1962

Problems Relating to: Redemption of Stock in the Family Business; Income in Respect of a Decedent; Marital Deduction Considerations

G. Charles Scharfy

Follow this and additional works at: https://scholarlycommons.law.case.edu/caselrev

Part of the Law Commons

Recommended Citation

G. Charles Scharfy, Problems Relating to: Redemption of Stock in the Family Business; Income in Respect of a Decedent; Marital Deduction Considerations, 13 W. Res. L. Rev. 346 (1962)
Available at: https://scholarlycommons.law.case.edu/caselrev/vol13/iss2/22

This Symposium is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Law Review by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.
IX

PROBLEMS RELATING TO: REDEMPTION OF STOCK IN THE FAMILY BUSINESS; INCOME IN RESPECT OF A DECEDENT; MARITAL DEDUCTION CONSIDERATIONS

G. Charles Scharfy

This article will consider a number of tax problems which customarily arise in the testamentary disposition of an interest in a small family-owned business because of the relationship of the distributee to the decedent or because of the nature of the interest distributed. More specifically, it will consider planning problems as they relate to the attribution provisions of the Code covering redemption of stock, to the Code provision treating income in respect of a decedent, and to the marital deduction provisions.

THE EFFECT OF THE ATTRIBUTION RULES

Where the business involved is a corporation, and particularly where that business is a "close" family owned corporation, tax planning will necessarily depend in large measure upon the attribution provisions of section 318. These provisions relate to a number of corporate transactions and in particular to stock redemption plans. Since the attribution rules have been extensively covered in other articles of this symposium, comment here will be for the most part confined to those family attribution rules which will have special bearing upon the disposition of any interest in a small, family-owned business.

Section 318(a)(1) sets out the rules for the attribution of stock ownership among members of a family. An individual is deemed to own all stock owned "directly or indirectly, by or for — (i) his spouse . . . , and (ii) his children, grandchildren, and parents." From this it can be seen, first, that there is no horizontal family attribution (except between spouses); second, that there is no attribution between persons more remotely related to the individual than as parent, child, or grandchild, and third, that there is no attribution between an individual and his grandparents.

One typical situation in which the attribution rules may successfully be avoided arises in the case of the testator who intends to leave his share of the business to a son and a daughter. In such cases the son is frequently involved in the business and is therefore considered the logical "heir" of his father's interest. Despite this, the father may accomplish
all of his purposes by leaving his share of the business to the son and
dughter with the understanding that the daughter’s shares are to be re-
deeded. If this redemption is accomplished, the son will retain control
of the business and at the same time the transaction will receive capital
gain treatment because of the absence of attribution between brother and
sister. Of course, the sister would have to cooperate in this planning and,
like all plans which depend upon future human volition, the plan will
amount to nothing if the sister decides to continue as part owner of the
business — as well she might if it is at all lucrative.

In speaking of the grandparent-grandchild relationship, it will be
noted that an individual is considered to own stock which is owned
by his grandchildren, but not stock which is owned by his grandparents.
Under these provisions the decedent might leave stock to his spouse and
his grandchildren, with plans for a subsequent redemption of the stock
owned by the grandchildren. In such a case the redemption would be
affected without interference from the attribution rules since the stock
still in the hands of the surviving spouse would not be attributed to the
grandchildren.

Some Particular Problems Under the Attribution Rules

The Section 302(c)(2) Exemption

When considering the effect of the family attribution rules, it is im-
portant to remember that under certain circumstances a redemption may
be exempted from their operation. The tests for this exemption are set
down in section 302(c)(2) of the Code. These tests are quite com-
plex and cannot therefore be adequately treated in this cursory discussion.
Briefly, it can be said that they involve a ten-year analysis of the distrib-
utee’s interest in the company. To qualify for the exemption, the re-
demption must completely terminate the stock interest actually owned
by the stockholder. Additionally, the distributee must show that he has
acquired no interest (other than as a creditor) in the business for a period
of ten years following the date of redemption. Finally, it must be shown
that the distributee has not acquired during the ten year period preceding
the redemption any part of the redeemed stock from a person whose own-
ership of stock at the time of the redemption would be attributable to the
distributee under the Code’s attribution rules. These, in part, are the

1. The exemption provided by section 302(c)(2) of the INTERNAL REVENUE CODE OF
1954 [hereinafter cited as CODE §] applies only to the family attribution rules, as distinguished
from the estate-trust beneficiary, partnership-partner, corporation-shareholder, and option
tribution rules. See note 6 infra.
2. CODE § 302(c)(2)(A)(i).
4. CODE § 302(c)(2)(B). There is some danger involved in relying on this exception in
matters of estate planning. See Treas. Reg. § 1.302-4(g) (1955) [hereinafter cited as Reg. §].
requisite tests to be met under section 302(c)(2). They are commonly referred to as the "ten year look ahead" and "ten year look back" rules.\(^5\)

**Trust/Estate-Beneficiary Attribution**

While the benefit of this section 302(c)(2) exemption should not be underrated, it must be remembered that it relates only to the *family* attribution rules and that other non-family attribution rules may operate to remove the redemption plan from the capital gain shelter. Among these are the rules which attribute ownership of stock proportionately from an estate or trust to its beneficiaries, and from the beneficiary to the estate or trust.\(^6\)

To illustrate the results which these additional attribution rules might bring, the following example may be used. X, the father, and Y, the son, each owns fifty per cent of the ABC Company. Later Z, X's father and Y's grandfather, dies, leaving X and Y as the beneficiaries of his estate. Z had no interest whatever in the ABC Company. In this case, family attribution between father and son might conceivably be avoided under the exemption allowed by section 302(a)(2). However, any attempt to redeem either X's or Y's stock would nevertheless fail to achieve complete termination of either of their interests because of the effect of the estate beneficiary attribution rules. If, for example, the corporation attempted to redeem X's fifty per cent share of the stock, there would be no complete termination of interest because Y's fifty per cent interest would be attributed to the estate and then in turn this fifty per cent interest would be proportionately attributed to both of the beneficiaries. Thus even after redemption of X's one-half interest in the company, X would still be considered the owner of one-half (his proportionate interest in the estate) of the remaining stock which is held by Y.\(^7\)

As a further illustration of the pitfalls and entanglements which may be encountered in estate-beneficiary attribution, the recent case of *Thomas G. Lewis*\(^8\) may be considered. Here the decedent, who was indebted to the corporation to the extent of $20,000, owned at her death over fifty per cent of the corporation's stock. The remainder of the stock was owned by her daughters and their husbands. After her death, the corporation redeemed the decedent's stock for a price sufficient to pay off her indebtedness to the corporation. This redemption, the Commissioner

---

5. These rules are discussed in greater detail in *Cavitch, Ohio Corporation Law* § 9.33(2)(c) (1961).

6. Attribution also exists between a partnership and its partners and, under certain situations, between a corporation and a shareholder. Also, a person holding an option to acquire stock is deemed to own that stock. *Code* § 318(a) (2) and (3).

7. Other examples of the application of multiple attribution are discussed in *Cavitch, Ohio Corporation Law* § 9.33(2)(b)(iii) (1961).

8. 35 T.C. No. 11 (October 20, 1960).
claimed, was essentially equivalent to a dividend and was therefore taxable as ordinary income. The Tax Court, after applying multiple attribution rules and determining the economic effect of the transaction, upheld the Commissioner's contention. Looking first to attribution, the court found that the stock owned by the two husbands was attributable (under family attribution) to the daughters and that all stock "owned" by the daughters was in turn attributed to the estate (in which the daughters enjoyed specific legacies of their mother's stock). As a result of this multiple attribution, the estate of the decedent was considered to have ownership of all of the stock in the corporation. Operating under this assumption that the estate owned 100 per cent of the stock of the corporation, both before and after redemption, and noticing in particular that the redeemed shares were not to be used for any corporate purpose, the court held the transaction to be one "essentially equivalent to the payment of a dividend."

Regarding the estate-beneficiary attribution problem, it is important to remember that this type of attribution ceases as to a particular beneficiary when his status as a beneficiary is terminated. It may therefore be advisable to make a specific bequest of stock to a particular beneficiary, with the intention that such stock is later to be redeemed by the business. In this way, the estate may quickly satisfy the legacy and thus bring to an end any estate-beneficiary attribution. With this accomplished, and in the absence of any family attribution, the redemption will operate as a complete termination of the beneficiary's interest. In contrast, if the particular beneficiary is also made a residuary legatee, the estate-beneficiary attribution will continue until there has been a final termination of the estate. Such final termination may not be achieved for many years.

The Catch-all Provision

Relief from the knotty entanglements of the various attribution rules has sometimes been achieved under the so-called "catch-all" or "basket" provision of section 302(b) (1). Under the very vague and general language of this provision, capital gain treatment will be allowed if the "redemption is not essentially equivalent to a dividend." In effect, the section allows the taxpayer to argue equitable or practical considerations which, if strong enough, may in some cases result in capital gain treatment even though the taxpayer's percentage of stock ownership is not sufficiently reduced to permit compliance with the more specific tests set down in section 302. For example, the taxpayer may contend that he was a minority shareholder with no voice in planning the transaction, or that an unrelated minority interest was significantly increased by the redemption. In addition, under the "catch-all" provision, the degree of
reduction in the taxpayer's ownership may be treated as being more substantial than would be indicated by a literal application of the attribution rules. The real issue underlying the stock ownership question is whether the redemption in fact substantially reduced the taxpayer's control over the corporation. While the attribution rules will be applied in determining stock "ownership," and while ownership prima facie determines control, there are some situations in which stock technically attributed to a taxpayer is not actually subject to his direction. Where this is clearly the case and the redemption has in fact substantially reduced his control over the corporation, the redemption will be treated as not essentially equivalent to a dividend, even though the taxpayer's technical "ownership" has been only slightly affected. Thus, in the case of a company owned fifty per cent by a father and forty-seven per cent by his son, a redemption of most of the father's stock was held to be qualified for capital gain treatment under the "catch-all" provision. Although after the redemption the father was deemed to own his son's shares as well as his own and, hence, still "owned" over ninety-five per cent of the stock of the company, the sharp disagreement between father and son over the conduct of the business meant that the practical effect of the redemption was to transfer control of the company away from the father.9

INCOME IN RESPECT OF A DECEDENT

Generally speaking, the term "income in respect of a decedent" refers to that income which the decedent has created or caused to be created before his death but which has not been reduced to possession prior to death.10 Because of the underlying tax principle that all items of income must be accounted for, the basic problem relating to income in respect of a decedent is one of establishing the terms by which that unrealized income will be taxed in the hands of those who will receive it. These terms are now set forth in section 691 of the Code. Subsection (a) provides that income in respect of a decedent must be included when received in the gross income of

9. Herbert C. Parker, 20 P.H. T.C. Mem. 893 (1961). A similar result was reached in Estate of Arthur H. Squier, 35 T.C. No. 105 (March 16, 1961), where stock was attributed to the estate from the beneficiaries, but where in fact a sharp cleavage between the executor and the beneficiaries meant that the redemption resulted "in a crucial reduction of the estate's control over the corporation." (Emphasis added by the court.) Conversely, in Bradbury v. Commissioner, 62-1 U.S. Tax Cas. 83343 (1st Cir. 1962), redemption proceeds were taxed as a dividend where complete harmony existed between the taxpayer and his daughter whose stock was attributed to the taxpayer.

10. Typical items of "income in respect of a decedent" include wages (including vacation pay and dismissal pay) earned but unpaid, interest on bank accounts, bonds, and insurance renewal commissions. See Windham, Tax Problems and Liabilities of a Surviving Spouse, U. SO. CALIF. 1961 TAX INST. 543; Spaulding, Limitations of Income in Respect of a Decedent, N.Y.U. 18TH INST. ON FED. TAX 1159 (1960).
(1) The estate, if it acquired the right to receive the income item and had not yet distributed the right;

(2) The person to whom the estate has distributed the right in the form of a bequest, devise or inheritance; or,

(3) The person who received the right if it was not received by the estate.\(^{11}\)

This income when in the hands of such a recipient retains the same character it would have taken had it been received by the decedent.\(^ {12}\) Thus, if as to the decedent the income would have been exempt from taxation, it will also be exempt as to the recipient.

Of fundamental importance to an understanding of the concept of income in respect of a decedent is the fact that federal income and estate taxes are not generally mutually exclusive. Because of this, the decedent's right to the unrealized income is an asset which is includible in his gross estate for estate tax purposes while the actual receipt of that income is at the same time taxable as income to the recipient. What results from this two-sided proposition is double taxation as to the income item. In an attempt to remedy this problem, section 691(c) permits the recipient of the income to claim a deduction, at the time he includes the item in income, for the amount of estate tax attributable to the inclusion of the item in the estate tax return. This section, though it does not strike a perfect mathematical balance,\(^ {13}\) does to a considerable extent relieve the burden of double taxation on such items.

Although there are many situations in which careful advance planning must be pursued in regard to income in respect of a decedent, one situation of special importance is that occasioned by payments under qualified pension plans. Such payments, although they constitute income in respect of a decedent, are specifically exempted from the deceased employee's estate for estate tax purposes.\(^ {14}\) For this reason, the problem of double taxation will not be encountered, even in those situations where section 691(c) itself brings no relief. Nevertheless, their

---

12. \textit{CODE} § 691(a)(3).
13. One author has made the following comment on the operation of section 691(c): "[Section 691(c)] ... represents an imprecise effort to ameliorate the effect of double taxation. Its purpose is to place the income recipient in an after-tax position similar to that which the decedent and his estate would have occupied if income had been realized prior to death. In the latter situation, the income would have been subjected to tax and the after-tax value would have been included in the estate. A more precise equalization under the statute, therefore, would involve a special estate tax deduction for the income tax paid on the income item ...." Spaulding, \textit{Limitations of Income in Respect of a Decedent}, N.Y.U. 18TH INST. ON FED. TAX 1159, 1169 (1960).
14. \textit{CODE} § 2039(c). But the Code provides that this exemption shall not apply to the amount of the pension plan payment which is proportionately attributable to the contributions made by the employee of the plan.
taxability as income will remain, and it is therefore important to dispose of them in the most advantageous manner.

Where the wife of the decedent has a substantial estate, it may be advisable to designate someone other than the wife as the beneficiary of the pension plan. If this is done, high bracket taxability may be avoided as to future payments under the plan, and at the same time maximum enjoyment of the proceeds of the plan may be assured. On the other hand, where the decedent does wish his wife to take the benefit of the plan, an alternative approach may be taken. This would be the setting up of a discretionary trust in favor of the decedent's wife, with the trustee named as beneficiary of the pension plan. Under such an arrangement, the wife would benefit from the proceeds of the plan during her life but would be required to pay no estate taxes thereon at her death. In this way, an entire generation's estate tax would be "skipped" (the husband's estate having been relieved of estate taxation on the pension plan by virtue of section 2039(c)).

**Marital Deduction Considerations**

When dealing with the marital deduction provisions of section 2056, some of the principal practical problems which must be considered are these: Should the maximum fifty per cent deduction be utilized? Should the wife receive more than the maximum allowed as a deduction? Should a "marital deduction formula" be used to describe what is intended to qualify?

To begin, it should always be remembered that each family planning arrangement must be directed to the particular requirements of the case at hand. Generalization in these matters is not meaningful. At times it may be advisable to waive immediate tax saving in favor of better long-range planning. And at times that which may at first appear to be disadvantageous from a tax viewpoint may prove in fact to be advantageous once all factors and all tax consequences have been considered.

Let us assume that our client's estate is large and that his wife's is negligible. The use of the maximum marital deduction would generally seem to be in order. On the other hand, if the two estates are evenly balanced, one might at first shy away from any marital deduction on the plausible theory that the property will merely be piled up in higher estate tax brackets in the wife's estate. But what if the wife's life expectancy is far greater than that of her husband? In this case, the income which would be earned on those funds attributable to the reduced estate taxes on the husband's estate might far exceed the additional estate tax which

15. However the executor of the decedent's estate should not be named as beneficiary. The exemption provisions of section 2039(c) apply where the payment is receivable "by any beneficiary (other than the executor).” [Emphasis added.]
the wife's estate would be required to pay. Furthermore, because of the marital deduction plan, the wife could give away all or part of the property which she received from her husband's estate. By making periodic gifts over the years to her children or other family members, the wife may dispose of all that she has received with little or no gift tax consequence.

As a rough illustration, using gross tax figures, if we assume a husband and wife each have $200,000 taxable estates, the estate tax on each would be $20,700 plus thirty per cent of excess over $100,000. This would result in estate taxes of $50,700 as to each estate or a total of $101,400 for both. If the husband passed $100,000 to his wife under a marital deduction, his tax would be cut to $9,500 plus twenty-eight per cent of the excess over $60,000, or $20,700. On the other side, the wife would be taxed on her $300,000 estate at the rate of $65,700 plus thirty-two per cent of the excess over $250,000, or $81,700. This would increase her tax by $31,000 while decreasing her husband's by $30,000, thus leaving an apparent tax "penalty" of $1,000. But the wife would now be in a thirty-two per cent estate tax bracket. Therefore, by giving away a mere $3,125, she would eliminate this $1,000 penalty. Furthermore, if she gives that $3,125 to charity she can at the same time realize income tax savings. And to return to the proposition stated in the preceding paragraph, if the wife should decide not to give the money away, the income earned on the $30,000 estate tax which was saved by the husband's estate ($50,700 reduced to $20,700), would in a very few years offset the combined tax "penalty" with a "free ride" given to the widow on that income during the remaining years of her life.

Achieving the Maximum Marital Deduction

There is a split of opinion on the question of what devices and procedures should be used to achieve the maximum marital deduction provided by the Code. Some writers firmly believe in the use of percentage formula clauses, believing them to be the most expedient, efficient, and safe means of achieving optimum results. Other writers believe that such clauses can often be attributed to careless draftsmanship, and that equally desirable results can be achieved without resorting to formulae. Personally, having studied opposing arguments over the years, this writer believes that formula provisions provide the most safe and effective means of obtaining the maximum deduction. With the passage of time, most of the standard objections to these clauses have proved groundless. Never-

theless, it cannot be denied that adequate results can be reached, without the use of formulae, by careful and circumspect draftsmanship.

Pecuniary Amount Versus Fractional Share Formulae

If it is decided by the draftsman that a formula clause shall be employed to achieve the maximum deduction, a choice remains between the use of a formula which gives a pecuniary amount or of a formula which gives a fractional share. Since there are peculiar advantages and disadvantages in both types of formula clauses, the particular objectives of the testator should dictate which type of formula is to be employed.

If a bequest is considered to be of a pecuniary nature (that is, reducible to a fixed dollar amount), and if such a bequest is satisfied by the distribution of assets which have appreciated in value, the estate will realize a taxable gain. This is so because the estate is discharging an obligation of X dollars with property having a basis of less than X dollars, and because the transaction is considered to be a taxable exchange.\(^\text{18}\) Under this proposition the Commissioner has ruled\(^\text{19}\) that where an instrument provides that "an amount" sufficient to achieve the maximum marital deduction is to be bequeathed in trust, such a bequest, couched in that language, is a bequest of a fixed and determinable "dollar amount." Therefore, the estate will be taxed, under capital gain treatment, for any gains or losses realized by the transfer of such assets to the trust. Later, in an attempt to clarify his position in the above situation, the Commissioner ruled\(^\text{20}\) that where the marital deduction formula provides that the spouse is to receive a percentage of the "adjusted gross estate" of the decedent, such an amount will, despite the language employed, be treated as a fixed and definite pecuniary amount which may bring gain or loss to the estate when the assets are distributed. The distinction drawn by the Commissioner between a percentage interest in an "adjusted gross estate" and a percentage interest in the residuary estate of the decedent is this: The amount with respect to the adjusted gross estate will become fixed and definite \textit{before} the time of distribution whereas the fractional or percentage share of the residuary estate will not become fixed and definite until the time has come for distribution. Accordingly, the residuary estate will already have shared in the appreciation or depreciation of the assets in question at the time the assets are distributed to the widow in discharge of the estate's obligation.

It can be seen from these rulings that particular caution must be exercised in the use of percentage formulae and in the descriptions given to

\(\text{18} \) Commissioner v. Brinkerhoff, 168 F.2d 436 (2d Cir. 1948).
\(\text{19} \) Rev. Rul. 56-270, 1956-1 CUM. BULL. 325.
\(\text{20} \) Rev. Rul. 60-87, 1960-1 CUM. BULL. 286. The basic soundness of this "clarifying" ruling is open to question.
those interests to which the percentages are meant to apply. What may be thought to be a percentage formula which will bring no taxable gain or loss to the estate may in fact be held to be a pecuniary amount which will result in such taxable gains or losses.

**Productivity of Marital Deduction Trusts**

Where an interest in property is left outright (not in trust) to a surviving spouse, and it is not a "terminable" interest, the interest will qualify for the marital deduction, regardless of the productivity or non-productivity of the property. However, where property is placed in a so-called marital deduction trust, the element of productivity becomes important. The position of the Internal Revenue Service, as expressed in the Regulations, is that there must be a reasonable likelihood of income being realized. If there is no such likelihood, the spouse must be given the right to control the conversion of non-productive property into productive property, or to receive the corpus at any time during her lifetime.

If therefore, the very nature of our family business is one of long-range appreciation (for example, the development of timber interests where there is little prospect of any actual immediate income yield) or if the interest in the business consists of shares of stock which have seldom, if ever, paid any dividends, there may be a question as to the qualification of such interests for the marital deduction. In situations such as this the alternative measures for qualification must be considered. Here many complications can be foreseen. Quite obviously, it will be neither feasible nor desirable for the spouse to be given a power to compel conversion of the trust corpus into more productive assets when the corpus consists of the decedent's interest in a small family business. In such a case, the decedent is left with the alternative of empowering the spouse to accelerate her interest in the corpus of the trust, a not altogether desirable solution of the problem.

Under the circumstances which have been noted above, a far more acceptable method of dealing with the business interest would be the transfer of that interest into a non-qualifying trust. In this case, the husband can transfer other qualifying assets, where they exist, into the marital deduction trust, thereby assuring the desired deduction.

---