Forms of Business Organization and Estate Planning

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FORMS OF BUSINESS ORGANIZATION AND ESTATE PLANNING

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The treatment of closely-held businesses, whether the form be that of sole proprietorship, partnership or corporation, presents complex problems to the estate planner.

One of the first things for consideration is whether the present form of organization should be changed. This will involve a comparison of the income tax burden under the present form with the tax burden under the proposed form. With the existing excess profits tax, it is entirely possible that the form can be changed to advantage if it presently is a corporation, and consideration should be given to the possibility of converting into a sole proprietorship or partnership. In this connection, not only must the rate of taxes on current income be taken into consideration, but also capital gain or loss upon the dissolution of the corporation. Generally speaking, the formation of a corporation in lieu of a sole proprietorship or partnership, does not give rise to capital gain or loss problems.

For a number of reasons the estate planner's problems are eased when the organization is in the form of a corporation. There is less hesitancy in attempting to continue the business by reason, first, of the absence of individual liability, and, secondly, because its continuity of existence, regardless of the death of the stockholders, simplifies the transition upon death. The corporate form may give rise to tax economies during life and after death by virtue of the ability, through payment of salaries and rent and by not paying dividends, to make a division of the corporate income between the corporation and its stockholders so as to minimize the over-all tax. Failure to pay out profits as dividends should be in the light of Sec. 102 of the Internal Revenue Code, having to do with improper accumulation of surplus.

More often than not the man who has built up a business is reluctant to see the business terminated at or shortly after his death, but frequently he does not fully appreciate the extent to which he *is* the business. Before any serious consideration is given to plans for perpetuating the business, a careful survey should be made to determine whether there exists in the business, personnel which is probably capable of providing profitable management. If there are several individuals active in management, it is entirely possible that those remaining can carry on the business profitably, and it will not be necessary that the family of the one dying retire from participation in the profits of the business. It should be recognized from the outset, however, that conflicts are likely to arise between the non-working owners of a business and those whose personal efforts are producing the profits to be di-

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vided, and for that reason some suitable arrangement must be made to adjust the salaries or other withdrawals of the survivors to compensate for this factor. Accordingly, if it is desired that the business be carried on, the necessary arrangements should be made to assure capable management, and some satisfactory plan should be devised with that management for division of profits and compensation for services.

BUY AND SELL AGREEMENTS

In the event it appears desirable to retire the interest of the decedent, it is usually preferable to have a definite pre-arrangement among the interested parties. It is customary in such cases to enter into buy and sell agreements among the proprietors. These agreements may consist of an option in the survivor to buy the interest of the decedent. Such arrangements, of course, are unsatisfactory to the decedent's estate for the reason that there is no compulsion upon the survivors to exercise the option and the estate may own a proprietary interest with, perhaps, all of the problems of a minority owner. In any event there is no assurance under this plan that funds will be available for payment of death tax and expenses of administration. The parties may prefer to enter into a binding agreement whereby the survivors agree to buy the interest of the decedent, but, of course, they should be aware of the dangers inherent in a commitment to purchase at an indeterminate future time when circumstances might be such as to threaten the solvency of the survivors. Generally speaking, however, if proper funding arrangements are made, so that the funds will be available upon the death of the decedent to pay the bulk of the purchase price, the binding agreement is likely to be the most satisfactory solution.

Such agreements, whether options or binding agreements, should provide a method for fixing the purchase price. Customary provisions for this purpose are book value, a stated price agreed in advance, a stated price to be varied from time to time by periodic agreement, appraisal at death, or a formula frequently related to book value, plus an adjustment for good-will value. Obviously, the less flexible the method of determining the purchase price, the less likely it is that the price arrived at by it, will closely approximate true value.

One important consideration is to arrange, if possible, that the purchase price fixed shall be fully effective to determine the value of the business interest for Federal Estate Tax purposes. In the first place, if there is any element of gift between the proprietors, e.g., if there is some family or other relationship between them whereby they are not dealing at arms length with each other, the Federal Estate Tax examiner is quite likely to reject the purchase price fixed in the agreement as being binding upon him. Of course, the estate tax examiner must take into consideration the existence of an agreement, since its existence is a factor in arriving at fair market value,[1] but such arrangement as a first refusal

[1] Estate of Matthews, 3 T. C. 525 (Dec., 1944).

will not be conclusive, for the reason that there is no assurance that the survivors will exercise their right. In order for a price set forth in the buy and sell agreement to be controlling on the Federal government, it must impose an effective barrier to sale by the decedent during his lifetime at a greater price than that which would be effective on his death.[2] The Federal courts have held that if the decedent had the right to sell his interest, during his lifetime, free from the buy and sell agreement, the fair market value just before death is the proper figure to include in the gross estate.[3] The decedent's estate also must be compelled to sell under the agreement in order for the price under the agreement to be fully effective.[4] Since most state death taxes are on the right to receive, the state courts have tended to accord less significance to buy and sell agreements than the Federal courts.

Use of Life Insurance to Provide Funds

Having arrived at a plan for a buy and sell agreement which points the way to the price to be paid, and having arranged the agreement in such a way that it is reasonably sure to be controlling for tax purposes, the next important problem is how to make the funds available at the proper time.

Obviously, life insurance is the most satisfactory solution since its proceeds are available simultaneously with the event which gives rise to the need for the funds.

Who Should Pay the Premiums?

Having decided upon life insurance as the means for providing a part or all of the purchase price, the next question is how the premiums should be paid. If paid by a partnership, the partner may be indirectly paying a part of the premium on the policy on his own life so that a corresponding part of the policy would be includible in his gross estate for Federal Estate Tax purposes.[5] This would seem quite clearly to be true if the premiums are treated on the books of the partnership as an expense of doing business or as a reduction of profits before division. The partnership books could, of course, be kept so that it clearly appears that no part of any premiums on the policy on the life of a particular partner are paid from his interest in partnership earnings or capital, but that the only premiums he pays, directly or indirectly, are on policies on the lives of his partners.

Some think there is danger in having a corporation controlled by a single stockholder pay the premiums on a policy on his life, because the Commissioner might contend that for purposes of taxation the corporation is the stockholder's *alter ego,* hence he indirectly pays the premiums. In this event there is a possibility that both the policy and the stock would be included in the gross estate of the deceased stockholder. If the corporation pays the

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[2] Lamb v. Sugden, 82 F. 2d 166 (1936).
[3] Estate of Matthews, *op. cit.*
[4] Lamb v. Sugden, *op. cit.*
[5] Sec. 811(g), I. R. C.

premiums, and the payment of premiums is for the benefit of the stockholder's estate rather than for the benefit of the corporation, the payment may be construed as the payment of a dividend.

In order to avoid the problems just alluded to, the customary plan is for each of the proprietors to take out on the lives of his co-proprietors insurance policies and to pay the premiums on such policies. In this way, upon the death of the insured, the survivors receive the proceeds free from income tax,[6] and there is no danger that the proceeds of the policies will be included in the gross estate of the decedent.

DESIGNATION OF BENEFICIARY

The next step is to determine who shall be the beneficiary of the insurance. If the policies are payable to the corporation or partnership, the proceeds will tend to increase the value of the decedent's interest in the business, frequently necessitating the inclusion of both the proprietary interest and, indirectly, a part of the insurance in the gross estate. Arrangements are made frequently to have the policy paid to the corporation, which in turn agrees to retire the decedent's stock. In most states such retirement can take place only out of surplus, and if surplus is deficient or non-existent, the contract cannot be fulfilled. It has been held that a contract by the corporation to retire stock, regardless of the condition of its surplus, is void and that no rights flow from the contract.[7] In order to avoid this, there frequently is an agreement among the stockholders to cause the corporation to retire the stock. This agreement, of course, can be carried out only if the requisite surplus is available. There is also the danger, under certain circumstances, if only a part of a stockholder's stock is retired, that the transaction will be treated as a taxable dividend under Sec. 115(g) of the Internal Revenue Code. Congress, in 1950, amended this section to make it possible, in certain limited cases, to retire sufficient stock to pay inheritance and estate taxes without the transaction being treated as a dividend, but this relief provision fails to cover the situations of many proprietors.

Another objection to having the corporation retire the stock of the decedent is that it becomes treasury stock, and while the surviving stockholders have caused the corporation to pay premiums on the policy, yet the insurance proceeds are not reflected as a part of their basis for the stock retired. The effect of this stock retirement is to reduce the outstanding stock, and this enhances the value of the remaining stock with no corresponding increase in income tax basis; accordingly, there will be a larger capital gain tax upon sale by the survivors. If the transaction is handled entirely outside the corporation, the surviving stockholders will have as a basis the purchase price of the stock, which will be derived in part from insurance proceeds. It must be recognized, however, that in these days of high taxes it is sometimes

[6] Sec. 22(b)(1), I. R. C.

[7] Topeka, Loring & Schwartz, Inc. v. Schwartz, (N. Y.) 163 N. E. 735.

difficult, if not impossible, for the individual stockholders to provide, after individual income taxes, enough available personal funds to insure the lives of the co-proprietors in an amount sufficient to serve the purpose, and for that reason there is no other practical way than to cause the corporation to pay the premiums and be the beneficiary of the policies.

Frequently, an arrangement is made so that the policies on the life of each proprietor are made payable to his wife, or some other member of his family, with the agreement providing that the surviving proprietors will receive the interest of the deceased proprietor in the business. This method, while having the merit that policy options can be made available to the beneficiary simply, has the serious defect that the business interest of the deceased proprietor has never passed through the probate court and hence has never been subjected to the claims of creditors nor have the proceeds of the insurance been subjected to such claims. In the event the deceased proprietor is insolvent at death, his co-proprietors have acquired a doubtful right to his interest.

Occasionally, such policies are made payable to the surviving stockholder or partner as beneficiary. In this case, however, the survivor holds the insurance proceeds and is in control of the business interest. This plan has the defect that the creditors of the survivor may intervene, or his position of being in control of both the purchase price and the thing to be purchased may give rise to delay or litigation.

To avoid the difficulties outlined above, the generally preferred method of carrying out a stock purchase agreement is to have the policies on the lives of the proprietors (in each case the premiums being paid by the proprietors other than the insured proprietor) payable to, or assigned to, a neutral trustee. If the business organization is a corporation, the stock is likewise deposited with the trustee in negotiable form. The trustee holds both the stock and the insurance policies, and when a death occurs he collects the insurance and receives from the survivors the notes, or other consideration for the difference between the purchase price and the insurance. He then delivers the stock to the survivor and the insurance proceeds and the notes to the decedent's executor. Not only does this plan avoid the possibility of the decedent making a sale, pledge or gift in violation of the agreement (the possibility of which has much to do with the conclusiveness of the price for Federal Estate Tax purposes), but the proceeds of the sale are clearly subjected to the claims of creditors, and questions as to the title of the survivors to the decedent's interest are eliminated.

Partnerships and Sole Proprietorships

In event the organization is a partnership, the procedure would be much the same except that the trustee would deliver the insurance proceeds and other consideration to the executor upon receipt from the executor of a relinquishment of all claim to partnership assets, and deliver it to the survivor.

The sole proprietorship is the most difficult form of organization to deal with, whether it is to be sold or continued in existence. In a very large percentage of the cases liquidation is the only feasible solution because there are no key men in the business, or members of the family, capable of continuing it for any length of time. The executor named will not likely be willing to continue operation over an extended period of time, unless the business is also willed to him. If the operation of the business was a full-time job for the decedent, it is likely to be the same for his executor. In certain cases there will be key men in the business who are capable of continuing its profitable management. In such case, consideration should be given to a buy and sell agreement with the key men, funded by life insurance. In some cases the net cost to the employer of increasing salaries sufficiently to pay premiums may not be prohibitive, after taking into consideration the owner's income taxes. In many cases the sole proprietorship could be converted into a partnership with the key men and the usual buy and sell agreement used. Unless some arrangement is made for a buy and sell agreement, then liquidation or sale of the sole proprietorship by the executor appears the only alternative. If so, the will should contain an adequate provision authorizing the executor to continue the business at the risk of the estate until such time as sale or liquidation to advantage can take place. If the business is likely to be continued for any length of time, there should be a specific provision in the will authorizing the executor to change the form of organization so that the business may be operated from time to time under any of the three recognized forms of organization.

It is obvious from the numerous questions touched upon, the problems in estate planning respecting the sole proprietorship or closely-held business interest are difficult. Many times it turns out that there is no really satisfactory solution which will adequately carry out the wishes of the owner. If a satisfactory solution is to be reached, it is most likely to be reached when a team consisting of lawyer, accountant, life underwriter and trust officer approach it together. It is quite possible that the trust officer may make a substantial contribution to the efforts of the team, because he has probably administered a very large proportion of the various plans which may be proposed, and his practical experience may shed considerable light upon the feasibility of any particular proposal.

BAR PRIMARY

The members of the Denver Bar Association were polled as to the qualifications of those who had announced their candidacies for judicial office on May 23, 1952. As a result of this primary, the Denver Bar Association endorses and urges your support of Philip B. Gilliam for Juvenile Court Judge, David Brofman for County Judge and Albert Frantz for District Judge.