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STOCK OF A CLOSELY HELD CORPORATION IN DECEDENT'S ESTATE—POST-MORTEM CONSIDERATIONS

When pre-death estate planning is absent or ineffective, the executor of an estate consisting primarily of stock of a closely held corporation faces a problem in deriving the liquidity necessary to pay estate taxes. The problem is aggravated if the beneficiaries wish to maintain the current balance of control in the closely held corporation. As a practical guide to executors in this situation, the author discusses the provisions of the Internal Revenue Code which can help mitigate the problem.

The federal estate tax presents a dilemma to the executor¹ of an estate consisting largely of stock of a closely held corporation.² The tax can take up to three-fourths of an estate's worth³ and is normally payable in cash within nine months of the decedent's death.⁴ Income to the estate from the closely held corporation may be insufficient to pay the tax within the period allowed. When the value of other marketable assets is limited, the executor must derive the funds necessary to pay the tax from the closely held stock. A sale of the stock, however, may be objectionable to the decedent's beneficiaries, since the result usually would be a decrease in their control over what is typically a family-owned business. A sale may not be even a feasible alternative; the decedent's will may prohibit it and the stock is seldom readily marketable.⁵ Nevertheless, there are ways in which the executor can successfully confront the dilemma.

Naturally, provision for the estate tax should be the subject of pre-death estate planning. If the size of the estate is reduced and means for achieving liquidity are provided during the decedent's lifetime, the burden of the tax payment is eased.⁶ Post-mortem planning is clearly more difficult because

1. In Maryland, an executor is known as a "personal representative." MD. ANN. CODE, Est. & Tr. Art., § 101(o) (1974).
2. The Internal Revenue Service (the "Service") has loosely defined "closely held corporation" as a corporation "the shares of which are owned by a relatively limited number of stockholders." See Rev. Rul. 59-60, 1959-1 CUM. BULL. 237.
3. INT. REV. CODE OF 1954, § 2001.
4. INT. REV. CODE OF 1954, §§ 6151, 6075(a). The filing period for estate tax returns was shortened from 15 months to nine months by Act of Dec. 31, 1970, Pub. L. No. 91-614, § 101(b), 84 Stat. 1836. This statute will facilitate a more rapid distribution of property to the beneficiaries.
5. See generally Ghingher, *Shareholders' Agreements for Closely Held Corporations—Special Tools for Special Circumstances*, 4 U. BALT. L. REV. 211 (1975).
6. For example, a decedent may provide for tax-free proceeds from an insurance policy on his life to go to the estate for payment of estate taxes. Also, a decedent may enter into a buy/sell agreement with other shareholders of the corporation (or with the corporation itself) in which he owns closely held stock. Upon the decedent's death his stock holdings would be purchased by the other shareholders and his estate would have cash with which to pay the estate taxes.

the executor is constrained by an estate of generally fixed size, severe time limits, and fewer means of deriving liquidity. There are, however, provisions in the Internal Revenue Code (the "Code") that may help mitigate these disadvantages. Within the context of these areas of constraint—estate size, time for payment and liquidity—this note will focus on how an executor of an estate consisting primarily of closely held stock can effectively utilize these Code provisions.

ESTATE SIZE AND VALUE

The executor's first step in post-mortem estate planning is to determine the size of the estate and its value for federal estate tax purposes.⁷ There are two essential considerations: (1) How to value the estate—factors with which the executor must be concerned in arriving at a valuation that is both beneficial to the estate and likely to receive acceptance by the Internal Revenue Service (the "Service"); and (2) When to value the estate—selection of a valuation date that may result in a reduction of the need for immediate liquidity.

Valuation of an estate consisting primarily of closely held stock is particularly difficult. The decedent's stock is included in his estate for federal estate tax purposes at its "fair market value."⁸ The Treasury Regulations (the "Regulations") define "fair market value" as "the price at which the property will change hands between a willing buyer and a willing seller, neither of which is under a compulsion to buy or sell. . . ."⁹ This definition is of little help in valuing closely held stock, since shares are rarely traded and the trading that occurs is generally forced by the seller's need for immediate funds.¹⁰ The Service avoids any further explanation of what constitutes "fair market value" of closely held stock, claiming that a sound valuation must be based on the relevant facts of each case. Nevertheless, several valuation factors are given particular emphasis by the Service.¹¹

Generally, overriding emphasis is given to the price of stock specified in a buy-sell agreement which restricts transfers during life as well as death, is mutually enforceable, and manifests good faith.¹² Otherwise, the Service¹³ (and the courts if necessary) consider the totality of the following factors:

7. Stock in a closely held or family corporation, typically comprising the principal asset of the decedent's estate, is included in the decedent's estate for federal income tax purposes under INT. REV. CODE OF 1954, § 2033.

8. INT. REV. CODE OF 1954, § 1014(a).

9. Treas. Reg. § 20.3031-1(b), T.D. 6826, 1965-2 CUM. BULL. 367.

10. For general discussions of valuation of valuation of closely held stock, see, for example, *Bader v. United States*, 172 F. Supp. 833 (S.D. Ill. 1959); *Baltimore Nat'l Bank v. United States*, 136 F. Supp. 642 (D. Md. 1955); Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, as modified by Rev. Rul. 65-193, 1965-2 CUM. BULL. 370, and Rev. Rul. 68-609, 1968-2 CUM. BULL. 327; Hartwig, *Valuing an Interest in a Closely Held Business for the Purpose of Buy/Sell Agreements and for Death Tax Purposes*, 26 SO. CAL. TAX. INST. 215 (1974).

11. See Treas. Reg. § 20.2031-3, T.D. 6296, 1959-1 CUM. BULL. 238.

12. Treas. Reg. § 20.2031-2(h), T.D. 7327, 39 Fed. Reg. 35354. See also *Broderick v. Gore*, 224 F.2d 892 (10th Cir. 1955); *Estate of Orville B. Littick*, 31 T.C. 181 (1958).

Where for the purpose of keeping control of business in its present management,

- (1) market price of stock of a particular corporation;¹⁴
- (2) whether the decedent owned a controlling or minority interest;¹⁵
- (3) general investment principles in current use, modified as necessary to reflect the inherent differences between closely held corporations and public corporations. A meld of the anticipatory (capitalization of earnings) with the historical (asset/book valuation) seems to most accurately reflect the Service's approach in this respect.¹⁶

These factors merely provide guidelines for valuation, and the relative weight accorded each depends on the facts in the individual case.¹⁷

Regardless of how the executor arrives at a valuation of the decedent's closely held stock, he has two choices for a date of valuation. As a general rule, the fair market value of the estate is determined as of the date of decedent's death.¹⁸ Under Section 2032 of the Code, the executor may alternatively value the estate as of six months after the date of death,¹⁹ provided some estate tax would be due if he used the value at the date of death.²⁰ The election to use this alternate valuation date is made on the estate tax return which need not be filed until nine months after the

the owners set up in an arm's length agreement . . . the price at which the interest of a part owner is to be disposed of by his estate to the other owners, that price controls for estate tax purposes, regardless of the market value of the interest to be disposed of.

Id. at 187. Note, however, that when a restrictive sales agreement expressly excludes good will of the business, the stipulated value may not bind a court's determination of value. See *Estate of George M. Trammell*, 18 T.C. 662 (1952).

13. When there is an option to purchase the decedent's stock, it is not certain that valuation is established by the stated price. In *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932), the court dismissed as extravagant the suggestion that market price of shares may exceed option price because of the possibility that the option might not be exercised, and found that "the property could not be sold for more than the option price." *Id.* at 684. However, in *Estate of Pearl G. Reynolds*, 55 T.C. 172 (1970), the court rejected the first offer formula price as the absolute determinant of fair market value on the ground that "such figure does not represent the value of all rights inherent in the ownership of [stock]." *Id.* at 190.
14. INT. REV. CODE OF 1954, § 2031(b).
15. If less than a controlling interest is owned, the value of the stock is often discounted. See, e.g., *Estate of Harry S. Leyman*, 40 T.C. 100, 118 (1963); *Worthen v. United States*, 192 F. Supp. 727 (D. Mass. 1961). In addition, see *Richard D. Makoff*, 26 T.C.M. 83 (1967), regarding allocation of voting and non-voting shares for valuation purposes.
16. See Rev. Rul. 59-60, 1959-1 CUM. BULL. 237. See *Butala. Valuation of Closely Held Corporations*, 7 INST. EST. PLAN. ¶ 73.1400 (1973), for an expanded treatment of valuation.
17. A study of cases decided prior to 1963 concludes that the Service tends to take the valuation position that results in higher tax liability for the taxpayer and that the Tax Court tends to make what appears to be compromise decisions between that advocated by the Commissioner and that of the taxpayer. C. BOSLAND, *ESTATE TAX VALUATION IN THE SALE OR MERGER OF SMALL FIRMS* 174 (1963). Not uncommon is the determination that occurred in the *Estate of Harry S. Leyman*, 40 T.C. 100 (1963), where the taxpayer's claim was a \$536 per share valuation. The Commissioner claimed \$700 per share and the court ultimately settled upon \$630 per share. Of course, to the extent that Bosland's conclusions are accurate, the courts are encouraging extravagant valuation claims.
18. INT. REV. CODE OF 1954, § 2031.
19. The alternate valuation date was changed from one year to six months after death by the Act of Dec. 31, 1970, Pub. L. No. 91-614, § 101(b), 84 Stat. 1836. Compare note 4 *supra*.
20. Treas. Reg. § 1.1014-3(a), T.D. 6500 (unpublished), states that fair market value, as appraised for federal estate tax purposes, also controls for determining basis to a distributee. If no estate tax return is to be filed (for example, if the estate is not worth

decendent's death—three months *after* the alternate valuation date.²¹ Thus the executor is able to determine in retrospect which of the two valuation dates is most advantageous.

If asset values decline during the first six months after death, the alternate valuation date will obviously result in lower estate taxes. Even when there is no decline in market value, the executor may be able to employ the alternate valuation date advantageously by improving the tax status of the estate's assets during the interim six months.²² For example, the executor may use the additional time either to decrease the estate's taxable value or increase the value of its holdings in a particular corporation so that the percentage requirements for a Section 303 redemption can be met.²³ This manipulation of assets might also enable the estate to meet the percentage requirements of Section 6166, so that an extension of the time for payment of the estate tax could be elected.²⁴

Notwithstanding the benefits, there are disadvantages to the use of an alternate valuation date. As one commentator has pointed out, problems can be presented by this choice when a redemption is followed by a merger of the redeeming corporation into another corporation, both occurring within six months of the date of death.²⁵ In this instance, the stock of the redeeming corporation is retired upon the merger and, arguably, would not be included in determining the size of the gross estate on the alternate valuation date. Thus any unredeemed stock the estate held in the corporation would not be included for purposes of meeting the minimum percentage requirements under Section 303(b)(2)(A).²⁶ The result is that the redemption loses the favorable tax treatment of Section 303.²⁷

over \$60,000), the fair market value for the purpose of determining basis will be the value of the property as appraised for state inheritance or transmission taxes. In Maryland, the death tax appraisal is made only as of the decedent's death. MD. ANN. CODE, Est. & Tr. Art., § 7-202(a) (1974). Therefore, in Maryland, when no federal estate tax return is required, the alternate valuation date may not be used for purposes of computing basis.

21. INT. REV. CODE OF 1954, § 6075(a). Note that under Section 6081(a), the time for filing may be extended up to six months.
22. An example occurs when the executor effects a post-death recapitalization which converts common stock to preferred and common. (Reasons for such recapitalization are discussed at p. 405 *infra*.) The newly-created preferred stock will take as its basis an allocated share of the stock held before the transaction. INT. REV. CODE OF 1954, § 358; Treas. Reg. § 1.358-2(a)(2) (1955). If the valuation of the estate's stock precedes the recapitalization, the basis of the preferred is tied to the basis of the old common. A subsequent redemption of the preferred stock will recognize any difference there may be between the allocated basis and the amount received in redemption. If, however, the valuation follows recapitalization, the preferred will be valued independently at its fair market value as of the alternate valuation date. Capital gain on a subsequent redemption is less likely in the latter instance.
23. Such action by the executor presumes that the estate holds controlling stock in the corporation and that the executor has sufficient discretionary powers under the will. Section 303 is discussed at p. 398 *infra*. See VanDemen, *Corporate Stock Redemption—Section 303*, 91-3d TAX MANAGEMENT (1967), for a complete treatment of Section 303.
24. INT. REV. CODE OF 1954, § 6166, discussed at p. 394 *infra*.
25. See Tiger, *How to Plan Stock Redemptions to Pay Estate Taxes—The Problems of Section 303*, 24 J. TAXATION 92 (1966).
26. The redeemed stock is included in determining the gross estate because it is valued as of the date of the redemption under INT. REV. CODE OF 1954, § 2032(a)(1).

This problem may be obviated by the Commissioner's recent ruling that blocks of stock of two corporations held at the date of death are considered separate stock for the purposes of the percentage requirements of Section 303(b)(2), despite a merger prior to the alternate valuation date.²⁸ In that case, however, the ruling was detrimental to the taxpayer. If, as in the problem posed above, the result would be a benefit to the taxpayer, the Commissioner might rule differently.

The executor should also bear in mind that the election to use the alternate valuation date will apply to all assets.²⁹ Accordingly, he may need to consider the effect that use of the alternate valuation date will have not only on the estate itself, but also on the beneficiaries' interests with regard to the marital deduction, state death taxes³⁰ and future income taxes. For example, under Section 1014(a) the asset valuation for estate tax purposes carries over as the distributee's or estate's basis for any future sales of those assets. The executor should compare the applicable estate and likely income tax rates to determine which valuation date will be more advantageous.³¹

TIME FOR PAYMENT

Once the size of the estate is known and the tax computed, the executor must next concern himself with the time limitation for making the tax payment. When the tax is large and the estate lacks liquidity, as is often the case if the estate consists primarily of valuable stock of a closely held corporation, the executor needs the maximum time available to pay the tax.

27. By similar reasoning, selection of the alternate valuation date when a merger has occurred within six months of death may affect an election to pay taxes in installments under Section 6166. If the interest of the estate in a closely held corporation is merged into another corporation, the estate may no longer meet the percentage requirements of Section 6166(a), and an extension of time to pay taxes may be prohibited. Redemptions that qualify under Section 303 are taxed at capital gains rates rather than ordinary income tax rates. See pp. 395, 399 *infra*.

28. Rev. Rul. 69-594, 1969-2 CUM. BULL. 44.

29. Treas. Reg. 20.2032-1(b)(2), T.D. 7238, 1973-1 CUM. BULL. 544. On the strength of the Regulations, there is a presumption that the value determined for estate tax purposes carries over as the fair market value for income tax purposes. See *Levin v. United States*, 373 F.2d 434 (1st Cir. 1967). The thrust of such a presumption may be parried by clear and convincing evidence to the contrary. See *McEwan v. United States*, 241 F.2d 887 (2d Cir. 1957); Rev. Rul. 54-71, 1954-1 CUM. BULL. 113.

30. For a thorough discussion of the effect of valuation on the marital deduction and Maryland state death taxes, see Page, *Maryland Death Taxes*, 25 MD. L. REV. 89 (1965).

31. In reaching his decision, the executor should also consider both the present value and the alternative cost of the potential savings to the estate. See Buttrey, *Post-Mortem Tax Planning: A Guide to the Elections Available to Estates and Beneficiaries*, 40 J. TAXATION 148, 149-50 (1974).

Before choosing a valuation date, it may be prudent for the executor to employ independent qualified appraisers to value the estate's assets both on the date of death and the alternate date. The benefit of an independent appraisal must of course be balanced against its cost. Note that in Maryland, a personal representative must secure an independent appraisal of corporate stock not listed on an exchange. See MD. ANN. CODE, Est. & Tr. Art., § 7-202(a) (1974). An expert opinion may strengthen the executor's position against possible challenge by a conflicting beneficial interest or the Service. *But cf.* *Central Trust v. United States*, 305 F.2d 393 (Ct. Cl. 1962).

Normally, payment must be made when the return is filed,³² within nine months of the decedent's death. Two Sections of the Code, Section 6161 and Section 6166, may provide the executor with additional time in which to make the payments.

General relief is provided in Section 6161(a)(1), which allows for extensions of up to 12 months from the date payment is due (a total of 21 months from the date of death) upon a showing of "reasonable cause."³³ According to the Regulations, an executor may establish "reasonable cause" by showing that the estate tax cannot be paid on time unless money is borrowed at a higher rate of interest than that generally available.³⁴ Although normally the executor must also show that reasonable attempts to liquidate the estate were unsuccessful, there is no requirement that he attempt to convert any interest in a closely held business to cash.³⁵ Thus if he cannot readily borrow the necessary funds, the executor of an estate consisting primarily of closely held stock should have little trouble showing "reasonable cause" for a 12-month extension of time to pay estate taxes.

Additionally, Subsection (a)(2) of Section 6161 provides that the Service may extend the due date for payment of the tax up to ten years, if the extension is necessary to avoid "undue hardship."³⁶ The Regulations allow "undue hardship" extensions when an executor otherwise would be forced to dissolve or sell a closely held business.³⁷

Estates that consist primarily of assets of a closely held business may also qualify for the specific relief granted by Section 6166.³⁸ While the applicability of Section 6161 is based upon the subjective tests of "reasonable cause" or "undue hardship," Section 6166 applies an objective standard: if more than 35 percent of the value of the gross estate or more

32. INT. REV. CODE OF 1954, § 6151.

33. Treas. Reg. § 20.6161-1, T.D. 7238, 1973-1 CUM. BULL. 544. This Section was amended to reflect the Congressional intent aired in committee reports for Act of Dec. 28, 1972, Pub. L. No. 91-614, § 101(b), 84 Stat. 1836. (The statute modified Section 6161(a)(1), allowing a twelve-month, rather than six-month extension.) The views reflected in committee were that extensions should be allowed on a more liberal basis. Previously the "undue hardship" standard applied to these extensions.

34. Treas. Reg. § 20.6161-1(a)(1), T.D. 7238, 1973-1 CUM. BULL. 544.

35. *Id. Ex. (4)*.

36. "Reasonable cause" extensions (Section 6161(a)(1)) presently accrue interest at the rate of six percent per annum; "undue hardship" extensions (Section 6161(a)(2)) at four percent per annum. See INT. REV. CODE OF 1954, § 6601(a), (b). However, effective July 1, 1975, the interest rate applicable to either type of extension under Section 6161 will be nine percent. In addition to updating the tax interest rate, the new law makes it responsive to future vicissitudes in money market rates by tying the tax interest rate to 90% of the prime rate. See Act of Jan. 3, 1975, Pub. L. No. 93-625, § 7(a)(1), 88 Stat. 2115.

37. The Regulations make no further attempt to define "undue hardship."

Treas. Reg. § 20.6161-1(a)(2)(ii), T.D. 7238, 1973-1 CUM. BULL. 544, provides that when an estate, which consists significantly of stock in a closely held business, does not qualify under Section 6166, and sufficient funds for the payment of the estate tax are not readily available, an undue hardship extension will be granted to facilitate the raising of funds. This is so, even if the closely held business could be sold to unrelated persons at its fair market value. Section 6166 is treated at p. 395 *infra*. With regard to the conjunctive use of Sections 6166 and 6161, see note 54 *infra* and accompanying text.

38. INT. REV. CODE OF 1954, § 6166 was added to the Code by the Act of Sept. 2, 1958, Pub. L. No. 85-866, § 206(f), 72 Stat. 1681.

than 50 percent of the taxable estate is held in the form of a closely held business,³⁹ the payment of that portion of the estate tax attributable to the closely held business may be made in up to ten equal annual installments.⁴⁰ The maximum amount the executor may elect to defer under Section 6166 is that percentage of the federal estate tax represented by the value of the interest in the closely held business divided by the gross estate.

The provisions of Section 6166 can be more advantageous than is readily apparent. The Section permits an extension of time for payment regardless of whether the estate actually lacks liquidity. Originally these extensions accrued interest at the rate of four percent per annum.⁴¹ Thus the executor could defer the taxes to the extent allowed and realize earnings to the extent that the amount deferred was alternatively invested to yield a higher return. This possibility still exists, although after June 30, 1975, the four percent interest rate on the extension is eliminated and the applicable rate is nine percent or an adjusted rate determined under Section 6621 for amounts outstanding on July 1, 1975.⁴² Even with the higher interest rate on the extension, the executor may find it preferable to retain whatever funds are available to the estate, use them for investment or other purposes, and pay the taxes out of investment returns or corporate earnings as they accrue.

The drawback to paying estate taxes out of corporate earnings is that before they can be applied toward the estate tax the earnings will be taxed as income to both the corporation and the estate. An alternative to funding the deferred tax installments with corporate earnings is to finance them with cash received in a tax-free redemption of stock pursuant to Section 303. The executor may plan a series of Section 303 redemptions to coincide with the due dates of the installments under Section 6166.⁴³ As illustrated in a recent revenue ruling, however, this solution may be of only limited

39. To qualify as a "closely held business" the corporate interest included in the gross estate must either include at least 20% (in value) of the voting stock of the corporation or be a corporation with ten or less shareholders. Furthermore, the corporation in which stock is held must be carrying on a trade or business. See INT. REV. CODE OF 1954, § 6166(c)(3); Treas. Reg. § 20.6166-2, T.D. 6522, 1961-1 CUM. BULL. 697. Note also that Section 6166 applies to sole proprietorships and partnerships, as well as closely held corporations.

40. INT. REV. CODE OF 1954, § 6166(e) provides that the first installment is due when the return is filed (nine months after the date of death). Therefore, this effectively extends payments over a nine year period, in equal annual installments. Section 6166 was enacted in the hope that the dissolution of family businesses, a result Congress deemed detrimental to the "free enterprise system," would no longer be necessary to achieve the liquidity to pay estate taxes if the period over which the taxes could be paid was prolonged. It was the belief of Congress that the extension would make it possible for the estate tax to be paid out of the earnings of the business in many cases, or would provide the heir with time to obtain the necessary funds without upsetting business operations. See H.R. REP. No. 8381, 85th Cong., 2d Sess. (1958).

41. INT. REV. CODE OF 1954, § 6601(b). Section 6601(b) was amended as part of the relief package under which Section 6166 was enacted. See Act of Sept. 2, 1958, Pub. L. No. 85-866, titl II, § 206(e), 72 Stat. 1606.

42. Act of Jan. 3, 1975, Pub. L. No. 93-625, § 7(a)(2)(A), (b)(1), 88 Stat. 2115.

43. There is no proscription against plural distributions under INT. REV. CODE OF 1954, § 303. See Rev. Rul. 67-425, 1967-2 CUM. BULL. 134.

assistance.⁴⁴ Redemptions under Section 303 may be made for only four years after decedent's death.⁴⁵ Any redemption occurring afterwards may trigger an acceleration of installment payments.⁴⁶

As a second alternative, the executor may plan a single redemption in exchange for a note payable in installments, each coincident with the Section 6166 deferral due dates. Redemption of stock in exchange for notes does not conflict with the four-year limit of Section 303 because redemption is deemed to occur when the notes are issued to the estate, so long as the note does not represent a corporate equity interest.⁴⁷

Section 6166 election must be made upon or before the filing of the estate tax return.⁴⁸ At that time, it is difficult for the executor to be certain whether the Service will concur with his valuations of the business, and, hence, whether the estate qualifies for Section 6166 deferment. To be safe, the executor should elect to make the deferment under Section 6166 even if it appears that the values of the estate do not qualify.⁴⁹ Furthermore, it may be prudent to elect the maximum deferment, although it is permissible to defer payment in amounts and for a period less than the maximum allowable.⁵⁰ The executor always may accelerate or increase the payments under Section 6166, but the duration and amount of the deferral may not otherwise be amended once the return filing date has passed.⁵¹

The wisdom of making such a protective election under Section 6166, contingent on the estate's qualification under the Section, is supported by the fact that Sections 6166 and 6161 are not mutually exclusive. The Regulations make it clear that the executor does not waive the right to request an extension under Section 6161 simply because he files a notification of an election to pay the tax in installments under Section 6166.⁵² A notification of the election to use Section 6166 will be treated as a timely-filed application for a Section 6161 extension if the executor so requests in writing within a reasonable time after being notified by the Service that the estate does not satisfy the requirements of Section 6166.⁵³ If

44. Rev. Rul. 72-188, 1972-1 CUM. BULL. 383.

45. INT. REV. CODE OF 1954, § 303(b)(1). See p. 400 *infra*.

46. INT. REV. CODE OF 1954, § 6166(h) provides for the acceleration of installment payments upon certain occurrences, including the disposition of 50% or more of the estate's interest in a closely held business qualifying under Section 6166. A Section 303 redemption is exempted from treatment as such if the money received in redemption is used in payment on the first installment following the redemption. However, the estate's interest in the business is reduced by the value of the stock redeemed under Section 303, effective on the date of death. Thus the redemption of more than 50% of the estate's interest in the closely held corporation, purportedly pursuant to Section 303, may cause an acceleration of payments if the redemption fails to qualify under Section 303 or if the value received in redemption is not applied against the tax on the next succeeding installment.

47. See Rev. Rul. 65-289, 1965-2 CUM. BULL. 86; Rev. Rul. 67-425, 1967-2 CUM. BULL. 134.

48. INT. REV. CODE OF 1954, § 6166(a). For a more thorough treatment of Section 6166, see Hocky, *Estate Tax Payments and Liabilities*, 219 TAX MANAGEMENT 1 (1969).

49. Treas. Reg. § 1.761-1 (1956).

50. INT. REV. CODE OF 1954, § 6166(a); Treas. Reg. § 20.6166-1(b),(c) (1960).

51. INT. REV. CODE OF 1954, § 6166(a).

52. See Treas. Reg. § 20.6161-1(b), T.D. 7238, 1973-1 CUM. BULL. 544, and § 20.6166-1(g) (1960).

53. Treas. Reg. § 20.6161-1(b), T.D. 7238, 1973-1 CUM. BULL. 544.

the estate does qualify under Section 6166 to pay in installments that portion of the tax attributable to the interest in a closely held business, the executor may also seek a Section 6161 "undue hardship" extension to defer payment of (1) that portion of the tax which is not attributable to the interest in the closely held business, and (2) the installments elected under Section 6166 which would otherwise be due within the period of the extension.⁵⁴

PROVIDING LIQUIDITY

Regardless of when the estate taxes are due the executor must produce the funds sufficient to make their payment. As previously mentioned, an estate consisting primarily of closely held stock is typically lacking in liquid assets and faces a potential financial bind unless a pre-death estate plan provided for the production of ready cash. Lack of funds may also be a problem where an estate planner accurately predicted the post-mortem cash requirements; even supposedly liquid assets may become unmarketable or decline in value, and the estate will be deprived of the cash the assets were expected to produce.⁵⁵

The executor must carefully choose what he surrenders from the estate in exchange for the necessary liquidity. The possibilities may be limited when the estate's major asset is closely held stock and the beneficiaries wish to retain the same degree of control over the corporation that the decedent possessed. If non-voting *preferred* shares are sold or redeemed, the relative control will not be affected. In the more typical situation, where the estate holds *common* stock, its sale is not a desirable alternative; an outside interest will obtain some measure of control unless the other shareholders have funds to buy the stock themselves. A less drastic alternative may be for the executor to effect a redemption of the common shares by the closely held corporation. By obtaining the necessary funds from the corporation, rather than from an outsider, the executor avoids causing a dissipation of the beneficiaries' control over the business, although a change in the balance of control may result. For this reason, and because the sale of stock of a closely held corporation is unlikely in any event, the executor will be forced to give more serious consideration to redemptions than sales.

In most situations it is the corporation, and not the shareholder, that determines whether shares will be redeemed. In order to make a redemption, the corporation must possess the power to do so under its charter and state law. In Maryland, for example, a redemption can be funded only out of surplus.⁵⁶ Furthermore, the corporation must also possess assets, either

54. Treas. Reg. § 20.6166-1(g) (1960).

55. Many of the estate's liquid assets may also pass outside of the will, such as jointly held property, life insurance payable to a named beneficiary other than the estate, and liquid assets which are the subject of trusts or powers of appointment. INT. REV. CODE OF 1954, §§ 2037, 2040-42.

56. MD. ANN. CODE art. 23, § 32(b)(3) (1973).

money or property, to exchange for the stock redeemed. As a practical matter, the executor may be able to motivate the corporation to meet these requirements if the estate holds the majority of the corporation's stock. If so motivated, the corporation can usually achieve the requisite power to make a redemption by amending its charter. Surplus can be provided by reducing the par value of the corporation's stock to create paid-in surplus, or by revaluing corporate assets. If the corporation does not currently possess the funds necessary for a redemption, it can execute a note for the shares.⁵⁷

The executor who considers a redemption as a means of deriving liquidity from the estate's stock must also be concerned with the tax consequences of his action. As a general rule, the return to the stockholder from the redemption is treated as a dividend (assuming the corporation has earnings and profits at least equal to the amount of the redemption), and is taxable as ordinary income to the stockholder whose shares were redeemed.⁵⁸ This heavy-handed tax treatment would seem to make redemptions unattractive. In certain situations, however, a redemption more closely resembles a sale of stock. In those special cases, any gain realized by the stockholder upon the redemption is treated under Section 302(b) as a capital gain, and taxed at the lower capital gains rate. Unfortunately, estates which consist primarily of closely held stock typically do not qualify under the requirements of Section 302.⁵⁹ Until 1950, this circumstance forced the executor to resort to a sale of the estate's closely held stock. In many cases, this constituted a sale of the entire business.

This forced sale of closely held businesses conflicts with public policy to the extent that small family businesses are absorbed by their larger competitors, with the resultant concentration of industry. Recognizing this fact, Congress promulgated what is now Section 303.⁶⁰

Section 303 provides that a distribution from a corporation to a shareholder in redemption of the stock of the corporation included in the gross estate of the decedent shall be treated as a sale of stock if the condi-

57. See p. 396 *supra*.

58. INT. REV. CODE OF 1954, § 302(d). The purpose of dividend treatment is to prevent a stockholder who owns 100% of a corporation's stock from foregoing corporate dividends over a period of years and then surrendering stock in exchange for cash. Such a transaction is essentially a dividend, for although the stockholder has relinquished some stock, his interest in and control over the corporation remains undisturbed. When a redemption more properly represents a sale than a dividend, it is accorded "capital gains" tax treatment. See INT. REV. CODE OF 1954, § 302(b). It is therefore Section 303 which is an exception to the general rules of Section 302. If a corporation makes a distribution in redemption when it has no surplus, the distribution is not treated as a dividend and therefore must be treated as a return of capital to the shareholder. See INT. REV. CODE OF 1954, § 316(a).

59. A closely held corporation typically is held by a single shareholder or by a small family. If A dies holding all of the stock of X corporation, a redemption of part of the stock by A's estate would not qualify for capital gains treatment under Section 302(b)(2) (substantially disproportionate) or Section 302(b)(3) (termination of shareholder's interest) or under Section 331(a)(2) (partial liquidations). The same is true with a redemption from an estate, if the remainder of the stock is owned by the decedent's old beneficiary—due to the constructive ownership rules of Section 318, all of the stock is essentially owned by the same person. Rev. Rul. 55-515, 1955-2 CUM. BULL. 222.

60. See H.R. REP. No. 2319, 81st Cong., 2d Sess. 427, 445 (1950); S. REP. No. 2375, 81st Cong., 2d Sess. 523, 542, 552 (1950), 1950-2 CUM. BULL. 380.

tions of Section 303 are met.⁶¹ Thus under Section 303 the redeeming estate is relieved of paying tax at ordinary income rates on the entire distribution and, instead, only pays tax at capital gains rates on the gain realized, if any, through the redemption. Since stock in the estate receives a fair market value basis at the decedent's death (or alternate valuation date), redemption of the stock at fair market value creates little or no taxable gain.⁶² Consequently, the most apparent advantage of a Section 303 redemption is that it permits an estate to reach into the corporation for the liquidity necessary to pay estate taxes, without incurring prohibitive income tax consequences.

There are additional benefits of Section 303 redemptions. If the value of its corporate stock declines after valuation, the estate may realize a loss on the redemption. While ordinarily the loss on sales or exchanges between certain related taxpayers is disallowed as a deduction under Section 267, the constructive ownership rules of that Section have been held not to apply to redemptions from an estate.⁶³ Accordingly, Section 303 redemption losses are deductible on the estate's income tax return notwithstanding Section 267.

Section 303 redemptions also offer advantages to the redeeming corporation. It is important to note that, like the shareholder, the corporation normally recognizes no gain in a Section 303 redemption.⁶⁴ Since income treatment of appreciated property given in exchange for the stock is also avoided,⁶⁵ Section 303 presents an opportunity for the corporation to distribute appreciated property to a shareholder without recognition of gain on the redemption. Furthermore, beginning in the year of decedent's death and thereafter, the accumulated earnings of a corporation necessary to fund a Section 303 redemption are exempted from the penalty tax imposed by Section 531. This tax is generally levied on the earnings that a corporation accumulates beyond its reasonable needs and is added to the normal corporate income tax.⁶⁶ A Section 303 redemption can therefore relieve the

61. See p. 400 *infra*.

62. If the decedent purchased stock in a closely held corporation for \$100 a share, and on his death the fair market value of that stock was \$150 per share, and the corporation then redeemed the stock at \$150 per share, his estate would realize no taxable gain on the redemption. Thus the \$50 per share gain realized over the price which the decedent paid for the stock goes untaxed. If, however, the decedent's estate redeemed the stock for \$200 per share, there would be capital gains tax on \$50 per share—the gain over the fair market value at the decedent's death.

63. Estate of Hanna, 320 F.2d 54 (6th Cir. 1963); Rev. Rul. 55-592, 1955-2 CUM. BULL. 573. For expanded treatment of the applicability of Section 267 to Section 303 redemptions, see Somers, *Stock Redemptions at Death: Does Section 267 Apply?*, 23 N.Y.U. INST. ON FED. TAX. 1133 (1965).

64. INT. REV. CODE OF 1954, § 311(d)(2)(E). The executor might also note that an increase in the percentage of ownership due to a Section 303 redemption will not operate to prevent carryover of net operating loss by the redeeming corporation. See INT. REV. CODE OF 1954, § 382(a)(1)(B)(ii).

65. INT. REV. CODE OF 1954, § 311(d)(2)(E). There are certain exceptions to this general rule. See INT. REV. CODE OF 1954, §§ 311(b) (LIFO goods), 311(d)(2)(E) (where liability exceeds basis), 1245, 1250 (recapture).

66. INT. REV. CODE OF 1954, § 537(a)(2), (b)(1). See also *Mountain State Steel Foundries, Inc. v. Commissioner*, 284 F.2d 737 (4th Cir. 1960). See generally Washington, *Can Earnings Still Be Accumulated to Finance Section 303 Redemptions?*, 44 TAXES 43 (1966).

corporation of this added income tax burden. A Section 303 redemption may also preserve a corporation's "Subchapter S" tax status when the shares held by the estate would otherwise pass to a trust.⁶⁷

Since Section 303 is designed to benefit a limited group of taxpayers, the requirements for qualification thereunder are strictly enforced.⁶⁸ Given the "tax stakes" involved in post-mortem stock redemptions (complete non-taxability under Section 303 versus tax on ordinary income if under neither Section 303 nor 302),⁶⁹ it is extremely important that these requirements are understood and carefully observed.

Redemptions after decedent's death must meet four general tests to qualify under Section 303.

- (1) The value of stock redeemed must be included in decedent's estate for federal estate tax purposes.⁷⁰
- (2) The amount of distribution in redemption must not exceed:
 - (a) the estate, inheritance, legacy and succession taxes imposed due to the death of decedent, and
 - (b) funeral and administrative expenses allowable under Section 2053 as federal estate tax deductions.⁷¹
- (3) The distribution in redemption must generally be made within the period of limitations for tax assessment plus 90 days.⁷² (Section 6501 limits tax assessment to three years after the return was filed. Thus the time limit is approximately four years after the date of death.)⁷³
- (4) The value of the stock of the redeeming corporation that is included in the decedent's estate for valuation purposes must be either:
 - (a) more than 35 percent of decedent's gross estate, or
 - (b) more than 50 percent of his taxable estate.⁷⁴ Stock of two or more corporations may be treated as the stock of one corporation to

67. See INT. REV. CODE OF 1954, § 1371(a)(2).

68. See *Davis v. United States*, 277 F. Supp. 602 (W.D. Pa. 1967); *Majerus v. Coyle*, 254 F. Supp. 214 (N.D. Ill. 1966).

69. See note 62 *supra*.

70. INT. REV. CODE OF 1954, § 303(a).

71. INT. REV. CODE OF 1954, § 303(a)(1), (2). Section 2053(a) limits funeral and administrative expense deductions to those allowable by the laws of the jurisdiction. In Maryland, funeral and administrative expenses are treated at MD. ANN. CODE, Est. & Tr. Art., §§ 8-106, 7-601 et seq. (1974).

72. INT. REV. CODE OF 1954, § 303(b)(1).

73. The general rule that Section 303 redemptions must be made within four years of death is subject to two exceptions. Section 303(b)(1)(B) allows that if a timely petition for deficiency determination is filed with the Tax Court, a Section 303 redemption may be made within 60 days after the Tax Court's decision becomes final. Section 6081 allows up to a six-month extension for filing the return, which in turn extends the period of limitations for tax assessment to six months. Note also, that the redemption qualifies for Section 303 treatment as long as distribution is made within the prescribed time limit from the date the return was filed; it does not matter that the return was filed late. See Rev. Rul. 73-204, 1973-1 CUM. BULL. 170.

74. INT. REV. CODE OF 1954, § 303(b)(2)(A). The gross estate of the decedent includes the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated. INT. REV. CODE OF 1954, § 2031(a). The value of the taxable estate is determined by deducting from the value of the gross estate the exemption and deductions provided for in Part IV of the Internal Revenue Code of 1954. INT. REV. CODE OF 1954, § 2051.

meet these percentage requirements if more than 75 percent of the value of the outstanding stock of each corporation is included in determining the gross estate.⁷⁵

Apparently, Congress intended that Section 303 relief would be available only in circumstances where true hardship exists, perhaps assuming that it would be restricted to a redemption of common stock from the decedent's estate in exchange for cash to pay the administrative expenses and tax due. In fact, the loose language of the Section allows the executor a certain degree of flexibility in its use. For example, Section 303 may apply even though the estate of the decedent is actually not subject to estate taxes. Accordingly, the redeeming estate may be of any size, even under \$60,000.⁷⁶ Likewise, a redemption in an amount equal to death-related expenses is permissible even if those expenses are not actually deducted under Section 2053.⁷⁷ Although normally the redemption is effected from common stock, any class of stock may be redeemed under Section 303.⁷⁸ Furthermore, there is no requirement that the estate actually lack sufficient liquid assets to pay estate taxes. This would enable any qualifying estate to take advantage of this unique opportunity to bail out corporate earnings without recognition of capital gain.

The protection of Section 303 is not restricted to a qualifying estate; any person whose stock holdings were included in the valuation of the decedent's estate may achieve their redemption (so long as the shares were not acquired in satisfaction of a specific monetary bequest or by gift or purchase from a beneficiary).⁷⁹ Thus a person who received stock from the decedent in contemplation of death, or to whom stock has already been distributed,⁸⁰ may effect a redemption of his shares alone, if the total amount of stock the decedent held in the redeeming corporation constituted a sufficient proportion of his gross or taxable estate to meet the percentage requirements of Section 303.

The percentage requirements of Section 303 may present a major obstacle when a redemption under the Section is desired. An executor, however, should recognize that he may exercise a significant amount of control over whether the closely held stock will represent either 35 percent of the decedent's gross estate or 50 percent of his taxable estate, and thereby meet the requirements. The Regulations specifically provide that, for purposes of determining whether the percentage requirements of Section

75. INT. REV. CODE OF 1954, § 303(b)(2)(B).

76. The basic estate tax exemption is \$60,000. INT. REV. CODE OF 1954, § 2052.

77. See Rev. Rul. 56-449, 1956-2 CUM. BULL. 180.

78. Treas. Reg. § 1.303-2(c)(1), T.D. 6724, 1964-1 CUM. BULL. 128.

79. Treas. Reg. § 1.303-2(e) (1955). *But see* United States v. Lake, 406 F.2d 941 (5th Cir. 1969), where the court was more interested in whether the party redeeming the stock used the redemption proceeds to pay estate taxes than in whether or not she was a purchaser. "Since the purpose of the 'purchase' exclusion is to deny special treatment to those who do not redeem stock in order to pay estate taxes, it should not be extended to cover those who do redeem to pay estate taxes." *Id.* at 950. Of course the executor may avoid such questions of exclusion by redeeming the stock before it passes out of the estate.

80. Treas. Reg. § 1.303-2(f), T.D. 6724, 1964-1 CUM. BULL. 128.

303 are met, the size of the estate may be computed either on the date of death or the alternate valuation date.⁸¹ This provides the executor with six months during which he can take steps either to decrease the size of the taxable estate or to increase the value of the closely held stock so that it represents a sufficient proportion of the estate's holdings to qualify for a Section 303 redemption. This can be accomplished in several ways.

The executor may deduct the funeral and administrative expenses allowable under Section 2053 on either the estate's income tax return⁸² or its estate tax return.⁸³ Regardless of which he chooses, the amount of the expenses is still added to the estate's total death tax bill for purposes of determining the amount of stock which can be redeemed.⁸⁴ If the executor is presented with an estate which does not meet the percentage requirements of Section 303(b)(2)(A), he should deduct the expenses from the gross estate on the estate tax return. This would yield a smaller net taxable estate, of which the value of the closely held stock would then constitute a higher percentage. If, however, the estate meets the percentage requirements, the executor is advised to deduct the expenses from the estate's gross income on its income tax return. The estate tax will be increased because the deduction was not taken on the estate tax return, and also because the deduction taken on the income tax return will result in more net income to the estate after taxes, increasing its size. This will maximize the amount of stock which may be redeemed pursuant to Section 303(a).

It also has been suggested that the executor might influence corporate policy to increase the corporation's asset value,⁸⁵ thereby increasing the value of the stock held by the estate.⁸⁶ The value of the stock might then be more than 35 percent of the decedent's gross estate or more than 50 percent of his taxable estate. With only six months in which to work, however, this exercise is recognizably of limited value.

If the estate holds stock of more than one corporation, the executor may have means available under Section 303(b)(2)(B) to meet the percentage requirements. If the value of the stock the estate holds in one corporation does not constitute a sufficient percentage of the estate's gross or taxable estate, the executor may qualify the estate by adding the value of such stock to the value of stock the estate holds in another corporation. This aggregation is possible only if the estate holds 75 percent in value of the outstanding shares of both corporations.⁸⁷ The estate's holdings may not meet this 75 percent test. In such a situation, the executor, under Section

81. Treas. Reg. § 1.303-2(b), T.D. 6724, 1964-1 CUM. BULL. 128.

82. In order to claim these deductions on the estate's income tax return, the executor must file a statement to the effect that the amounts were not deducted on the estate tax return and waive the right to deduct them from the estate tax return in the future. INT. REV. CODE OF 1954, § 642(g).

83. INT. REV. CODE OF 1954, § 2053(a).

84. INT. REV. CODE OF 1954, § 303(a)(2).

85. For example, corporate asset value might be increased in the short run through retention of earnings and/or reduction of expenditures.

86. Tiger, *supra* note 25, at 92.

87. INT. REV. CODE OF 1954, § 303(b)(2)(B); Treas. Reg. § 1.303-2(c)(1), (2), T.D. 5902, 1964-1 CUM. BULL. 128.

351, may be able to increase the estate's proportionate holdings in a corporation to 75 percent by effecting a non-taxable exchange of other estate property for additional stock. Section 351 also may be employed by an executor to set up "holding corporations" in order to increase the estate's stock holdings to 75 percent of the outstanding shares.⁸⁸

A corporate merger may be another method by which the estate can increase its stock holdings in a corporation so that aggregation is permissible.⁸⁹ While the Commissioner has ruled that an estate cannot merge two corporations to meet the percentage requirements of Section 303,⁹⁰ the ruling was based upon the fiction that even after a merger the blocks of stock from the two merged corporations remain separate and distinguishable for Section 303 valuation purposes.⁹¹

Despite its benefits, a Section 303 redemption can be disadvantageous in special cases. For example, a post-valuation redemption of the shares of a deficit corporation without current or accumulated earnings and profits would serve to accelerate recognition of gain when the value of the shares increases between the date of valuation and the date of redemption.⁹² Since the funds obtained from stock redeemed pursuant to Section 303 are taxable to the extent that they reflect the stock's appreciation, the choice of a redemption would result in more taxable income to the estate than would a dividend, which in this case would be treated as a non-taxable return of capital.⁹³ Additionally, when the corporation discharges a pre-existing obligation of a surviving shareholder through the redemption, the shareholder may be subject to tax.⁹⁴

Furthermore, the operation of Section 303 is not elective, so redemptions must be carefully planned in order to avoid unnecessary tax consequences. The rules of attribution of Section 318 do not apply to a Section 303 redemption so long as the price paid for the stock does not exceed the amounts allowable under Section 303(a)(1) and (2).⁹⁵ If the price exceeds the limits of Section 303, however, the excess is subject to the dividend equivalency rules of Section 302⁹⁶ and to the rules of attribution. If multiple redemptions which do not all qualify under Section 303 are planned, the order of the redemptions could be important. Distributions in a redemption will be applied against the total amount which qualifies for treatment under

88. Milefsky, *Estate Planning for the Corporate Owner: the Benefits Available, Steps to Take*, 33 J. TAXATION 168, 172 (1970).

89. Levenfeld, *Post Death Planning Under Section 303*, 51 A.B.A.J. 495 (1965).

90. Rev. Rul. 69-594, 1969-2 CUM. BULL. 44.

91. Compare note 28 *supra* and accompanying text.

92. Note that Maryland law requires that, with a few exceptions, redemptions be made out of surplus. MD. ANN. CODE art. 23, § 32(b)(3) (1973).

93. See note 58 *supra*.

94. See Rev. Rul. 58-614, 1958-2 CUM. BULL. 920.

95. See *Estate of Byrd v. Commissioner*, 388 F.2d 223 (5th Cir. 1967). The taxpayer in *Byrd* contended that the attribution rules of Section 318 do apply to a Section 303 redemption because Section 303 is one of the exceptions to the dividend-treatment rule of Section 302(d), to which Section 318 expressly applies. The court rejected the argument, holding that Sections 302 and 303 are not interdependent. *Id.* at 230.

96. See, e.g., Rev. Rul. 71-261, 1971-1 CUM. BULL. 109.

Section 303 in the order in which the distributions are made.⁹⁷ Thus redemptions to which Section 303 as well as Section 302 could apply should be effected first. Redemptions which qualify under Section 302, but not under Section 303, should be delayed until the Section 303 limit is exhausted.

Redemptions under Section 303 may present additional problems when the stock redeemed is common stock. First, since common stock is difficult to value, the executor may remain uncertain through the time of redemption whether the estate will meet the requirements of Section 303. Secondly, voting common stock represents participation in the control of the corporation. Although a redemption of such stock does not result in a loss of control over the corporation to an outside interest, it can cause an undesirable shifting in the balance of control—especially where the business is in the hands of more than one family. The redemption of preferred stock can solve both problems. Controversy as to fair market value is diminished because preferred stock is normally redeemable at its stated value.⁹⁸ When the preferred stock is non-voting, the redemption will not affect the balance of control.

Preferred stock might be deemed advantageous to the estate for other reasons as well. A conversion to preferred stock prevents any appreciation in the value of the stock used in the redemption, thereby limiting taxable gain. When the estate's prime beneficiary does not intend to participate in the business, the interests of all parties will probably be better served if the estate passes non-voting preferred stock with mandatory dividends to the beneficiary. The active shareholders retain total operating control while the beneficiary gets a fixed income.

The executor is not necessarily foreclosed from redeeming preferred stock merely because all of the decedent's holdings were in the form of common shares. A readjustment of the corporation's capital stock to provide for preferred stock in the estate can solve the problem. Two methods are available by which the executor can achieve this solution without invoking unfavorable tax consequences. Under Section 368(a)(1)(E), preferred stock can be issued by means of a recapitalization,⁹⁹ which is loosely defined as a reshuffling of the capital structure within the framework of an existing corporation.¹⁰⁰ Section 305(a) provides for the issuance of preferred stock in a stock dividend. If the preferred stock issued by either method is later sold,

97. Treas. Reg. § 1.303-2(g)(1), T.D. 7346 1975-1 CUM. BULL. 62.

98. Preferred stock is generally valued at its stated par value assuming dividends are current, the rate of return on the preferred shares is reasonable, the company has adequate cash, and the stock is fully callable at par. See, e.g., *Problems in Valuing Stock of a Close Corporation—A Panel Discussion*, 23 N.Y.U. INST. ON FED. TAX. 1261, 1275, 1280 (1965).

99. Treas. Reg. § 1.368-2(e)(3), T.D. 7281, 1973-2 CUM. BULL. 92. According to Bittker and Eustice, the underlying assumption of the tax-free exchange provisions of Section 368(a)(1)(E) is that the new corporate structure is substantially a continuation of the old. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶14.01 (abr. ed. 1971). Their conclusion receives support from Treas. Reg. § 1.368-1(b) (1955).

100. *United Gas Improvement Co. v. Commissioner*, 142 F.2d 216 (3d Cir. 1944), cert. denied, 323 U.S. 739 (1944).

however, the proceeds from the disposition may be taxable as ordinary income.¹⁰¹ The executor should be aware of this potential problem, but it will rarely hamper his plans. First, it is unlikely that the beneficiaries would want to dispose of the stock received since one of the purposes of the issuance is to provide them with a permanent fixed income. Secondly, the stock issued may be redeemed pursuant to Section 303,¹⁰² rather than sold, if a disposition is desired.

In a transaction that qualifies under Section 368(a)(1)(E) as a recapitalization, the estate, as corporate shareholder, can exchange some of its common stock for newly-issued preferred stock without recognition of gain or loss. While a detailed discussion of recapitalization is beyond the scope of this note,¹⁰³ two areas of concern specifically related to a preferred-on-common recapitalization deserve mention.

First, the recapitalization must be pursuant to a plan of reorganization having a valid business purpose.¹⁰⁴ A design to place control in the hands of the working shareholders has generally been recognized as a valid business purpose.¹⁰⁵ When the preferred-on-common recapitalization is accomplished solely to enable the procurement of a Section 303 redemption without loss of corporate control, however, it can be argued that it is the interests of the shareholders, and not those of the business, which are being advanced.¹⁰⁶ It could also be contended that such a recapitalization actually benefits the business as well, since the purpose of Section 303 is to avoid forced dissolutions of family businesses, and since a Section 303 redemption is recognized in the Code to be a "reasonable need of the business."¹⁰⁷

Secondly, a literal interpretation of the Code would evoke the opinion that preferred stock issued through a recapitalization constitutes a taxable dividend.¹⁰⁸ Despite the language of the Code, the Regulations make it clear that there is no intention to impose a tax on a *bona fide* recapitalization of this type.¹⁰⁹

101. INT. REV. CODE OF 1954, § 306(c)(1)(B). The preferred stock may be free of the taint if distributed solely for the purpose of estate planning, and not to avoid income tax. Compare *Parshelsky's Estate v. Commissioner*, 303 F.2d 14 (2d Cir. 1962). Note also that Section 306 stock ceases to be so classified upon the stockholder's death. Treas. Reg. § 1.306-3(e), T.D. 7281, 1973-2 CUM. BULL. 92. INT. REV. CODE OF 1954, § 306(a) is the legislative response to a technique of siphoning corporate earnings known as a preferred stock bailout. See *Rosenberg v. Commissioner*, 36 T.C. 716 (1961).

102. Treas. Reg. § 1.303-2(d), T.D. 6724, 1964-1 CUM. BULL. 128.

103. For an expanded treatment of tax-free rearrangements of corporate capital surplus, see Henderson, *The Use of Different Classes of Stock in Maintaining Control in the Close Corporation*, 24 N.Y.U. INST. ON FED. TAX. 531 (1966).

104. Treas. Reg. § 1.368-1(c) (1955).

105. *E.g.*, *Marjorie Dean*, 10 T.C. 19 (1948); Rev. Rul. 54-13, 1954-1 CUM. BULL. 109; *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951).

106. The Commissioner has argued on occasion that a shareholder business purpose is not of itself sufficient and that a corporate business purpose is necessary. See *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947).

107. INT. REV. CODE OF 1954, § 537(a)(2).

108. INT. REV. CODE OF 1954, § 305(b)(3).

109. Treas. Reg. §§ 1.305-7(c), T.D. 7281, 1973-2 CUM. BULL. 92, 1.305-3(e), *Ex. (12)*, T.D. 7281, 1973-2 CUM. BULL. 92.

The estate's alternative source of preferred stock is a preferred stock dividend. Issuance of preferred stock by this method avoids the "business purpose" test. In determining whether it is preferable to obtain the preferred stock through a dividend as opposed to a recapitalization exchange, the executor should consider the consequences under each method if the transaction fails to meet the requirements of the respective sections of the Code and is thus characterized by the Service as a taxable dividend. The gain on a recapitalization exchange which fails to qualify is taxed under Section 356(a)(2) at ordinary income rates only to the extent of the shareholder's pro rata share of the corporation's earnings and profits. A preferred stock dividend not qualifying under Section 305 is taxed under Section 301(c) at ordinary income rates to the full extent of the corporation's earnings and profits. Although it may be more difficult to meet the business purpose test in order to qualify a transaction as a recapitalization under Section 368(a)(1)(E), failure to do so does not incur the burdensome tax consequences of an unsuccessful attempt to qualify for a preferred stock dividend.

If the executor is successful in his efforts to obtain preferred stock, it will be possible to secure the benefits of a Section 303 redemption without affecting the balance of control in the redeeming corporation. In the final analysis, then, the decision of whether to redeem the shares may be reduced to a balancing of costs. The executor should examine the corporation's earning power to determine whether the loss of the estate's shares through a redemption will be more expensive than the cost of obtaining the necessary funds through a loan or other source.

CONCLUSION

The unique characteristics of an estate consisting primarily of stock of a closely held corporation make its administration difficult. Fortunately, the Code recognizes the problem and provides some means by which it can be mitigated. Primary among these are the provisions which permit the use of an alternate valuation date, deferment of tax payments and a favorable income tax treatment of distributions received from a redemption of stock to pay estate taxes. The executor who understands these sections and effectively employs them can not only lessen the estate's immediate financial bind, but can also realize substantial tax savings.

Greg Williams