | 6 days |
| mushroom grower & supplier | Thompson, Estate of Barbara F. 18 T.C.M. 801 | 225.00 | 535.00 | 283.50 | 7 yrs | 9 mo | 27 days |
| newspaper | S. Carolina Nat'l Bank v. McLeod 256 F. Supp. 913 | 700.00 | 980.00 | 800.00 | 5 yrs | 7 mo | 25 days |
| oil drilling supply sales | Burda, Estate of L.J. 2 T.C.M. 497 | 3.00 | 10.00 | 5.00 | 1 yrs | 6 mo | 7 days |
| paper products wholesaler | Worthen v. U.S. 7 AFTR 2d 1801 | 100.00 | 175.00 | 104.00 | 7 yrs | 6 mo | 4 days |
| ranching | O'Connell, Estate of J.E. 78,191 P-H Memo T.C. | 485.33 | 1,631.00 | 1,000.00 | 5 yrs | 7 mo | 17 days |
| real estate development | Hanscom, Estate of Edward E. 24 B.T.A. 173 | 50.00 | 100.00 | 100.00 | 5 yrs | 1 mo | 18 days |
| retail shops | Kessler, Estate of Bernard 78,491 P-H Memo T.C. | .50 | 4.96 | 3.67 | 6 yrs | 7 mo | 20 days |
| sawmill & finishing plant | Brooks v. Willcuts 78 F. 2d 270 | 140.00 | 175.00 | 175.00 | 5 yrs | 4 mo | 22 days |

| Type of Business | Name of Case | Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|---|---|
| shipping firm | Brush, Estate of Marjorie G. 22 T.C.M. 900 | $ 3.00 | $ 7.37 | $ 5.50 | 5 yrs | 3 mo | 2 days |
| shoe store | Patton, Estate of Walter L. 10 T.C.M. 1066 | 300.00 | 414.25 | 365.00 | 7 yrs | 2 mo | 16 days |
| steel fabrication | Huntsman, Estate of John L. 66 T.C. 861 | 18.40 | 36.64 | 29.00 | 5 yrs | 6 mo | 12 days |
| steel mill equipment manufacturer | Harrison, Estate of Florence M. 17 T.C.M. 776 | 4.00 | 5.85 | 5.85 | 5 yrs | 7 mo | 3 days |
| tobacco dealer | Nienhuys, Jan W. 17 T.C. 1149 | 115.00 | 285.00 | 172.68 | 5 yrs | 9 mo | 6 days |
| woolen textile manufacturer | Olney, Estate of Lizzie F. 46,138 P-H Memo T.C. | 676.00 | 1,100.00 | 855.00 | 3 yrs | 10 mo | 17 days |

## AVERAGES IN THE PREVIOUS 54 CASES

| Value Per Share: Estate's Value on Return | Value Per Share: IRS Challenge | Value Per Share: Court's Decision | Delay from Date of Death to Closing of Case | | |
|---|---|---|---|---|---|
| $ 654.28 | $ 1,680.82 | $ 1,202.32 | 6 yrs | 7 mo | 20 days |

Even in those cases in which the court agreed with the estate,
it took an average of 7 years, 7 months and 5 days to resolve the dispute.

## BUY/SELL AGREEMENTS HELP FIX THE VALUE

In Each of These Cases the Court Upheld the Value as Established in the Agreement

| | | Value Per Share | | |
|---|---|---|---|---|
| Type of Business | Name of Case | Value As Provided In Agreement | IRS Challenge | Court's Decision |
| advertising agency | Mitchell, Estate of John T. H. 37 B.T.A. 1 | $ 123.45 | $ 348.63 | $ 123.45 |
| coal wholesaler | May et al., v. McGowan 194 F. 2d 396 | -0- | 100.00 | -0- |
| electrical parts wholesaler | Salt, Albert B. 17 T.C. 92 | 20.00 | 60.00 | 20.00 |
| mental hospital | Slocum v. U.S. 256 F. Supp. 753 | 100.00 | 1,108.62 | 100.00 |
| newspaper | Littick, Orville B. 31 T.C. 181 | 298.50 | 384.94 | 298.50 |
| optical & lens manufacturer | Lomb v. Sugden 82 F.2d 166 | 69.44 | 100.00 | 69.44 |
| real estate development | Fieux's Estate 149 N.E. 857 | 100.00 | 200.50 | 100.00 |
| shoe store | Third National Bank v. U.S. 64 F. Supp. 198 | 100.00 | 150.00 | 100.00 |
| soft drink bottler | Strange, Estate of John Q. 42,247 P-H Memo T.C. | 250.00 | 5,953.16 | 250.00 |

## COMPARISON
## CROSS PURCHASE & ENTITY PURCHASE

| | Cross Purchase | Entity Purchase |
|---|---|---|
| **Purchaser** | Surviving stockholders (see charts, pages 135, 139 and 147). | Corporation (see charts, pages 131 and 147). |
| **Seller** | Deceased stockholder's estate. | Deceased stockholder's estate. |
| **Policy Owner** | Individual stockholders (or trustee, see chart page 139). | Corporation. |
| **Number of Policies Required** | Multiple policies depending upon number of stockholders (unless trusteed cross purchase, or funded with first-to-die insurance, see chart page 139 and page 411). | One policy on each stockholder. |
| **Premiums** | Paid by individual stockholders and not deductible (but could use split-dollar, see chart, page 221). | Paid by corporation and not deductible. |
| **Taxation of Life Insurance Death Benefits** | Received tax-free by surviving stockholders (but may be subject to notice and consent requirements, see pages 369-371). | Received tax-free provided notice and consent requirements have been met (see pages 369-371). Could be subject to corporate alternative minimum tax (see page 375). |
| **Effect on Surviving Stockholders** | Stockholder's basis increases in an amount equal to price paid for deceased's stock. | Value of stock owned by survivors increases if corporation retires stock (but no increase in stockholder's basis). |
| **Impact of Attribution** | No effect. | Redemption is subject to attribution rules (see pages 170-175). |
| **Taxation of Deceased Stockholder's Heirs** | Basis is stepped-up at death and no gain recognized (see page 550). | Basis is stepped-up at death and no gain recognized, provided redemption meets either Code section 302(b)(3) or Code section 303 requirements. (see footnote 1, page 149 and page 550). |
| **Legality of Arrangement** | No problem, unless professional corporation and state law restricts sale to other professionals. | Must meet state laws regarding corporate purchase of own stock. |
| **Flexibility to Change Plans** | Transfer of existing policies to corporation could be an exception to transfer for value rules (see page 562). | Transfer of corporate owned policies to co-stockholder violates transfer for value rules, unless co-stockholder is also a partner of the insured (see page 562). |

## COMPARISON
## CROSS PURCHASE & TRUSTEED CROSS PURCHASE

| | Cross Purchase | Trusteed Cross Purchase |
|---|---|---|
| **Purchaser** | Surviving stockholders (see chart, page 135). | Trustee as escrow agent for surviving stockholders (see chart, page 139). |
| **Seller** | Deceased stockholder's estate. | Deceased stockholder's estate. Stock certificates held in escrow by trustee are transferred to surviving stockholders. |
| **Policy Owner** | Individual stockholders. | Trustee as agent for stockholders. |
| **Policy Beneficiary** | Individual stockholders. | Trustee as agent for surviving stockholders. Trustee transfers funds to deceased's estate in return for deceased's stock interest. |
| **Number of Policies Required** | Multiple policies depending upon number of stockholders (see footnote 3, page 137). | One policy on each stock-holder (see footnote 7, page 141). |
| **Premiums** | Paid by individual stock-holders. | Paid by trustee from funds obtained from stockholders (see footnote 5, page 141). |
| **Taxation of Life Insurance Death Benefits** | Received tax-free by surviving stockholders (but may be subject to notice and consent requirements, see pages 357-359). | Received tax-free by trustee as agent for surviving stockholders (but may be subject to notice and consent requirements, see pages 357-359). |
| **Effect on Surviving Stockholders** | Surviving stockholder's basis in stock increases in an amount equal to price paid for deceased's interest. | Surviving stockholder's basis in stock increases in an amount equal to price paid for deceased's interest. |
| **Taxation of Deceased Stock-holder's Heirs** | Basis is stepped-up at death and no gain recognized (see page 561). | Basis is stepped-up at death and no gain recognized (see page 561). |
| **Flexibility to Change Plans** | Transfer of existing policies to corporation could be an exception to transfer for value rules (see pages 573-574). | Transfer of existing policies to corporation could be an exception to transfer for value rules. However, there is a potential transfer-for-value problem after the first death (see footnote 8, page 141 and pages 573-574). |

Note: A trusteed cross purchase agreement can also be used with a partnership (see footnote 1, page 141).