

ESTATE PLANNING FOR OWNERS OF CLOSELY HELD CORPORATIONS: A CRITICAL VIEW OF CODE SECTIONS 303, 6166 AND 6166A *

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Sections 303, 6166 and 6166A of the Internal Revenue Code of 1954 have been adopted by Congress in recognition of the harsh effects of federal taxes on estates that are comprised substantially of interests in closely held businesses and in an effort to avoid the forced sale of such businesses to meet estate tax liability. As will be discussed at greater length later in this article, section 303 allows a limited redemption of a decedent's close corporation stock to be treated as a sale or exchange rather than as a dividend, thereby affording the advantages of capital gains treatment. Sections 6166 and 6166A allow an estate to defer payment of a portion of the federal estate tax if an interest in a closely held business constitutes a significant portion of the decedent's estate.

Although this article will set forth the methodology and mechanics of these provisions, the article's primary purpose is not to serve as a practitioner's guide to the use of these sections. Rather, its purpose is to show, through the use of examples found in practice, how these provisions are utilized by talented estate planners to secure great generosity for the estates of decedents owning closely held businesses. As this article will demonstrate, this generosity frequently goes beyond that needed to achieve the expressed congressional purpose.

This article first sets out the mechanics of sections 303, 6166 and 6166A, and demonstrates what makes these provisions overly generous in many cases. This article then examines four examples of estate planning and administration for owners of closely held businesses found in practice. The concluding part of the article summarizes techniques that estate planners use to take advantage of the generosity of these provisions and sets forth some suggested statutory changes which, if enacted, would limit the use of these provisions to estates truly needing such relief.

I. THE MECHANICS OF SECTIONS 303, 6166 AND 6166A

A. Section 303

If its requirements are met, section 303 of the Internal Revenue Code¹ accords sale treatment, with consequent capital gains taxation, to a redemp-

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¹ I.R.C. § 303 provides in full:

(a) IN GENERAL.—A distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation

tion of stock included in the gross estate of a decedent, even though the redemption might not otherwise qualify for sale or exchange treatment under

which (for Federal estate tax purposes) is included in determining the gross estate of a decedent, to the extent that the amount of such distribution does not exceed the sum of—

(1) the estate, inheritance, legacy, and succession taxes (including any interest collected as a part of such taxes) imposed because of such decedent's death, and

(2) the amount of funeral and administration expenses allowable as deductions to the estate under section 2053 (or under section 2106 in the case of the estate of a decedent nonresident, not a citizen of the United States),

shall be treated as a distribution in full payment in exchange for the stock so redeemed.

(b) LIMITATIONS ON APPLICATION OF SUBSECTION (a).—

(1) PERIOD FOR DISTRIBUTION.—Subsection (a) shall apply only to amounts distributed after the death of the decedent and—

(A) within the period of limitations provided in section 6501(a) for the assessment of the Federal estate tax (determined without the application of any provision other than section 6501(a)), or within 90 days after the expiration of such period,

(B) if a petition for redetermination of a deficiency in such estate tax has been filed with the Tax Court within the time prescribed in section 6213, at any time before the expiration of 60 days after the decision of the Tax Court becomes final, or

(C) if an election has been made under section 6166 or 6166A and if the time prescribed by this subparagraph expires at a later date than the time prescribed by subparagraph (B) of this paragraph, within the time determined under section 6166 or 6166A for the payment of the installments.

(2) RELATIONSHIP OF STOCK TO DECEDENT'S ESTATE.—

(A) IN GENERAL.—Subsection (a) shall apply to a distribution by a corporation only if the value (for Federal estate tax purposes) of all of the stock of such corporation which is included in determining the value of the decedent's gross estate exceeds 50 percent of the excess of—

(i) the value of the gross estate of such decedent, over

(ii) the sum of the amounts allowable as a deduction under section 2053 or 2054.

(B) SPECIAL RULE FOR STOCK OF TWO OR MORE CORPORATIONS.—For purposes of the 50 percent requirement of subparagraph (A), stock of two or more corporations, with respect to each of which there is included in determining the value of the decedent's gross estate more than 75 percent in value of the outstanding stock, shall be treated as the stock of a single corporation. For the purpose of the 75 percent requirement of the preceding sentence, stock which, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property shall be treated as having been included in determining the value of the decedent's gross estate.

(3) RELATIONSHIP OF SHAREHOLDER TO ESTATE TAX.—Subsection (a) shall apply to a distribution by a corporation only to the extent that the interest of the shareholder is reduced di-

sections 302 or 331. Qualifying stock may be redeemed up to an amount equal to the total of federal and state death taxes, funeral expenses, and expenses of administration.² To qualify for sale or exchange treatment under section 303, the following requirements must be met:

(1) The value of the close corporation stock included in the decedent's gross estate must exceed 50% of the value of the adjusted gross estate.³ The value of stock in two or more corporations may be aggregated to meet the

rectly (or through a binding obligation to contribute) by any payment of an amount described in paragraph (1) or (2) of subsection (a).

(4) **ADDITIONAL REQUIREMENTS FOR DISTRIBUTIONS MADE MORE THAN 4 YEARS AFTER DECEDENT'S DEATH.**—In the case of amounts distributed more than 4 years after the date of the decedent's death, subsection (a) shall apply to a distribution by a corporation only to the extent of the lesser of—

(A) the aggregate of the amounts referred to in paragraph (1) or (2) of subsection (a) which remained unpaid immediately before the distribution, or

(B) the aggregate of the amounts referred to in paragraph (1) or (2) of subsection (a) which are paid during the 1-year period beginning on the date of such distribution.

(c) **STOCK WITH SUBSTITUTED BASIS.**—If—

(1) a shareholder owns stock of a corporation (referred to in this subsection as "new stock") the basis of which is determined by reference to the basis of stock of a corporation (referred to in this subsection as "old stock"),

(2) the old stock was included (for Federal estate tax purposes) in determining the gross estate of a decedent, and

(3) subsection (a) would apply to a distribution of property to such shareholder in redemption of the old stock, then, subject to the limitations specified in subsection (b), subsection (a) shall apply in respect of a distribution in redemption of the new stock.

(d) **SPECIAL RULES FOR GENERATION-SKIPPING TRANSFERS.**—Under regulations prescribed by the Secretary, where stock in a corporation is subject to tax under section 2601 as a result of a generation-skipping transfer (within the meaning of section 2611(a)), which occurs at or after the death of the deemed transferor (within the meaning of section 2612)—

(1) the stock shall be deemed to be included in the gross estate of the deemed transferor;

(2) taxes of the kind referred to in subsection (a)(1) which are imposed because of the generation-skipping transfer shall be treated as imposed because of the deemed transferor's death (and for this purpose the tax imposed by section 2601 shall be treated as an estate tax);

(3) the period of distribution shall be measured from the date of the generation-skipping transfer; and

(4) the relationship of stock to the decedent's estate shall be measured with reference solely to the amount of the generation-skipping transfer.

² I.R.C. § 303(a).

³ The adjusted gross estate is the gross estate less deductions allowed by sections 2053 and 2054 for the debts of the decedent, administration expenses, and losses incurred during the period of administration. I.R.C. § 303(b)(2)(A).

50% test if more than 75% of the value of the outstanding stock of each corporation is included in the decedent's gross estate.⁴

(2) The stock generally must be redeemed within four years after the decedent's death. Redemptions may be made after that period, however, to the extent that the amount of stock redeemed does not exceed the lesser of (i) the aggregate amount of federal and state death taxes, funeral expenses, and administration expenses that remain unpaid immediately before the redemption, and (ii) the aggregate amount of federal and state death taxes, funeral expenses, and administration expenses that are paid within one year after the date of such redemption.⁵

(3) The "interest of the shareholder" from whom the redemption is made must be "reduced directly (or through a binding obligation to contribute) by any payment" of federal and state death taxes, funeral expenses, and expenses of administration.⁶

If the requirements set forth above are met, a redemption under section 303 is available to any shareholder whose stock was included in the decedent's gross estate. Thus, stock belonging to an heir, a legatee, a surviving joint ten-

⁴ I.R.C. § 303(b)(2)(B).

⁵ I.R.C. § 303(b)(4).

⁶ I.R.C. § 303(b)(3). The Tax Reform Act of 1976 added § 303(b)(3) which provides, in pertinent part, that a redeeming shareholder can obtain § 303 treatment "only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by any payment of" federal estate taxes, state death taxes, and funeral and administration expenses. As the House Report on the Tax Reform Act makes clear, Congress intended § 303(b)(3) to prevent the abuse that formerly occurred when the interest in the decedent's estate of the shareholder whose stock was redeemed did not bear any of the estate liabilities. See H.R. REP. NO. 1380, 94 Cong., 2d Sess. 35, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3389 (1976). An example of such abuse is the situation in which a decedent specifically bequeathed the stock of his closely held corporation to his son, directed the payment of death taxes and expenses out of the residue, and bequeathed the residue to his daughter. But for § 303(b)(3), stock received by the son could be redeemed, if the estate qualified under § 303, up to the sum of death taxes and expenses even though the daughter's share of the estate bore the burden of payment of these expenses.

Despite the clear Congressional intent to eliminate such abuses, it is unclear because of an ambiguity in § 303(b)(3) whether this section actually prevents such abuses. The ambiguity centers on whether the phrase "interest of the shareholder" means the shareholder's interest in the corporation or his interest in the estate. The former interpretation is an unlikely one for several reasons. First, if the word "interest" means interest in the corporation, § 303 treatment will be available only to a shareholder to the extent that the assets of the estate other than the stock are insufficient to pay taxes and expenses. Such an interpretation would confine the use of § 303 to estates facing truly severe liquidity problems and might be sounder on tax policy grounds; however, it is a more drastic change than Congress intended. Second, if the word "interest" means interest in the corporation, § 303(b)(3) would create serious administrative problems because estates would have to trace redemption proceeds to the actual payment of taxes and expenses. Finally, such a reading would conflict with sections 303(b)(1)(A) and (B). Those sections allow redemptions at any time within a specified period *after* the filing of the federal estate tax return, whereas such a reading would permit redemptions only if they are completed before the filing of the return. For these reasons the word "interest" cannot refer to the shareholder's interest in the corporation. Rather, "interest" must refer to the redeeming shareholder's interest in the estate.

ant who furnished none of the consideration, a trustee of a grantor trust created by the decedent, an executor, or a donee of a gift made within three years of death may be redeemed under section 303.⁷ However, if a shareholder received stock from the decedent's executor in satisfaction of a specific pecuniary bequest, his stock may not be redeemed under section 303 unless the decedent's will specifically gives the authority to satisfy pecuniary bequests by distributions in kind.⁸

At times the redemption of two or more shareholders' stock qualifies for sale treatment under section 303. When this occurs, the Regulations use a first-in-time rather than a pro rata rule to determine which redemptions qualify for sale treatment under section 303.⁹ To illustrate how this rule works, assume that X and Y each receive \$150,000 worth of stock from A's estate, and both qualify under section 303. Assume also that A's estate incurs qualifying taxes and expenses of \$125,000. If the corporation redeems \$100,000 worth of X's stock, the redemption is treated as a sale under section 303. If the corporation later redeems \$100,000 worth of Y's stock, only \$25,000 of the redemption proceeds qualify for sale treatment under section 303.

At times a redemption qualifies for sale or exchange treatment under both section 303 and another section of the Code. Under the Regulations such a redemption is deemed to be under section 303.¹⁰ Thus, in the example above, even if the redemption of X's stock terminated his interest in the corporation, and thereby qualified for sale treatment under section 302(b)(3), it nevertheless is deemed to be a section 303 redemption.¹¹

A number of other Code sections interact with section 303 to affect the tax treatment of the corporation and its shareholders when a redemption under section 303 is effected. Some discussion of these interactions and the planning possibilities created by them is necessary in order to appreciate the liberal treatment accorded under these provisions. Most importantly, section 303 in conjunction with section 311 allows corporations to use appreciated property to redeem stock without recognizing any gain, and section 303 affects a corporation's potential accumulated earnings tax problems.

Generally, when a corporation distributes appreciated property to a shareholder in redemption of his stock, the corporation recognizes gain in the amount of the excess of the fair market value of the property distributed over its adjusted basis in the hands of the corporation.¹² In the case of section 303

⁷ I.R.C. § 303(a); Treas. Reg. § 1.303-2(f) (1978).

⁸ Treas. Reg. § 1.303-2(f); Rev. Rul. 70-297, 1970-1 C.B. 66 (1978).

⁹ Treas. Reg. § 1.303-2(g)(1) (1978).

¹⁰ Treas. Reg. § 1.303-2(g) (1978).

¹¹ There is no prohibition against combining a § 303 redemption with a redemption independently qualifying for capital gains treatment under some other Code section.

¹² Section 311(d)(1) provides:

IN GENERAL—IF—

(A) a corporation distributes property (other than an obligation of such corporation) to a shareholder in a redemption (to which subpart A applies) of part or all of his stock in such corporation, and

(B) the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation), then a gain shall be recognized to the

redemptions, however, section 311(d)(2)(D) creates an exception to this recognition rule, and allows gain at the corporate level to avoid tax. Thus a corporation holding substantially appreciated securities or real estate can distribute these assets to a redeeming shareholder without recognizing any gain and without depleting the cash resources of the corporation.¹³ Such a distribution of appreciated property does trigger the depreciation recapture provisions of sections 1245 and 1250 and the investment tax credit recapture provisions of section 47.

Just as section 303 alters the normal rules governing corporate distributions of appreciated property, it affects the rules governing corporate accumulations of earnings and profits. Stated generally, sections 531 through 537 of the Code impose an accumulated earnings tax on a corporation that accumulates its earnings and profits beyond those required for the "reasonable needs of the business," rather than distributing its earnings and profits to shareholders.¹⁴ Accumulated earnings tax problems can arise in two situations under section 303: when a corporation accumulates funds before the death of an older shareholder in anticipation of a section 303 redemption, and when a corporation accumulates funds in the years immediately after a shareholder's death in order to effectuate a redemption or redemptions during the period allowed under section 303(b)(1).

The rules regarding pre-death accumulations for a possible section 303 redemption are easily stated. Accumulations to redeem a *minority* stockholder's stock serve a bona fide business purpose of assuring smooth post-death operations of the corporation and, therefore, are not unreasonable accumulations subject to the accumulated earnings tax.¹⁵ Pre-death accumulations to redeem a *majority* shareholder's stock generally are held not to be accumulations for the "reasonable needs of the business" and, hence, are subject to the accumulated earnings tax.¹⁶ Pre-death accumulations to redeem a 50% shareholder's stock are not subject to a settled rule.¹⁷

distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of the distribution. Subsections (b) and (c) shall not apply to any distribution to which this subsection applies.

¹³ If the corporation needs the distributed assets in its operations, a leaseback of them might be arranged. If the decedent's death occurs within the next few years and if the distributed asset is depreciable, the shareholder may be able to obtain future deductions from ordinary income at little cost to him since his basis in the stock redeemed will be the fair market value at the time of the decedent's death or, for decedents dying after 1979, the decedent's basis, adjusted upward for any appreciation deemed to have occurred before December 31, 1976 and for any Federal and state death taxes attributable to such appreciation and, therefore, he may not recognize much gain on the redemption. I.R.C. § 1014(a) and §§ 1023(c) and (h). However, as the years pass and the benefits of the "fresh-start" provisions of § 1023(h) diminish, the capital gains costs of a § 303 redemption will clearly be greater.

¹⁴ I.R.C. § 532(a)

¹⁵ See, e.g., *Ted Bates & Co., Inc. v. Commissioner*, 24 T.C.M. (CCH) 1346 (1965).

¹⁶ See, e.g., *Pelton Steel Casting Co. v. Commissioner*, 28 T.C. 153 (1957), *aff'd*, 251 F.2d 278 (7th Cir. 1954) *cert. den.*, 356 U.S. 958 (1958).

¹⁷ See, e.g., *Mountain State Steel Foundaries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960) (accumulations upheld as reasonable needs of business).

Post-death accumulations for purposes of a section 303 redemption are immune from the accumulated earnings tax. Since 1969, section 537(a)(2) has defined "reasonable needs of the business" to include "the section 303 redemption needs of the business." Section 537(b)(1) defines these redemption needs as "the amount needed (or reasonably anticipated to be needed) to make a redemption of stock included in the gross estate of the decedent (but not in excess of the maximum amount of stock to which section 303(a) may apply)." ¹⁸

Section 303 is a valuable estate planning tool because of the potential significant benefits this section affords owners of closely-held corporations. As the following examples demonstrate, careful estate planning can assure the future availability of a section 303 redemption while also improving the liquidity of the estate and, hence, reducing the likelihood that the burden of death-related expenses will require the sale of the business.

When planning for the use of section 303, an estate planner first must insure that the client's estate meets this section's requirements. As noted earlier, section 303 requires that the value of the close corporation's stock included in the decedent's estate exceed 50% of the value of the adjusted gross estate. Thus, the estate planner's first objective is to increase the value of the corporate stock or, conversely, to reduce the value of assets other than the corporate stock which will be included in the client's estate in order to assure qualification under section 303.

The simplest way to satisfy this objective is to encourage the client to make gifts of assets other than the stock in the closely held corporation to other family members. Such gifts decrease the size of the gross estate while increasing the percentage of the estate made up of the corporate stock. Since the advent of the \$100,000 gift tax marital deduction¹⁹ and the substantial unified credit for lifetime gifts,²⁰ this technique has become increasingly attractive.

Another easy planning strategy is to encourage the client to contribute some assets to the corporation under section 351. By making such tax-free contributions, the client decreases the absolute and relative value of his assets other than the stock in the closely held corporation and increases the absolute and relative value of the corporation and its stock. Clearly, there are limits on the types of property which can be contributed; however, if the corporation has expansion opportunities that require more cash than it can generate internally, a contribution of cash or other liquid assets is justifiable.

Similarly, the client can contribute insurance policies on his life to the corporation. Such a transfer would not be a transfer for value pursuant to section 101(a)(2)(B). The proceeds of such policies would then be available upon the decedent's death to redeem a portion of his stock in the corporation

¹⁸ Where a corporation redeems stock by giving the stockholder a note rather than cash, section 537 permits the corporation to accumulate funds to discharge the note. I.R.C. § 537(b)(3).

¹⁹ I.R.C. § 2523(a)(2).

²⁰ I.R.C. § 2505.

under section 303 from his estate, thus returning the liquidity of the insurance proceeds to the decedent's estate and, ultimately, to his family.

While the three estate planning strategies outlined above are simple and effective, estate planners often use more complicated strategies to give their clients more flexibility in disposing of their assets. One such strategy involves the declaration of a preferred stock dividend, or the recapitalization of the corporation involving the issuance of preferred stock. The issuance of preferred stock accomplishes several objectives. First, if the preferred stock bears a reasonable rate of interest, its value is generally fixed at or near its par or liquidation value. Thus, the shareholder is able to freeze the value of the portion of his interest in the corporation represented by the preferred stock. In conjunction with this partial freeze, the shareholder can make gifts of common, often non-voting, the value of which has been temporarily depressed by the issuance of the preferred, but which stands to realize all of the appreciation in the value of the business over time.²¹ Second, the shareholder can later bequeath the preferred to members of his family who do not take an active part in the business, thus guaranteeing them future income from the business if their stock is not redeemed under section 303, while assuring that those family members who are active in the business will have voting control. Finally, the issuance of preferred can satisfy a lifetime need of the controlling shareholder by assuring him of adequate income from the corporation when his partial or full retirement forces the corporation to reduce his salary under the reasonable compensation rules.

The issuance of preferred stock as an estate planning strategy has its disadvantages as well as its advantages, however. If the corporation issues the preferred stock as a dividend on common at a time when it has sufficient earnings and profits, the preferred is tainted as section 306 stock.²² Generally speaking, section 306 treats all or part of the gain on the redemption or sale of such stock as ordinary income rather than capital gain.²³ Additionally, if the preferred is received in a recapitalization, the stock is section 306 stock "to the extent that . . . the effect of the transaction was substantially the same as the receipt of a stock dividend . . ."²⁴

Before the enactment of the carryover basis rules of section 1023, the owners of closely-held corporations often were unconcerned that preferred stock which was issued as a dividend on common stock or as a part of a recapitalization constituted section 306 stock. First, the shareholder probably

²¹ By making gifts of non-voting rather than voting common stock, the shareholder can retain control of the corporation.

²² I.R.C. § 306(c)(1)(A).

²³ If the shareholder later sells § 306 stock, the proceeds are treated as a dividend and, hence, as ordinary income to the extent of the stock's pro rata portion of the corporation's earning and profits at the time the corporation issued the stock. I.R.C. § 306(a)(1). If the corporation later redeems § 306 stock, the proceeds are treated as dividend income to the extent of earnings and profits at the time of the redemption. I.R.C. § 306(a)(2). In both cases, the basis of the stock is ignored in determining the amount that will be treated as dividend income.

²⁴ I.R.C. §§ 306(c)(1)(B) and 368(a)(1)(E).

anticipated no lifetime sale or disposition of the stock which would unlock its ordinary income component. Second, if the shareholder did contemplate a lifetime disposition of the stock, he probably envisioned a sale or redemption of his entire stock interest in the corporation, in which case the disposition would qualify for capital gain treatment despite its section 306 taint.²⁵ Finally, if the section 306 stock passed to his heirs at his death, its ordinary income taint was removed.²⁶

With the advent of the carryover basis provisions of section 1023 for decedents dying after December 31, 1979, however, section 306 stock may retain its ordinary income taint in the hands of the decedent's legatees. In the Revenue Act of 1978, however, Congress added section 306(b)(5) which provides that, for decedents dying after 1979, section 303 overrides section 306(a) and that, therefore, section 306 stock may be redeemed under section 303 at capital gains rates.²⁷

It should be remembered, however, that section 306 stock might be sold by an heir or legatee or redeemed in a transaction to which section 303 would not apply. To lessen the adverse effect of the sale or redemption of section 306 stock in conjunction with the carryover basis provisions, the Revenue Act of 1978 added new section 306(a)(3) providing that, in the case of a sale of section 306 stock or a redemption of such stock under paragraphs (1), (2), or (4) of section 302(b), which stock was distributed before January 1, 1977, ordinary income will be realized only to the extent that the amount realized on the sale or redemption exceeds the sum of the adjusted basis of the stock on December 31, 1976, and any basis increase under section 1023(h).²⁸ It should be noted that the relief accorded by new section 306(a)(3) applies only to section 306 stock issued before 1977 and, therefore, sales or redemptions (not under section 303) of such stock issued after January 1, 1977 will be subject to the normal rules of section 306.

One additional point should be noted regarding section 303. The preceding discussions have assumed that the corporation would pay for stock redeemed under section 303 soon after the decedent's death. In Revenue Ruling 67-425,²⁹ a corporation was allowed to issue its notes payable in exchange for the stock redeemed. The issuance of such notes could greatly reduce the cash drain on the corporation occasioned by a large section 303 redemption. Additionally, if one of the estate tax deferral provisions were elected, the payments under such notes could be timed to coincide with the deferred tax payments. Furthermore, section 303(b)(1)(C), added to the Code by the Tax Reform Act of 1976, specifically allows redemptions throughout the period of estate tax deferral if section 6166 or section 6166A is elected, subject to the limitations of section 303(b)(4) discussed above. The limitations, discussed below, of sections 6166(g) and 6166A(h) must, however, be borne in mind when a corporation issues notes payable in exchange for stock.

²⁵ I.R.C. § 306(b)(1).

²⁶ I.R.C. § 306(c)(1)(C); Treas. Regs. § 1.306-3(e) (1978).

²⁷ Revenue Act of 1978, Pub. L. No. 95-600, § 702(a)(2).

²⁸ Revenue Act of 1978, Pub. L. No. 95-600, § 702(a)(1).

²⁹ 1967-2 C.B. 134.

*B. Sections 6166 and 6166A: The Estate
Tax Deferral Provisions*

The estate tax deferral rules of sections 6161, 6166, and 6166A are potentially as valuable to an estate holding stock in a close corporation as the capital gains redemption rule of section 303. These deferral provisions, the latter two of which are limited to estates holding stock in closely held corporations, provide two major benefits to estates. First, they enable the estate to defer portions of the estate tax bill for up to fifteen years. The estate can dispose orderly of non-corporate assets or gradually withdraw cash from the corporation to fund the tax bill, thereby assuring that more property ultimately reaches the hands of beneficiaries. Secondly, to the extent that the interest charged by the Treasury on these deferrals is less than the market cost of borrowings by such estates and the close corporations they hold, the net present value of the deferred payments is reduced below the actual sum of the tax and interest payments due. Consequently, these deferral provisions, in conjunction with section 303, often provide more liquidity relief than Congress may have intended. In the remainder of this section, I will discuss individually sections 6166 and 6166A.³⁰

For an estate to qualify for a deferral under section 6166A,³¹ the value of the decedent's "interest in a closely held business" included in his estate must exceed either 35% of the value of the decedent's gross estate, or 50% of the value of the decedent's taxable estate.³² If the estate meets either of these qualifying tests, the executor may elect to pay that amount which bears the same ratio to the total federal estate tax due as the value of the "interest in a

³⁰ The following section of the article discusses at length §§ 6166 and 6166A. Section 6161(a)(2) provides, in general, that the Secretary of the Treasury may "for reasonable cause" extend the period for payment of the federal estate tax due at that time of filing of the federal estate tax return "for a reasonable period not in excess of 10 years." Section 6161(a)(2) also allows the Secretary to extend the period for payment of an estate tax installment due under § 6166 or § 6166A for up to 12 months. Pursuant to § 6621, these deferred payments bear interest at a rate set periodically by the Treasury at approximately 90% of the commercial bank prime lending rate. The current interest rate on deferred payments is 6%. Rev. Rul. 77-411, 1977-2 C.B. 480. Internal Revenue News Release I.R.—2169, Oct. 12, 1979 raised the rate to 12% effective Feb. 1, 1980.

³¹ Before the Tax Reform Act of 1976, § 6166A was embodied in the Code as § 6166.

³² I.R.C. § 6166A(a). Section 6166A(c) defines "interest in a closely held business" as:

(1) an interest as a proprietor in a trade or business carried on as a proprietorship;

(2) an interest in a partnership carrying on a trade or business if at least 20% of the total capital interest in the partnership is included in the decedent's gross estate or if the partnership has ten or fewer partners; and

(3) an interest in a corporation carrying on a trade or business if at least 20% of the value of the voting stock of the corporation is included in the decedent's gross estate or if the corporation has ten or fewer shareholders.

To meet the 35% or 50% qualifying tests, an estate can aggregate interests in two or more closely held businesses if more than 50% of the value of each business is included in the decedent's gross estate. I.R.C. § 6166A(d).

closely held business" bears to the total gross estate in not less than two or more than 10 equal, annual installments, without the necessity of any showing that the estate lacks sufficient liquid assets to pay the estate tax with the filing of the estate tax return.³³ That is, the deferral is available only for that portion of the estate tax which is attributable to the inclusion of the decedent's interest in a closely held business in the estate. The first installment is due at the time of filing of the federal estate tax return; later payments are due on the same day of succeeding years.³⁴ Amounts deferred under section 6166A currently bear interest at 6%.³⁵

In contrast to section 6166A, section 6166, which was added to the Code by the Tax Reform Act of 1976, has more stringent qualifications, but offers much greater deferral benefits for qualifying estates. For an estate to qualify for deferral under section 6166, the "value of an interest in a closely held business"³⁶ included in the decedent's estate must exceed 65% of the value of the adjusted gross estate.³⁷ Like section 6166A, section 6166 allows the qualifying estate to defer payment of estate tax equal to an amount which bears the same ratio to the total federal estate tax due as the value of the interest in the closely held business bears to the value of the adjusted gross estate.³⁸ Unlike section 6166A, however, section 6166 allows the qualifying estate to defer all federal estate taxes for up to five years with the tax then due in two

³³ I.R.C. § 6166A(a). To secure payment of the deferred taxes, the Secretary may demand a bond in an amount up to twice the sum of the deferred taxes and interest. I.R.C. § 6165. In addition, § 6324A calls for the creation of a lien on property owned by the decedent to secure payment of the deferred tax and interest.

³⁴ I.R.C. § 6166A(e). Payment of some or all of the deferred tax is accelerated if:

- (1) an installment payment is not timely made;
- (2) the estate holds undistributed net income for any taxable year after its fourth taxable year;
- (3) 50% or more of the value of the interest in a closely held business is "distributed, sold, exchanged, or otherwise disposed of," other than by a § 303 redemption; or
- (4) "aggregate withdrawals of money and other property from the trade or business . . . equal or exceed 50% of the value of such trade or business."

I.R.C. § 6166A(h).

³⁵ I.R.C. § 6621; Rev. Rul. 77-411, 1977-2 C.B. 480. See note 30 *supra*.

³⁶ Section 6166's definition of what constitutes "an interest in a closely held business" is generally the same as that of § 6166A, except that § 6166's definition includes interests in partnerships having fifteen or fewer partners or corporations having fifteen or fewer shareholders. I.R.C. § 6166(b)(1).

³⁷ I.R.C. § 6166(a)(1). To meet the qualifying test of 65% of the adjusted gross estate, the estate may aggregate interests in two or more businesses if the deceased shareholder's interest in such businesses included in the estate represents 20% of their total value. I.R.C. § 6166(c). In addition, § 6166(b)(2)(D) attributes stock owned by the decedent's siblings, spouse, ancestors, and lineal descendants to the decedent for purposes of the qualifying test.

³⁸ I.R.C. § 6166(a)(2).

to ten equal, annual installments.³⁹ During the five year moratorium, interest on the deferred tax is due annually.⁴⁰

II. CASE HISTORIES

Having described the mechanics of sections 303, 6166, and 6166A, I turn now to case histories which illustrate how estate planners use these provisions to secure significant estate tax advantages for their clients. As previously stated, this article is not intended to be a practitioner's guide to the use of these provisions. Rather, it is intended to point out the ways in which estate planners use these sections to aid certain estates to a greater extent than Congress intended. Four examples found in practice of estate planning and administration for owners of closely-held corporations will be discussed. The first two examples involve decedents; the other two involve living, controlling shareholders of family businesses.

To focus on the unintended generosity of section 303 and the deferral provisions shown by these examples, the reader should bear in mind the following questions:

(1) Although the businesses involved in the following examples are closely held, are they really "small," in an absolute sense, and therefore in need of Congressional protection?

(2) How illiquid are families owning closely-held businesses, and how illiquid are the businesses themselves?

(3) Considering of the size of the family property holdings, the size of the businesses, and the liquidity of both the families and the businesses in the following examples, how burdensome is the federal estate tax load?

A. Robert Miller

Robert Miller, a widower, died in early 1966, at age 78. He was survived by his daughter, Betty, age 48, and his son, Randall, age 45. At the time of his

³⁹ I.R.C. § 6166(a)(3). Liability for the deferred tax is accelerated if:

(1) one-third or more of the value of the interest in the closely held business is "distributed, sold, exchanged, or otherwise disposed of," except under § 303;

(2) an amount exceeding one-third of the value of the decedent's interest in the business is withdrawn from the business, except under § 303;

(3) the estate has undistributed net income for any taxable year ending on or after the due date of the first installment and the executor fails to "pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments" before the due date for the estate's income tax return; or

(4) any installment payment is not timely made.

I.R.C. § 6166(g).

⁴⁰ I.R.C. § 6166(f)(1). Normally, the executor is personally liable for the deferred tax. However, the executor is excused from liability if all persons having an interest in the business consent to a line upon the property. I.R.C. § 6324A. The interest rate on taxes deferred under § 6166 is 4% on amounts up to the lesser of \$345,800 (reduced by the amount of available unified credit), or the amount of deferred tax, I.R.C. § 6601(j); the interest rate imposed on sums in excess of this amount is the same as that imposed on taxes deferred under § 6166A. I.R.C. §§ 6601(a) and 6621.

death, Miller was supporting his grandson, Thomas, age 18, a college student who was the only child of Miller's eldest son and his wife, both of whom were deceased. At the time of Miller's death, Betty was actively engaged as treasurer of the Miller Steel Co., was married and had two children. Randall, the father of three children, practiced law in Chicago and had never taken any part in the family business.

The Miller Steel Company, founded by Miller's father and uncle in 1880, manufactured structural steel products for heavy construction. Miller entered the business in 1912 and succeeded to the presidency in 1920 upon his father's death. The chart below shows the operating results of Miller Steel for the five fiscal years preceeding Miller's death.

MILLER STEEL—OPERATING RESULTS (in thousands)

| | FY1962 | FY1963 | FY1964 | FY1965 | FY1966 |
|--------------------|---------|---------|---------|---------|---------|
| Sales..... | \$7,675 | \$7,600 | \$7,500 | \$8,250 | \$8,700 |
| Net Income | | | | | |
| before Taxes | 700 | 625 | 600 | 700 | 850 |
| Federal and State | | | | | |
| Income Taxes..... | 321 | 300 | 285 | 320 | 400 |
| Net Income..... | 379 | 325 | 315 | 380 | 450 |
| Total Retained | | | | | |
| Earnings at | | | | | |
| end of year..... | \$2,800 | \$2,925 | \$3,050 | \$3,200 | \$3,450 |

The following chart summarizes Miller Steel's balance sheet for the same five years:

MILLER STEEL—BALANCE SHEETS (in thousands)

| Assets | FY1962 | FY1963 | FY1964 | FY1965 | FY1966 |
|--------------------------|----------------|----------------|----------------|----------------|----------------|
| Cash..... | \$1,010 | \$ 950 | \$ 700 | \$ 650 | \$ 650 |
| Accounts | | | | | |
| Receivable | 1,500 | 1,600 | 1,690 | 1,775 | 1,950 |
| Inventory..... | 1,175 | 1,200 | 1,300 | 1,305 | 1,335 |
| Misc. Current | | | | | |
| Assets | 20 | 25 | 5 | 25 | 5 |
| Total Current | | | | | |
| Assets | \$3,705 | \$3,775 | \$3,695 | \$3,775 | \$3,940 |
| Net Property, | | | | | |
| plant and | | | | | |
| equipment..... | 700 | 710 | 1,000 | 1,100 | 1,200 |
| Misc. Assets..... | 145 | 140 | 95 | 150 | 160 |
| TOTAL ASSETS..... | \$4,550 | \$4,625 | \$4,790 | \$5,025 | \$5,300 |

Liabilities & Stockholders' Equity

| | | | | | |
|---|----------------|----------------|----------------|----------------|----------------|
| Liabilities | \$ 625 | \$ 575 | \$ 615 | \$ 700 | \$ 725 |
| Capital Stock | 1,125 | 1,125 | 1,125 | 1,125 | 1,125 |
| Retained Earnings | 2,800 | 2,925 | 3,050 | 3,200 | 3,450 |
| Total Stock- holders equity | 3,925 | 4,050 | 4,175 | 4,325 | 4,575 |
| TOTAL LIABILITIES AND STOCK- HOLDER'S EQUITY | \$4,550 | \$4,625 | \$4,790 | \$5,025 | \$5,300 |

In 1940, the company was recapitalized into the Class A voting and Class B non-voting common stock. At the time of the recapitalization, Miller owned 67% of the total outstanding stock; his uncle's heirs owned the remaining shares. This recapitalization was effected to allow Miller to reduce the size of his potential estate by making substantial gifts of non-voting stock to family members without losing voting control. At the time of Miller's death, the stockholdings were as follows:

| Class A Voting | Shareholder | Class B Non-Voting |
|-------------------|--|-----------------------|
| 4,006 | Robert Miller | 6,162 |
| 1,000 | Betty Miller | 620 |
| --- | Randall Miller | 1,000 |
| --- | Betty Miller as trustee for Thomas Miller | 2,230 |
| 2,494 | Heirs of Harold Miller | 4,988 |
| 7,500 | | 15,000 |

Thus, at Miller's death, he held 53% of the voting stock of Miller Steel and slightly over 41% of its non-voting stock. Betty acquired her shares of stock by gift from her father in 1944, shortly after she had joined the firm. Because the company was much smaller and less prosperous at that time, the gift was completely shielded from gift taxes by the gift-splitting, combined lifetime exemptions, and annual per donee gift tax exclusions of Mr. and Mrs. Miller.⁴¹ Randall acquired his shares of stock upon his graduation from law school in 1947. Miller gave him the shares of non-voting stock to assure him dividend income from the company. The gift was valued at \$70,000, upon which Miller paid \$5,000 in gift taxes. After the death of Thomas's parents, Miller established an irrevocable trust for his benefit to which Mr. Miller contributed 170 Class B shares each year from 1955 to 1964. The total gift tax cost of these gifts was \$40,000. In late 1965, Miller added 530 shares of Class B stock, valued at \$95,000, to the trust. Gift taxes of \$20,000 upon this gift were owing at the time of Miller's death. The Internal Revenue Service

⁴¹ The Millers utilized the 1939 Code's versions of §§ 2513, 2521, and 2503(b).

agreed that the gift was not in contemplation of death. Since 1940 the company had paid equal annual dividends on the two classes of common stock. During the five years immediately preceding Miller's death, the annual dividends were \$10 per share.

Despite these various lifetime gifts of stock, Miller's interest in Miller Steel comprised the bulk of his estate. The stock, both Class A and Class B, was valued at \$175 per share for federal estate tax purposes.⁴² Consequently, the total value of Miller Steel was just under \$4,000,000; the total value of Miller's stock was \$1,775,000.⁴³ The remainder of Miller's estate consisted of real estate valued at \$70,000, cash and marketable securities worth \$177,000, and life insurance, payable to his executrix, worth \$120,000.

Miller's will was relatively simple. In it, Miller directed his executrix to sell the real estate and add the proceeds to the residue. Miller bequeathed approximately \$20,000 to his college. He established three generation-skipping trusts: a trust for the benefit of Randall, the corpus of which was to be made up of assets other than stock in Miller Steel to the extent possible; a similar trust for Betty, the corpus of which was to be made up of Class A stock;⁴⁴ and a trust for Thomas, the corpus of which was to consist of Class B stock and other estate assets.

The following table summarizes Miller's estate for federal estate tax purposes:

| ITEMS IN GROSS ESTATE | |
|---|-------------------------|
| Miller Steel Company stock | \$1,775,000 |
| Real Estate | 70,000 |
| Cash and marketable securities..... | 177,000 |
| Life insurance (payable to executrix)..... | 120,000 |
| Gross Estate | <u>\$2,142,000</u> |
| Less: Administration expenses and debts..... | 90,000 |
| Adjusted gross estate..... | 2,052,000 |
| Less: Charitable deduction..... | 20,000 |
| Less: Exemption..... | 60,000 |
| Taxable Estate | <u><u>1,972,000</u></u> |
| Gross Federal estate tax | 740,000 |
| Credit for state death taxes | <u>100,000</u> |
| Net Federal estate tax | <u>640,000</u> |
| State death taxes payable | <u>100,000</u> |

⁴² This figure represents slightly less than 90% of the per share book value, and approximately 10 times the average of the proceeding five years' per share earning.

⁴³ If Miller had not given his children and grandchild any stock, the value of the stock included in his estate would have been \$2,628,150. During his life Miller transferred stock worth \$850,000 at his death at a gift tax cost of only \$65,000.

⁴⁴ To assure Betty of voting control of Miller Steel, Miller made her co-trustee of the trust.

Because the Miller Steel stock accounted for almost 87% of the value of Miller's adjusted gross estate, the estate easily qualified under sections 303 and 6166 as these sections existed before the Tax Reform Act of 1976. Miller's executor elected to use these sections in tandem.

Under former section 6166(b), Miller's estate elected to defer payment of 83% of the federal estate tax, or approximately \$530,000, over ten years. The estate paid only \$163,000—17% of the total federal taxes due—when it filed its estate tax return in July, 1968, and was committed to make nine additional yearly installments of \$53,000, plus interest at the former statutory rate of 4%, in July of each succeeding year.

Under section 303, Miller's estate could redeem up to \$830,000 worth of stock, the sum of federal and state death taxes, debts and administration expenses. In order to fund the initial payment of \$163,000 in federal estate taxes, Miller Steel redeemed 800 shares of Class B stock from the estate, at its then appraised value of \$200 per share,⁴⁵ for \$160,000. In July, 1969, the company redeemed 400 shares of Class B stock from the estate, at \$205 per share, for \$82,000. Finally, in July, 1970, with section 303's limitation period of 3 years and 90 days from the filing of the federal estate tax return drawing near, the company redeemed 2,600 shares of Class B stock at \$210 per share for \$546,000. In its final redemption the company paid \$204,000 in cash, and gave the estate a note payable which called for six annual payments of \$57,000 plus interest at 4% in July of each year.⁴⁶ The note payments nicely covered the estate's annual installments of deferred estate taxes and interest under section 6166, as well as providing some additional funds for the estate.⁴⁷

With these facts in mind, it is appropriate to examine the liquidity needs of Miller's estate and its use of sections 303 and 6166 in light of the expressed congressional purpose of these sections.

Miller's estate faced federal estate taxes, state death taxes, and administration expenses of \$830,000. The absolute amount of these costs, however, is irrelevant. Rather, it is the liquidity of the estate and the family business in relation to these costs and the cash needs of the family that is relevant. At the time of Miller's death, his estate held just under \$300,000 in cash, marketable securities and insurance proceeds which could have been used to meet part of these expenses.

The ability of Miller Steel to make an immediate redemption or pay out temporarily higher dividends to allow the estate to meet its liabilities must also be examined. In the year preceding Miller's death, Miller Steel had net income after taxes of \$450,000 and held \$650,000 in cash, even after distributing almost \$225,000 in dividends. The company had never borrowed from a bank, had total liabilities of less than 20% of its current assets, and had no concrete plans for immediate expansion. Thus, the company could have used

⁴⁵ This value was \$25 more than the date of death value of the stock.

⁴⁶ As noted earlier, Rev. Rul. 67-425, 1967-2 C.B. 134, authorized businesses to issue notes in § 303 redemptions.

⁴⁷ The company and the estate timely paid all installments through 1975. With the event of the higher, 9% interest rate in July, 1975, however, the company combined its final two payments under the note and the estate paid all remaining tax installments.

a huge chunk of cash, perhaps as much as \$500,000, to redeem a significant portion of the estate's stock or to pay additional dividends. Without section 303, however, it would have been difficult for the estate to obtain capital gain treatment for the redemption.⁴⁸

Thus, because of this potential cash "short fall," the estate clearly needed some tax relief, either in the form of capital gain treatment for a redemption or an extension of the time in which to pay estate taxes. In this case, however, sections 303 and 6166 provided more relief than was necessary. Although the estate faced a cash short fall of about \$530,000, section 303 allowed the company to redeem up to \$830,000 worth of stock. Additionally, section 6166 allowed the estate to defer \$530,000 in estate taxes. Given the financial strength and liquidity of Miller Steel, the relief provided under either section alone would have been sufficient.

B. Graham Sterling

Unlike Robert Miller's estate, which illustrates the tremendous advantages that sections 303 and 6166 can accord to well planned estates, Graham Sterling's estate illustrates the advantages these sections provide even to relatively unplanned estates. A dynamic man, Sterling had taken few steps towards planning his estate before he died unexpectedly in April, 1973, at age 55. His wife, Althea, age 57, and two daughters, Sarah, age 29, and Priscilla, age 26, survived him. Sarah was active in the family business. No other family members took any active part in the business.

In 1952, Sterling founded Sterling Realty to engage in residential real estate sales. During the next 15 years, the business diversified to include the brokerage of commercial real estate. After Sarah entered the business in 1967, it expanded into the ownership and leasing of commercial properties.

The table below summarizes operating results for the two years preceding Sterling's death:

STERLING REALTY—OPERATING RESULTS

| | 1972 | 1971 |
|--|-----------|-----------|
| Net Income before Taxes..... | \$250,000 | \$220,000 |
| Federal and State Taxes..... | 115,000 | 70,000 |
| Net Income before Extra-ordinary Item..... | 135,000 | 150,000 |
| Extraordinary Loss on Destruction of Building..... | --- | (140,000) |
| Net Income | 135,000 | 10,000 |
| Retained Earnings at Beginning of Year | 235,000 | 225,000 |
| Retained Earnings at End of Year | 370,000 | 235,000 |

⁴⁸ Because of the family attribution rules of § 318, it is extremely unlikely that the redemption could have qualified for capital gains treatment under § 302(a). See I.R.C. § 302(b)(2).

At the time of Sterling's death, the company had total assets of approximately \$2,000,000, including \$125,000 in cash. Sterling owned 60% of the outstanding stock of the company. His mother, who had provided much of the company's initial capital, owned the remaining 40%. The company had never paid any dividends. Because of a recent surge in income and strong continued profitability expected in the commercial development division, the company was valued at \$1,000,000 for estate tax purposes, roughly eight times the average after-tax net income of the two years immediately preceding Sterling's death. Sterling's 60% interest, therefore, was valued at \$660,000.

Sterling's estate plan was very simple. He bequeathed roughly \$125,000 worth of property (net of insurance proceeds) to his wife. This bequest was relatively modest because his wife was the life income beneficiary of a substantial trust established by her father which provided more than ample annual income for her. Sterling bequeathed the residue of his estate in equal shares to his two daughters. The following chart summarizes the composition of Sterling's estate and the taxes thereon:

ITEMS IN GROSS ESTATE

| | |
|--|------------------|
| Interest in Sterling Realty | \$660,000 |
| Cash and marketable securities..... | 35,000 |
| Investment real estate | 20,000 |
| Insurance (proceeds payable to wife or estate)..... | 70,000 |
| Gross Estate..... | <u>\$785,000</u> |
| Less: Debts of decedent | 30,000 |
| Less: Funeral and administration expenses..... | 25,000 |
| Less: Marital deduction | 125,000 |
| Less: Exemption..... | <u>60,000</u> |
| Taxable Estate..... | <u>\$545,000</u> |
| Gross Federal estate tax..... | 161,450 |
| Credit for state death taxes..... | <u>14,200</u> |
| Net Federal estate tax..... | <u>147,250</u> |
| State death taxes payable..... | 15,000 |

In order to meet the estate's taxes, debts and expenses of \$217,250, the executor elected to defer part of the federal estate tax under former section 6166. Since the value of Sterling's stock in Sterling Realty constituted 84% of the value of his gross estate, the estate elected to pay that percentage of the federal estate tax, or roughly \$123,000, in ten annual installments of \$12,300 plus interest. The estate paid the remaining \$24,250 when it filed its estate tax return in mid-1973. The estate also induced Sterling Realty to redeem stock under section 303. In May, 1976, the corporation redeemed roughly 17% of the estate's total stockholdings, for a total of \$150,000, paying cash for

the shares redeemed.⁴⁹ As a result of this redemption, the estate had more than sufficient liquid funds to meet the deferred federal estate tax payments.

Although Sterling's estate easily met its federal estate tax obligations, careful planning before Sterling's death could have reduced greatly the estate's tax load. For example, Sterling could have recapitalized the company into voting and non-voting common stock and non-voting preferred stock. He then could have made gifts of common stock, mostly non-voting, to Sarah, since she had taken an active role in the business. He also could have made some gifts of non-voting stock to Priscilla.⁵⁰ By utilizing the gift splitting provisions of section 2513, his and his wife's combined lifetime exemptions under former section 2521 and annual exclusions under section 2503(b), Sterling could have made tax-free gifts of \$72,000 worth of stock to his daughters in the first year and \$12,000 each year thereafter. If he had adopted such a plan in 1967, when Sarah entered the business, he could have given his daughters \$132,000 worth of stock tax-free by 1972. Since the stock was appreciating rapidly in value during this period, such gifts would have removed a much greater amount from Sterling's estate.

Sterling's early, unexpected death, the lack of lifetime giving, the small marital bequest, combined with the relative illiquidity of the estate should make this estate the model of the illiquid, relatively unplanned estate to which section 303 and the deferral provisions were directed. However, I believe the combination of sections 303 and 6166 provided more relief than was needed, especially in this situation where the needs of the decedent's family were amply met. Since the estate's major asset was non-dividend paying stock of Sterling Realty, a section 6166 deferral alone would have been of little help. Therefore, some redemption was necessary, but section 303 allowed the estate to redeem up to \$187,250 worth of stock when the state really only needed a redemption of \$137,250. As noted, the business did redeem \$150,000 worth of stock for cash, and the estate then elected to pay \$24,150 in Federal taxes when the estate tax return was filed and deferred the remaining \$123,000 of Federal taxes under section 6166 with interest at the then-prevailing rate of 4%. By allowing a deferral after the estate had enjoyed a section 303 redemption and had adequate cash to pay its taxes and expenses, section 6166 provided additional relief beyond what Congress may have intended. •

C. Thomas Kraft

Thomas Kraft's case history, like the Miller and Sterling case histories, demonstrates the excessive tax relief that may be afforded by sections 303 and

⁴⁹ The estate's total stockholdings before the May, 1976 redemption were 1440 shares with a basis of \$462.50 per share. In the May, 1976 redemption, the corporation redeemed 240 of those shares at \$625 per share.

⁵⁰ Because Sterling's mother was interested in current income but not in voting power, Sterling could have considered a recapitalization in which his mother would have exchanged her common stock for non-voting preferred. Such preferred stock probably would not have been deemed § 306 stock since Sterling's mother would have surrendered her voting rights in exchange for it. Even if it had been deemed § 306 stock, § 306(b)(4) might have exempted it from § 306 treatment.

6166 in certain situations. Unlike Miller and Sterling, however, Kraft exemplifies the living head of a family owned corporation who has adopted an aggressive, carefully conceived gift and estate plan. Thomas Kraft is 54 years old. His family includes his wife Nancy, age 51, sons Stanley, age 27, and William, age 24, and daughters Christina, age 25, and Margaret, age 20. Stanley is active in the family business with his father; none of the other children, all of whom are still in school, have worked in the business or expressed any interest in it.

Kraft founded Car Care Centers, Inc. (CCC) in 1957. Since its inception, CCC has grown rapidly; it now includes eight stores that sell tires and automobile replacement parts, and provide a full range of automobile repair services. The following table summarizes the operating results for the five most recent years for which figures are available, during which the company has experienced tremendous growth:

CCC OPERATING RESULTS (in thousands)

| | <u>1973</u> | <u>1974</u> | <u>1975</u> | <u>1976</u> | <u>1977</u> |
|---|----------------|----------------|----------------|----------------|----------------|
| Sales..... | <u>\$2,305</u> | <u>\$2,825</u> | <u>\$3,150</u> | <u>\$3,725</u> | <u>\$4,460</u> |
| Net Income before Taxes | 131 | 105 | 160 | 355 | 365 |
| Federal and State Income Taxes..... | <u>51</u> | <u>41</u> | <u>62</u> | <u>156</u> | <u>170</u> |
| Net Income..... | 80 | 64 | 98 | 199 | 195 |
| Retained Earnings at Beginning of Year..... | 418 | 498 | 562 | 660 | 794 |
| Addition to Capital Stock | — | — | — | 65 | — |
| Retained Earnings at End of Year..... | <u>498</u> | <u>562</u> | <u>660</u> | <u>794</u> | <u>989</u> |

At the end of 1977, the balance sheet showed total assets of \$1,585,000, consisting of \$110,000 in cash, \$81,000 of accounts receivable, \$300,000 of inventory, \$975,000 of net property, plant, and equipment, and \$119,000 of other assets. Total liabilities were \$496,000, capital stock was \$100,000, and retained earnings were \$989,000. The company is the owner and beneficiary of \$250,000 of life insurance on Kraft's life. Although Kraft does not expect the tremendous growth rate of the past few years to continue, he expects average annual sales and earnings growth of about 15% over the next five years.

The Kraft family has substantial assets aside from the business. Mr. Kraft owns the family home valued at \$125,000, cash and marketable securities worth \$75,000, undeveloped land valued at \$20,000, and tangible personal property worth \$30,000. Mrs. Kraft, who is a life income beneficiary of a

large trust established by her grandfather, owns insurance policies on Mr. Kraft which have a face value of \$60,000.

To reduce his potential estate, Kraft adopted an aggressive gift plan. Prior to 1975, Kraft owned all 450 outstanding shares of CCC common stock. In 1975, the corporation was recapitalized into 450 shares of Class A voting common and 1,350 shares of Class B non-voting common. The recapitalization enabled Kraft to give non-voting stock to his children, reduce the value of CCC that would be included in his estate, and retain full voting control of the company. In December, 1975, Kraft gave fifty shares of Class B stock to each of his four children. For gift tax purposes, the Internal Revenue Service agreed to value the stock at \$425 per share.⁵¹ Kraft's gifts to his four children totalled \$85,000. After splitting the gift with Mrs. Kraft and deducting \$12,000 in annual gift tax exclusions and his \$30,000 specific exemption, Mr. Kraft was left with a taxable gift of \$500 on which he paid \$11 in gift taxes. Mrs. Kraft also paid \$11 in gift taxes. In January, 1976, Mr. and Mrs. Kraft exhausted their combined \$24,000 annual gift tax exclusions by giving each child fourteen additional shares of Class B stock. The stock was again valued at \$425 per share, since the gift occurred only a few days after the 1975 gift. In January, 1977, Mr. Kraft gave each child twelve shares of Class B stock. Because the stock was valued at \$500 per share for gift tax purposes, these gifts exhausted Mr. and Mrs. Kraft's annual gift tax exclusions.

By the time Mr. Kraft's unified credit reaches \$47,000 in 1981, he plans to have made additional yearly gifts of stock to his four children exhausting his unified credit and his and Mrs. Kraft's annual exclusions. Assuming that CCC grows at a 15% annual rate in net earnings and that the stock value at the end of each year is obtained by adding the increase in book value during the year to the stock valuation of the preceding year, by 1981 Kraft will be able to give approximately 400 additional shares to his four children.

After the 1981 gift, Kraft will own all 450 shares of Class A stock and 694 shares of Class B stock; his children as a group will own 656 shares of Class B stock. Stated differently, Kraft will own 64% of the company's stock and his children will own 36%. Thus, assuming the Class A and B stock are valued the same, Kraft will have transferred 36% ownership of an enterprise with an expected book value in 1981 of \$1,730,000, or \$692,000 worth of stock, at a total gift tax cost of \$22 paid on the initial 1975 gift.⁵² Of course, Kraft's estate will not have the benefit of the unified credit.

To illustrate the advantages that Kraft's gift-giving program affords, we now shall examine what his estate would look like were he to die shortly after 1981.⁵³ Under Kraft's will, his wife is to receive outright all tangible personal

⁵¹ At that time the book value per share was \$390 and the 1975 earnings per share were \$55.

⁵² If Kraft lives past 1981 he presumably will continue to make yearly gifts of stock to his children in amounts up to the \$24,000 combined annual exclusions available to him and his wife.

⁵³ For the sake of simplicity I have ignored the fact that § 2035 would return to the estate any gifts that Kraft made within three years of his death.

property, the family home, and other property sufficient to exhaust the estate tax marital deduction. After the payment of taxes and costs, the residue is to flow into a spray trust which will terminate at Mrs. Kraft's death with the children taking the corpus in equal shares. Since Stanley is expected to remain active in the management of CCC, he will receive as much of the Class A voting stock of CCC held by the trust as is compatible with an equal division of the corpus. The table below summarizes Kraft's potential estate and its tax burden:

ITEMS IN GROSS ESTATE

| | |
|--|----------------------|
| 64% Interest in CCC (at book value)..... | \$1,100,000 |
| Residence..... | 125,000 |
| Cash and marketable securities..... | 75,000 |
| Investment real estate..... | 20,000 |
| Tangible personal property..... | 30,000 |
| Total Gross Estate | <u>\$1,350,000</u> |
| Less: Deductible Administration expense and debts | 75,000 (est.) |
| Adjusted Gross Estate | <u>\$1,275,000</u> |
| Less: Marital deduction | 637,500 |
| Taxable estate | <u>637,500</u> |
| Gross Federal Estate Tax | 206,675 |
| less: Credit for state death taxes..... | 15,500 |
| Net Federal estate tax..... | <u>191,175</u> |
| State death taxes payable..... | <u>15,500 (est.)</u> |

Although Kraft's estate would face debts and expenses totaling \$281,675, it would hold only \$95,000 in cash and readily saleable real estate to meet those liabilities. Thus, the estate would face a potential cash deficit of \$186,675. However, since Kraft's interest in CCC would comprise 86% of the value of his gross estate, both sections 303 and 6166 would be available to the estate. Under section 303, the company could redeem \$281,675 of stock⁵⁴ even though the estate would need only \$186,675 in additional liquid funds.⁵⁵ Moreover, under section 6166, the estate could defer 86%, or \$164,410, of its federal estate taxes for five years, and pay the deferred taxes in annual installments of \$16,441, plus interest at approximately 4%, over the next ten years.

⁵⁴ CCC's \$250,000 life insurance on Kraft could provide the cash needed for the redemption. CCC should need only a small amount of the insurance proceeds to provide a cushion after Kraft's death since Stanley should be well-groomed to succeed his father as chief executive officer. Thus, the bulk of the insurance proceeds should be available for an immediate cash redemption.

⁵⁵ In fact, the estate would need slightly more than \$186,675. Because of the "fresh start" rules associated with the carryover basis provisions, I.R.C. § 1023(h), the estate would realize some capital gain on the redemption. Consequently, the estate would need some cash to pay the capital gains tax.

By using sections 303 and 6166 in tandem, Kraft's estate not only could satisfy its legitimate need for cash to meet its obligations, but could reap generous tax benefits as well. Section 303 would allow CCC to redeem \$281,675 worth of stock, providing the estate with \$95,000 more cash than the deficit faced by the estate even if it were to pay in full all costs and taxes at the time it filed the estate tax return. And, despite the fact that CCC should have ample cash resources to make such an immediate cash redemption, it would not need to do so because section 6166 would allow the estate to defer paying \$164,410 in federal taxes. Thus, sections 303 and 6166 would enable the Kraft family to withdraw excess cash from the business at capital gains rates while providing a 15 year, low interest loan of \$164,410. It should be remembered, too, that Mrs. Kraft has ample financial resources in her own right and, therefore, the family does not require the generosity afforded by sections 303 and 6166 in this case. While the Kraft case is an example of an estate that is worthy of some tax relief, the relief provided by sections 303 and 6166 is probably greater than that intended by Congress.

D. Oliver Bates

Oliver Bates, a 76 year old widower, has two children; Ted, age 42, and Mary, age 40. Bates founded Bates Canning over 30 years ago to engage in the processing and marketing of food products. Ted joined the firm in the late 1950's after college. Under their combined management, the firm has dramatically increased its sales and profits. The last five years have been particularly successful ones for the firm. The table below summarizes operating results over the last four years.

BATES CANNING—OPERATING RESULTS

| | <u>1975</u> | <u>1976</u> | <u>1977</u> | <u>1978</u> |
|--------------------|------------------|--------------------|--------------------|--------------------|
| Sales | <u>\$990,000</u> | <u>\$1,486,000</u> | <u>\$1,700,000</u> | <u>\$1,950,000</u> |
| Net Income | | | | |
| Before Taxes | 105,000 | 155,000 | 205,000 | 265,000 |
| Federal and State | | | | |
| Income Taxes | <u>37,000</u> | <u>70,000</u> | <u>95,000</u> | <u>115,000</u> |
| Net Income | 68,000 | 85,000 | 110,000 | 150,000 |
| Retained Earnings | | | | |
| at Beginning of | | | | |
| Period | 359,500 | 424,500 | 506,500 | 613,500 |
| Preferred Stock | | | | |
| Dividends | 3,000 | 3,000 | 3,000 | 3,000 |
| Retained Earnings | | | | |
| at End of | | | | |
| Period | <u>424,500</u> | <u>506,500</u> | <u>613,500</u> | <u>760,500</u> |
| Income per | | | | |
| Common Share | 87 | 107 | 140 | 195 |

At the end of 1978, the company's balance sheet showed total assets of \$1,020,000. Assets consisted of \$570,000 in current assets, including \$220,000 cash, \$150,000 in inventory, and \$150,000 of accounts receivable; net property, plant, and equipment of \$400,000; and other assets of approximately \$50,000. Total liabilities were \$156,500, capital stock was listed at \$103,000, and retained earnings stood at \$760,500. The company owns \$35,000 of life insurance on Oliver Bates' life.

Of the 766 shares of Bates Canning common stock outstanding, Bates owns 550 and Ted owns the remaining 216 shares. Bates gave Ted his shares over a fifteen year period beginning in the late 1950's. No gift tax was paid on these transfers because the value of the gifts, made at a time when the value of Bates Canning was much less than it is now, were sheltered under the combined annual gift tax exclusions and lifetime exemptions of Bates and his wife. No dividends have ever been paid on the common stock. Bates also owns all of the outstanding 750 shares of 4% redeemable, non-cumulative preferred stock of the company. The company issued this preferred stock, which constitutes section 306 stock, in 1956 to assure Bates of some additional income from the company were he to retire from active participation in its management.

In addition to his ownership of 72% of the common and 100% of the preferred stock of Bates Canning, Bates has other substantial assets. He has \$75,000 in cash, marketable securities worth \$10,000, and \$30,000 in life insurance on his life, payable to his estate. His principal home is valued at \$80,000 and his vacation home at \$75,000. Although Bates is still active, his health has deteriorated since his wife's death several years ago. Consequently, it is not unrealistic to analyze his potential estate as if he were to die in 1979.

Bates' estate planning goal is to insure that Ted will have complete voting control of Bates Canning while effecting as nearly equal a division of his estate between his two children as is consistent with his first goal. Bates's will bequeaths his principal residence and his preferred stock in Bates Canning to Mary and his vacation home to Ted. His executor is directed to redeem the maximum amount of common stock possible under section 303 and to distribute the remaining common stock to Ted. After payment of death taxes and expenses, the residue of the estate is to be divided equally between Ted and Mary.

In analyzing Bates's estate and its probable tax load, the most difficult problem is establishing a value for the stock of Bates Canning. As regards the common stock, the book value is about \$800,000 and the average annual net income after taxes of the past four years is \$103,000. Given this average earnings figure, the earnings growth of the past two years, the strong asset position of the company, and the prospect of continued growth under Ted's management, it would be difficult to argue for an enterprise valuation of less than book. Consequently, Bates's 72% interest in the company's common stock would be worth \$576,000. As regards the preferred stock, the face value is \$75,000. Because the preferred carries a low dividend rate, is non-cumulative and is not marketable, its value is much less than face. For discussion, assume the preferred would be valued at approximately \$40,000.

Assuming that his common and preferred stock together are valued at \$616,000, Bates's potential estate and its tax load are as follows:

ITEMS IN GROSS ESTATE AND ESTATE EXPENSES

| | |
|---|------------------|
| Common Stock of Bates Canning..... | \$576,000 |
| Preferred Stock of Bates Canning..... | 40,000 |
| Cash and Marketable Securities..... | 85,000 |
| Life Insurance..... | 30,000 |
| Real Estate..... | 155,000 |
| Total Gross Estate | <u>\$886,000</u> |
| Less: Deductible Administration Expenses | <u>36,000</u> |
| Taxable Estate..... | <u>\$850,000</u> |
| Gross Federal Estate Tax | 287,300 |
| Less: section 2010 Credit..... | 38,000 |
| Less: Credit for State Death Taxes | <u>25,200</u> |
| Net Federal Estate Tax..... | <u>224,100</u> |
| State Death Taxes Payable | 25,200 (est.) |

Although the estate's taxes and expenses would total \$285,300, it would hold only \$115,000 in liquid funds. In the absence of some tax relief provisions, Bates's estate would have difficulty meeting its liabilities. However, both sections 303 and 6166 would be available to the estate.

In fact, Bates's will specifically directs the estate to take full advantage of its redemption rights under section 303. Under that section, the company could redeem up to \$285,300 worth of common stock, or approximately 49% of the estate's common stock, assuming the stock were redeemed at the date of death value. The remaining shares of common stock, under the terms of the will, would pass to Ted. After the redemption, Ted would hold all of the common stock, and Mary would hold all of the preferred stock.

Section 6166 would afford Bates's estate additional advantages. Under this section, the estate could defer 68%, or \$152,388, of its federal estate tax obligation. By taking advantage of this option, the estate could reduce its immediate obligations for taxes and expenses from \$285,300 to \$132,912. Since the estate would hold \$115,000 in cash on Bates's death, it would need to redeem immediately only \$18,200 worth of stock. As regards the other \$267,100 worth of stock that could be redeemed under section 303, the company could effect an immediate redemption to lock-in the redemption price and give the estate an installment note which could defer all principal payments for the five year moratorium provided by section 6166, with principal payments spread over the following ten year period.⁵⁶

⁵⁶ Although an immediate cash redemption is unnecessary in this case, Bates Canning could effect a large cash redemption. The company had approximately \$220,000 in cash at the end of 1978 and it is the beneficiary of \$35,000 of life insurance on Bates. From a business standpoint, Bates Canning is sufficiently liquid to use as much as \$200,000 of this cash to redeem stock.

In many respects, Bates's estate fits the model of the illiquid estate for which Congress intended the benefits of sections 303 and 6166. Without these provisions, the estate would face taxes and expenses far in excess of its ready cash. Thus, the estate clearly would need some redemption or deferral privilege to meet its cash deficit of approximately \$170,000 without selling Bates's residences or some of his stock in Bates Canning.

The maximum redemption that the estate warrants, however, is \$170,000 worth of stock, the amount needed to meet the estate's cash deficit. By allowing the estate to redeem \$285,300 worth of stock, section 303 affords much greater tax benefits than are necessary. Furthermore, section 6166 permits the company to defer payment for much of the stock redeemed for five years and to spread payments over the following ten years with interest at only 4%. In light of the tax benefits that sections 303 and 6166 afford, it is apparent that these provisions would provide relief greater than that intended by Congress.

III. SUMMARY AND RECOMMENDATIONS

A. *Estate Planning Techniques Affording Liberal Use of Sections 303 and 6166*

This article has summarized the estates of two decedents, both of which utilized sections 303 and 6166 as those sections existed before the Tax Reform Act of 1976, and the potential estates of two living men, both of which could use present sections 303 and 6166. It is clear from these four examples that section 303 and the deferral provisions have provided, and will continue to provide, relief that is greater than that needed to alleviate the hardship of death-related expenses and to prevent the forced sales of family-owned businesses.

As the four examples discussed above demonstrate, careful estate planners often utilize three gift and estate planning techniques which reduce the need for these relief provisions and which are, consequently, often the keys to the excessive generosity provided by these provisions. The first technique is the making of lifetime gifts of company stock to family members. The second technique, which is often employed when the family may have trouble maintaining control after a large section 303 redemption, involves the recapitalization of the company with the issuance of voting and non-voting common stock and, perhaps, preferred stock. The third technique is the transfer of non-business assets to other family members to insure that the estate meets the qualification tests of section 303 and the deferral provisions. The remainder of this section of the article is devoted to a more detailed discussion of these techniques.

1. Lifetime Gifts and Recapitalizations

As the case histories discussed earlier show, lifetime gifts have two major advantages for persons owning substantial blocks of close corporation stock: first, the gifts are tax-free if made on an annual basis in amounts below the client's and his spouse's combined \$3,000 annual gift tax exclusions, and, hence, they do not deplete the client's unified credit; second, such lifetime gifts remove both the present value and any subsequent pre-death apprecia-

tion in the value of the gift from the client's estate. Bates's and Miller's estates illustrate both advantages of lifetime gifts. Miller was able to make gifts of stock worth \$850,000 at his death at a gift tax cost of \$65,000. Bates has been able to transfer ownership of almost 30% of the common stock of his company, worth approximately \$225,000, without paying any gift taxes. Kraft's estate also demonstrates the advantage of lifetime gifts. Because his business is growing so rapidly, he has established a gift plan utilizing both the annual exclusion and the planned lifetime exhaustion of his unified credit which, if carried to fruition, should enable him to transfer \$692,000 worth of stock by 1981 at a tax cost of only \$22.

As the case histories discussed earlier also demonstrate, if an owner of a closely held corporation has less than a 100% ownership interest or if he desires to make extremely large lifetime gifts while assuring continued family control after a planned section 303 redemption, a recapitalization of the company into voting and non-voting common stock often allows the owner to make substantial gifts of non-voting stock without diluting his voting control.⁵⁷ Moreover, if the controlling stockholder wants to assure himself of a steady income stream from the company after he relinquishes management to younger family members, a recapitalization involving the issuance of both preferred and non-voting common stock is necessary. Since preferred stock rarely appreciates in value, the issuance of preferred also serves to transfer a greater proportionate share of the future appreciation in value of the company to the common stock, the non-voting class of which may be used as a gift stock. Both Miller and Kraft used recapitalizations to further their gift and estate plans. Miller caused Miller Steel to be recapitalized into voting and non-voting common and made lifetime gifts of almost 40% of the non-voting common stock. Similarly, Kraft caused his company to be recapitalized into voting and non-voting common stock. If Kraft's gift plan is carried to fruition, he will be able to transfer approximately 36% of the value of the business to his children through gifts of non-voting stock.

2. Transferring Non-Business Assets

While an owner of a family business often does not need to use the first two estate planning techniques—recapitalizations and lifetime transfers of company stock—to qualify for the tax benefits of sections 303, 6166, or 6166A, many owners of family businesses must employ the third technique—transfer of non-business assets to other family members—to qualify under these sections. Such transfers both decrease the percentage of the estate composed of non-business assets and simultaneously increase the percentage of the estate consisting of the closely held business while reducing the potential estate tax load.

⁵⁷ Members of the tax bar once were concerned that the value of non-voting common stock given away by a decedent who retained voting control of the company would be included in his gross estate under § 2036(a). However, in the Revenue Act of 1978 Congress amended § 2036 to make clear that the gift of non-voting stock does not constitute an indirect retention of voting rights so as to force the non-voting stock to be included in the donor's estate.

The transfer of non-business assets to other family members, usually the shareholder's spouse and children, often can be accomplished without disruption of the client's non-tax goals. The two obvious candidates for transfer to a spouse are the family home and life insurance policies on the shareholder's life. Since spouses often hold the family home as joint tenants or tenants by the entirety, a shift to sole ownership by the shareholder's spouse would not, in the vast majority of cases since the liberalization of the section 2523 marital gift exclusion, trigger any gift tax liability. As regards life insurance, there is rarely any estate planning reason why the controlling shareholder of a close corporation should own the life insurance on his life. If his estate is not expected to face a large tax load, and, hence, will not need large amounts of cash after his death, the controlling shareholder's spouse should own the policies. If the estate is expected to face a large tax load and the estate will need cash, the corporation can own the policies. Then, after the client's death, the corporation can use the insurance proceeds to redeem stock held by the estate, thus putting the needed cash in the executor's hands and allowing for the diversification of the family's assets. Most of the taxpayers discussed in the case histories used this planning tool to insure that the estate qualified under section 303 and the deferral provisions. For example, in Miller's case his wife owned the family's principal residence and summer home. Mrs. Kraft owns the family's life insurance on Kraft's life, and the business owns \$250,000 of life insurance on his life.

As the case histories demonstrated, these relatively simple techniques can help insure qualification for section 303 and the deferral provisions, decrease the estate's anticipated death tax load, and increase the estate's liquidity, thus reducing the very need for these relief provisions.

B. Suggested Statutory Changes

Congress intended section 303 and the deferral provisions to provide relief for estates consisting largely of interests in closely held businesses in order to prevent forced sales of such businesses and economic hardship for the decedent's families. As the case histories discussed earlier reveal, however, many estates meeting the qualification tests of section 303 and the deferral provisions do not face severe liquidity problems. Moreover, these provisions, especially when elected in tandem, often provide more relief to estates with liquidity problems than the estates need to meet the congressional objective. One reason for this overgenerosity is the qualifying tests for these provisions. These tests, which are based on the percentage of the estate consisting of an interest in a closely held business, supposedly measure an estate's liquidity. As the examples above demonstrate, however, many estates that meet these qualifying tests do not face severe liquidity problems. Thus, while administratively simple, the qualifying tests simply do not accurately identify estates which need the full amount of estate tax relief provided by these sections.

The examples have shown that section 303 often allows redemptions of amounts in excess of the actual cash deficits faced by qualifying estates, thus allowing the withdrawal of locked-in earnings at capital gains rates and enabling the controlling families to diversify their assets. An apparent solution to this problem is to allow section 303 redemptions only to the extent of the cash

deficit faced by an estate. Any attempt to codify such a solution, however, would result in a terribly complex, administratively cumbersome statutory provision which could cause harsh results. While such a drastic statutory revision is, therefore, unworkable, less radical changes are both necessary and possible. To this end, I propose several changes in sections 303, 6166, and 6166A.

First, as regards section 303, I propose that Congress clarify the rule of section 303(b)(3) regarding the shareholders from whom stock may be redeemed. Congress should amend that section to provide that a section 303 redemption could be made only of stock held by the decedent's estate, by a revocable trust established by the decedent which actually bears part of the burden of death taxes and administrative expenses, or by an heir or legatee who actually pays part of these expenses.

Second, I propose that Congress amend section 303 to provide that a section 303 redemption may be effected only to the extent that the estate has paid or reasonably expects to make payments of death taxes and funeral and administration expenses within a reasonable period, for example six months, after the redemption. As the Sterling estate demonstrated, estates often effect a section 303 redemption shortly after a decedent's death even though they have elected to defer payment of a substantial portion of their federal estate taxes for several years under sections 6166 or 6166A. In such a case, the estate, and indirectly the beneficiaries, can use a substantial portion of the redemption proceeds for purposes unrelated to the estate's liabilities until the taxes and expenses are actually paid. Sections 6166(g)(2) and 6166A(h)(2) attempt to correct this problem by requiring the estate to prepay a portion of the deferred federal estate taxes during any year in which the estate holds "undistributed net income." These provisions do not adequately cure the problem, however. Consequently, Congress should amend section 303 to attack the problem directly.

As regards sections 6166 and 6166A, I believe that these deferral provisions, especially when combined with section 303, often provide more relief than the liquidity needs of qualifying estates might warrant. Therefore, I propose conditioning the availability of estate tax deferral on the actual liquidity needs of the estate. As a general policy matter, estate tax deferral is defensible if the amount deferred bears a reasonable relation to the actual liquidity needs of the estate and the decedent's family, and if the interest rate is reasonable. Measuring an estate's actual cash deficit, however, would be an administratively cumbersome chore. I propose, therefore, that Congress make deferral of estate tax under section 6166 available only at the discretion of the Secretary of the Treasury or his delegate. Congress also should make the moratorium on federal estate tax principal payments under section 6166 discretionary up to a five-year maximum. Finally, Congress should replace the overly favorable interest rate for deferrals under section 6166 with the normal rate of section 6621. Conditioning the availability of tax deferral on the Secretary's approval should abolish the need for the current qualifying tests.

There are several reasons for my proposal with regard to section 6166. First, I doubt that the relief provided by this section will actually be needed by any significant number of estates. That is, I do not believe that there will be

estates for which an extended moratorium on the payment of a large portion of the federal estate tax will be the only viable alternative to a forced sale of a closely held business. Second, as the examples demonstrated, I fear that section 6166 may provide excessive liquidity relief to many qualifying estates. Third, on a policy level, I question whether it is a wise decision to buoy up those businesses truly needing all the relief provided by section 6166 because they are so inefficient that they are unable to generate internally sufficient cash within a reasonable period to pay death taxes and are not suitable collateral for a bank loan to an estate.

In addition to substantially modifying section 6166, I would propose amending section 6166A to substitute the qualifying test of section 6166—that the value of the interest in the closely held business exceed 65% of the value of the adjusted gross estate—for the present qualifying test of section 6166A. As noted earlier, the qualifying test attempts to be a short-hand measure of the illiquidity of an estate and, hence, its need for deferral. Stated simply, I believe that the examples have demonstrated that any estate truly needing deferral relief could meet this more stringent test. For those estates unable to qualify under section 6166A, a discretionary deferral under amended section 6166 or under the “reasonable cause” standard of section 6161 might still be available.

Finally, despite the above criticisms of the long term deferral provisions, many estates comprised substantially of closely held businesses do face cash deficits which they can meet only by withdrawing cash from the business at a time when the business may be straining to adapt to the loss of a key person. To remedy this situation, Congress should adopt a new section of the Code providing for short-term estate tax deferrals. The new section should provide a two year extension of time for paying that portion of the federal estate tax which bears the same ratio to the total tax payable that the value of the closely held business bears to the adjusted gross estate. The new section should be available only to estates where 50% or more of the value of the adjusted gross estate consists of an interest in a closely held business as currently defined in section 6166A(c). Interest on the deferred tax should accrue at the current rate set by section 6621. This new provision would provide a guaranteed period during which the business might be advantageously sold or internally reorganized to deal with the loss of a key person.

The changes that I propose in sections 303, 6166, and 6166A do not guarantee that no estate will obtain greater benefits from these provisions than are warranted. A complete elimination of abuses is neither feasible nor desirable, since it would require extremely complex and administratively cumbersome statutory provisions and could prevent some estates from obtaining tax relief which they truly need. My proposals aim instead at a few common abuses of these sections. Nevertheless, I believe that these proposals would go a long way towards conforming these provisions to the congressional purpose behind them.

CONCLUSION

Estates comprised substantially of interests in closely held businesses often face serious liquidity problems. In an effort to alleviate these problems and to

avoid forcing estates to sell their interests in family owned businesses to meet estate tax obligations, Congress enacted sections 303, 6166, and 6166A. While these provisions undoubtedly provide much needed aid to some estates, they also frequently provide overly generous tax benefits to other estates. Careful estate and gift planning can often reduce the need for the relief that these sections provide. However, because the present tests for determining which estates qualify for relief under these sections are overinclusive, qualifying estates often obtain substantial tax benefits that were probably not intended by Congress. These estates can use section 303 to withdraw, at capital gains rate, locked-in earnings of the closely held corporation regardless of whether they need to pull cash out of the corporation to meet death taxes or other expenses. These estates also can use section 6166 or section 6166A to postpone paying a substantial portion of their estate taxes for as long as fifteen years at as low an interest rate as 4%. Despite the serious and frequent abuses of these sections, the sections are necessary for some estates. Consequently, Congress should retain the provisions, but should act to confine their use to estates truly needing the relief provided by these provisions.

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