Estate Planning Essentials for the Closely Held Business Owner – Part One

Edward Perkins JD, LLM, Tax (CPA)
GIBSON&PERKINS, PC

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UNIT ONE - INTRODUCTION

I. Introduction

For our purposes, a “closely-held business” is a business whose ownership is limited to a finite private group of owners – who are in most but not all cases members of the same family. In addition, this program will be primarily focused on “asset based” businesses, i.e., businesses that, unlike service businesses, have a value separate and apart from the participation of the owner, and that can be transferred to a family member or sold to a third party.

II. Why is It Different?

A. Overview

Fundamentally a good estate plan should, of course, fulfill the client’s intent as to how he or she wishes to dispose of his or her property at death. The plan should also address the manner in which that property is transferred, e.g., outright or in trust. An estate plan should also be designed to reduce the costs of dying such as death taxes (i.e., the federal estate tax and state death taxes) and probate costs, to the lowest possible level. When a closely held business is a part of the estate the objectives remain the same, but the process may be more complex. Why?

B. The Nature of the Asset

First, there is the nature of the closely held business itself. A closely held business represents an illiquid asset which is difficult to value within the context of estate planning without a contemporaneous sale or appraisal. Also, it is not an asset which is easily monetized, and it is not an asset which can be transferred to just anyone and expect its value to be maintained.

C. The Dispositional Issues

From a dispositional point of view the penultimate question is “What do you do with it?” That is, to whom should the business be transferred, when, and how? The options may include a transfer to a family member or members, either during the lifetime of the owner or at his or her death, or an “inside sale” to an already existing busines partner, or valued employee. Also, to be considered:

- An “outside sale” to an unrelated third party, or
- A liquidation of the business.

D. Administrative Issues

Also, to be considered are the issues which are inherent in the business being part of the probate estate during the period of estate administration, and possibly as an asset held in trust after the estate administration has been completed. Does the executor have a duty to operate the business during the period of estate administration? Or is the executor’s duty actually to liquidate the business? Does an executor of trustee have the power to operate the business? Or sell the business?

E. Estate Tax Planning

Finally, there is the question of how to plan the estate to avoid death taxes – specifically the federal estate tax and any applicable state death taxes.

III. The Difference Between Estate Planning and Succession Planning

A word about the difference between estate planning and succession planning. When a closely-held business is a significant part of the estate, estate planning is primarily focused on the question of how to transfer the business to the owner's heirs at the lowest transfer tax (i.e., estate or gift) cost. In most cases, the planning discussion occurs without addressing specifically how the transfer will potentially impact the business, the business owner and his or her family. Succession planning on the other hand is intended to be a more expansive approach addressing not only the question of how to reduce or avoid transfer taxes but also questions of how, when, and to whom the business interest should be transferred. In addition, depending on the exit strategy, the question of retirement from active participation of the business is also a part of succession planning.

IV. This Treatise

This treatise will provide an overview of the estate planning issue when a closely held business is a significant asset in the client's estate and will provide insight into the manner in which these issues should be addressed and resolved.

UNIT TWO – GETTING STARTED

I. Introduction.

To competently complete a client's estate plan, you must have complete information. This should include a complete picture of the client's financial situation and complete family information as well. When a closely held business is part of the estate, information regarding the business is also necessary. A comprehensive estate-planning questionnaire completed by the client will help to ensure that the information is complete and up to date. This questionnaire should only be the starting point, however. It should serve as a basis for a more thorough discussion and is a good way to organize the required information. A meeting with the client will also be necessary in order to more fully discuss some of information requested and the issues raised by the questionnaire.

II. Complete Financial Information.

A. Overview

A good estate planning review requires that you have a complete picture of the client's financial profile. The objective of obtaining this information is; (1) to identify the assets of the estate, (2) to estimate their relative value and (3) determine the manner in which they are owned. Again a comprehensive questionnaire is a good first step in requesting and organizing this information.

B. Assets Disclosure

The financial information requested should include a list of assets by the type of property. It is important also to have a clear picture of not only the type of property owned by the client, but also the current fair market value of each asset group. One exception is life insurance, which should be stated at the face value of the policy, not its cash surrender value. Aggregate value organized by general asset category will suffice in most cases. For example, it is not necessary that you identify each stock owned - instead, just the total stock investment can be noted.

The assets categories should include the following:

- Cash and Bank Accounts
- Notes, Accounts Receivable, Mortgages
- Bonds
- Listed Stocks
- Closely Held Business Interests
- Real Estate
- Insurance
- Employee Benefits
- Miscellaneous property (e.g., personal effects, collections, patents, trademarks, copy-rights, etc.)

C. Liability Disclosure

Also included should be a list of the client’s liabilities, such as the following:

Real Estate Mortgages

Notes to financial institutions

. Loans on Insurance Policies

Other obligations, such as charitable pledges, and tax liabilities.

D. How Assets Are Titled

Finally, for a married couple it is also important to know how the property is titled, whether it is held in the wife or husband’s name alone or whether it is titled in joint names.

III. Complete Family Information

A. Identification of Heirs

The requested family information should be designed to first identify the natural heirs of the client. It is therefore important that the client provide the identity and age of each of the members of his or her immediate family, their children, and grandchildren, including step children, as well as other potential heirs – such a friends or charitable institutions.

B. Additional Facts

In addition, the family information should tip you off as to any facts which may affect the plan of how the assets are to be disposed. The following information may be helpful in this regard and should also be requested through the questionnaire:

1. What is the client’s and his or her spouse’s current occupation?
2. In the case of a married couple - whether this is a first or subsequent marriage?
3. Whether there is a pre-nuptial agreement which affects the disposition of assets of either spouse?
4. Whether there is a property settlement agreement with a former spouse which imposes any financial obligations on either spouse?
5. Whether the children are natural or adopted?
6. Whether any of the children have special needs, or are otherwise in need of special attention?
7. Whether any of the identified heirs have special needs or have other issues which would prevent them from inheriting property outright?
8. Whether the client, and the client’s spouse are US citizens?
9. Whether the client or the client’s spouse had residence or currently reside in a community property state?

IV. The Existing Estate Planning Documents

Copies of the client's current estate planning documents should also be requested. These should include the following:

1. A copy of the client's Last Will and Testament
2. A copy of any Trust documents executed by the client or documents in which the client is a named beneficiary.
3. A copy of any financial or Medical Powers of Attorney adopted by the client.
4. A copy of the current designation of beneficiary forms in regard to any life insurance, 401ks, IRAs, or other qualified retirement plans.
5. If the client owns annuities the designation of beneficiary as well as the settlement option chosen.

V. Complete Business Information

A. Overview

In reviewing the business information, you request, what should you be looking for?

1. The legal form of the business entity
2. The nature of the ownership interest held by the client
3. The value of the business
4. Whether there are restrictions on transfer
5. Whether there is a buy sell agreement in place

B. What is the legal form of the Business Entity?

Knowing the legal form of the business should be fundamental to the planning process. In some cases, even the continued viability of the business entity itself may be impacted by the owner's death. For example, the death of a general partner may result in the dissolution of a general or limited partnership.

The legal form of the business may also restrict how and to whom an ownership interest can be transferred. In the case of an S corporation, transferring stock to an ineligible shareholder will result in termination of the S election. And for sole proprietorships special attention must be paid to the identification of the assets comprising the business to avoid conflicts and to ensure the business is fully transferred to the intended beneficiary.

C. The Nature of the Ownership Interest held by the client?

The nature of the ownership interest held by the client should also be looked at. Whether the interest represents a controlling or non-controlling interest will have several collateral affects. First, it will be a factor in valuing the interest, with a controlling interest being entitled to a "control premium", while a non-controlling interest may be entitled to a "minority discount". Second, the nature of the interest may affect its transferability. For example, an inter vivos transfer of a partnership interest with a negative capital account will trigger phantom taxable income. Also, the transfer of S Corporation stock to an ineligible shareholder will void the S election.

D. Who else is involved in the business?

Ask the client who else is involved in the business. Who are the key employees and what are their roles? Are there any family members currently involved in the business? Or are there any family members who might want to be involved in the future? Are there any other owners or individuals who have been promised ownership? Learning this type of background information will give you needed insight in developing the dispositional plan, as well as the Contingency Plan for the business.

E. Relevant Documents -

1. Governance Documents

In order to get a full picture in regard to the business entity and the owner's relationship with the entity, you should review the following:

- For partnerships – the Partnership Agreement
- For Limited Liability Companies – the Operating Agreement
- For Corporations – Any shareholders agreements, the Articles and Bylaws, as well as any Buy-Sell Agreement.

In examining these agreements look for any restrictions to the right of the owner to transfer the interest. Also, you should determine whether the ownership interest is subject to an obligation, or option, to sell the interest in the event of the death of the owner. In the context of a partnership or limited liability company these provisions are often contained within the partnership agreement or operating agreement. In the case of corporations, a separate buy sell agreement is often in place.

2. Employment Agreements

Also request any employment contracts, if they exist, for both the owner, and any key employees. Look for any death benefit accruing to the owner's estate or the surviving spouse upon his or her death. Also, an important question for many is whether there is any obligation on the part of the entity to provide continuing health insurance coverage for the surviving spouse, upon the death of the owner.

3. Tax Returns

In addition, three years tax returns for the entity will reveal a lot about the business entity. A trained eye can determine a good approximation of the value of the entity

VI. What is the Value of the Business?

The process of determining the actual value of the business is complex, and the answer may vary depending on the context. For example, the value of the business as determined by the IRS for federal estate tax purposes may be different than the value to a prospective buyer. We will deal with the valuation question in detail in Unit X. At this point in the estate planning process you will only need a sense of that value. Remember owners often have a tendency to overvalue their business. Don't take their statements of value as determinative. Look at the tax returns and other relevant documentation to reach your own conclusions. A purchase price in a Buy Sell Agreement may be determinative if the parties are not related, but subject to question if they are.

UNIT THREE - THE VALUATION QUESTION

I. Overview

The value of a closely held business is sometimes an allusive concept. The owner may have his or her opinion, an appraiser another, and a potential buyer a third. The real answer depends on the context in which the question is being addressed. For estate planning purposes the first question is “What is the economic value of the business? Is that value significantly impacted if the owner dies or becomes permanently disabled today? Is the business interest subject to a buyout obligation under a buy sell agreement? Could the business be sold to a third party? If not, what is its liquidation value of the business?” A second that must be addressed is “What is the value of the business in the taxable estate?” Believe it or not the values may be quite different.

The answer to the first question is important to give the owner and his or her family a clear idea as to what they can expect in terms of financial support in the event that the owner dies or is permanently disabled. The answer to the second question has relevance to determine whether the estate has exposure to federal estate tax or state inheritance tax and whether tax avoidance strategies should be considered.

II. What is the Economic Value of the Business?”

A. Overview

A realistic assessment of what the business could realize in sale or liquidation is an important part of a family’s financial plan but is also a question which should be addressed by the estate planner. Part of that analysis is how important the owner is to that value. A personal service business, such as a law practice or accounting practice, may have little realizable value, apart from liquidation value, when a principal owner dies. On the other hand, businesses with significant goodwill value based on the name and reputation of the business itself, separate and apart from the owner as an individual, may have significant realizable value, even without the owner being involved in the business.

B. For Purposes of a Third-Party Sale

1. Factors in Determining Valuation

In a sale to a third party you don’t price a company – you let the market determine the value. However, these are some of the factors the market takes into account:

- What are you selling?
- Multiple of EBITDA as adjusted
- Future earnings as a factor
- Plus or minus factors considered by the Buyer
- Value added premiums for quality businesses
- Return on investment

2. What are you selling?

The purchase price on both sides of the transaction may affect the price. Are you selling assets or equity interests (stock, partnership or LLC membership interests)? If you are selling assets- are all the assets which produced the income of the business included in the sale? And what is their condition and suitability for the future operation of the business? If you are selling equity what obligations of the business are being assumed by the buyer, and is there a discount for undisclosed liabilities?

3. Multiple of EBITDA as Adjusted.

a. Definition

"EBITDA" - the term "earnings before interest, taxes, depreciation, and amortization" (EBITDA) is typically used for middle market companies, companies usually earning more than $500,000. The term is generally used to show an investor/buyer (vs. an owner/operator) how much a company is earning. The investor does not actively run the company and must pay a professional manager to do that for him. Thus, the manager's salary is expensed and is included in the earnings calculation. (It is not added back into earnings like with smaller companies). Simply put, EBITDA is a way for an investor to measure the return on investment he will receive should he purchase a company.

b. The Rationale Behind EBITDA

(1) EBITDA attempts to standardize the earnings number by excluding items that are variable and discretionary from company to company. For example, one company may have a heavy debt load while another may have none. So, we exclude interest expense from EBITDA. A buyer then calculates what his specific debt load will be and can adjust the earnings number to fit his situation. Same with taxes – some companies have different tax strategies, so EBITDA uses a pretax earnings number. Depreciation and amortization are non-cash expenses, and also are more of an accounting method rather a reflection of than a real-world depreciation of the value of an asset, so we exclude that as well. However, don't completely discount depreciation of assets. A smart seller will capitalize and depreciate assets (instead of expensing them) in the years before a sale to boost earnings. A smart buyer will remove depreciation, but then look at expected capital expenditures ("CapEx") so they know they will have the cash flow in the future to buy needed assets and continue to improve the business.

(2) Advanced investors go further than EBITDA and use discounted free cash flow or discounted cash flow (DCF) analysis. EBITDA is not a true cash flow analysis, and really what an investor wants to know is how much cash a business will generate in the future. A DCF model includes taxes, working capital, growth, and anything else that impacts cash flow. It then discounts those future cash flows to a present value. DCF is hard to do correctly because it can be very difficult to estimate future cash flows and to calculate a discount rate factor for risk, so it isn't used all that often.

c. Adjusting Earnings

(1) The value of a business is almost always dependent on earnings. But it is adjusted earnings, called Adjusted EBITDA, that is used for the valuation. For instance,

EBITDA is often adjusted to make sure it is before taxes, interest and depreciation. "Owner's benefit" can also be an adjustment, and that can be a tricky add-back.

(2) Often the easiest way to do this is to add back ALL the current owner's wages and benefits. Then you subtract out the market rate wages and benefit of a professional manager.

(3) Other add-backs for owner's benefit are health insurance, life insurance, pension and any owner perks, such as personal expenses written off as company expenses.

d. Multiples of EBITDA

(1) Medium-size companies (above $1,000,000 in earnings) typically use a multiple of EBITDA for valuations, and they typically range from three to seven, with four to six being common.

(2) Larger companies with EBITDA more than $20 or $30 million can often be valued by comparing to similar public companies. Smaller ones generally have too many additional risk factors to be able to estimate value using this method.

(3) The basic rule of thumb valuation for a growing company with about a million in earnings is a value of five times EBITDA.

4. Future Earnings as a Factor

a. Valuation comes down to how much money the business will produce in the future and the risk factors associated with generating that money. For larger companies, great effort is placed in modeling the future, then discounting that stream of cash to present-day dollars. Two valuation approaches based on this premise are the income method and the discounted free cash flow approach. This can be incredibly complex, right down to calculating the discount rate to be used.

b. Small and mid-size companies also use future earnings. However, since it is too difficult and risky to predict the future, we assume the past will indicate what the future will bring. Thus, when a mergers and acquisitions firm or a business appraiser says you are worth five times your earnings, there is a big assumption that those earnings will continue into the future. Everything is based on that basic assumption.

5. Plus or Minus Factors

a. Strategic

A strategic buyer who can go further, take the company to a new level of sales growth and open up new opportunities (usually as well as the cost synergies above) possibly can afford to pay more than other buyers. Note that it still comes down to financial performance and earnings, but the strategic buyer is betting they can pay now for later earnings. If the buyer can clearly expand the market and leverage growth opportunities, he or she may increase the multiple to 6x or possibly higher.

b. Synergistic

EBITDA can be enhanced by a buyer who can reduce costs and take advantage of other synergies, and because of that, the synergistic buyer can afford to pay a little more for the company. They will not want to, of course, but with a competitive situation and negotiation, the price can be driven up. Also to be considered is whether the buyer is a competitor or a complimentary firm and are there any cost savings to the buyer or the chance for horizontal expansion.

c. Performance –

Financial buyers, private equity groups, opportunistic buyers will generally focus on past performance in valuing a business.

d. Weaknesses and Risks

Customer concentration, contract risk, uneven performance, and messy financials, etc., may be factors in lowering a valuation.

6. Value Premiums for Quality Business

a. Overview

A quality business is a business which makes a buyer comfortable that they know what they are buying. Here are some factors which a buyer may consider important.

b. Clean financials.

(1) There is nothing more comforting to a buyer than knowing that $2 million in earnings really is $2 million in earnings. If the owner has been cheating heavily on taxes, the buyer's comfort level goes down. If the financials are messy and fuzzy, the comfort level goes down.

(2) Buyers also like to see consistency in the financials and stability with a long-standing relationship with a noted accounting firm.

c. Management.

(1) Buyers focus on the continuity of the business, and management plays a key role in that. Is the business dependent on the owner? Is the owner staying? Is there a management team in place if the owner is leaving? If all the pieces are not in place, buyers start to feel uncomfortable.

(2) Buyers will pay a premium for a business in which the owner has built a solid management team and the business is not heavily dependent upon the owner/founder/entrepreneur.

d. Customers.

(1) Are the customers committed to buying in the future? Is any single customer responsible for more than 15 percent of revenues? Are they good at paying in a timely manner? Could a new owner expand the relationship with the current customer base?

(2) Strategic buyers are frequently motivated to acquire a company in order to obtain a new customer base.

e. The Future.

(1) A smart buyer takes a look at the $2 million historical earnings over 5 years but focuses on the future. They take a close look at booked orders, market trends, life stages of the company's products and services, etc. Anything that can make the buyer feel comfortable that the $2 million in earnings is sustainable and can grow will move that company into the quality territory.

(2) The opportunity for the future and the buyer's ability to tap into that potential will be directly reflected in the price they pay.

(3) That is why it is so important to identify the value drivers of the business and spend a lot of time talking about future growth potential.

f. All of the Above:

(1) A quality company has several characteristics that, when considered alone, wouldn't bump up a price. But together, these characteristics cause a buyer to say, "There isn't a lot to worry about with this company – I could imagine owning this."

(2) The purchase price of a business still comes down to future earnings, but with a quality company those earnings have less risk associated with them and less risk commands a premium

g. Who Are You Selling to?

(1) Although some acquirers speak in terms of multiples of earnings when they discuss pricing a business, in the end it all comes down to future earnings and how much of those earnings are available as a payback on the initial investment. Return on investment (or return on equity) is a method of measuring that payback and involves forecasting the cash flow of the acquisition compared with the initial investment and calculating the rate of return.

(2) There is a significant difference between the return on investment that a venture capitalist seeks (often more than 50 percent per year), the ROI that a private equity group seeks (between 25 and 35 percent) and the ROI that a large company may seek (some are at 15 percent per year) from a potential business acquisition.

C. Liquidation Value.

In the event that the business cannot be sold, its value economically will be reduced to what can be realized by selling the assets and satisfying the outstanding liabilities of that business.

D. Buy Sell Purchase Price

A Buy Sell Agreement will generally restrict the right to transfer an interest in a closely held business. Generally, the agreement will provide that if the owner attempts to transfer the ownership interest the remaining owners or the entity itself will have either an option or an obligation to purchase the interest at an agreed upon price. That price will effectively set the ceiling for the economic value of the interest.

III. What is the Value of the Business for Transfer Tax Purposes?

A. Overview

1. Fair Market Value Standard

The standard for valuing any asset for purposes of the federal estate or gift tax is its "fair market value." That term is defined by the IRS as the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts

2. Difference Between Estate Value and Gift Value

The federal estate tax is a tax on the gratuitous transfer of property at death. The federal gift tax is a tax on the gratuitous transfer of property during lifetime. Both taxes begin with a determination of the fair market value of the property interest transferred. Under the estate tax, the determination is made on the date of death. However, the federal estate tax also allows the determination of value to be made on an aggregate basis at an alternate valuation date six months after the date of death. Under the gift tax, the determination of fair market value is made as of the date of the transfer. The estate tax value is based on the value of property owned by the decedent while the gift tax is based upon the value of what is received by the individual done.

B. The IRS Approach

1. Rev. Rul. 59-60

a. Overview

Rev. Rul. 59-60 provides that "all available financial data, as well as all relevant factors affecting the fair market value" should be considered in evaluating the stock of a closely held corporation. Among these are eight basic factors that, though not all-inclusive, are considered by the IRS to be fundamental to the determination of the fair market value of any closely held security. The weight given any one factor depends upon the facts and circumstances surrounding the corporation being valued. Where some factors are not relevant in a given situation, a well-reasoned demonstration of that irrelevance enhances the validity of the valuation.

b. Eight Factors

The eight factors listed in Rev. Rul. 59-60 are:

- The nature of the business and the history of the enterprise from its inception.
- The general economic outlook and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The company's earning capacity.
- Its dividend-paying capacity.
- The existence or absence of goodwill or other intangible assets.

- Sales of the stock and the size of the block of the stock to be valued; and
- The market price of stocks of corporations engaged in the same or similar lines of business having their stock actively traded in the free and open market, either on an exchange or over the counter.

2. Valuation Methods

a. Overview

Revenue Ruling 59-60 describes the some of the most common methodologies for valuing stock in closely held businesses. These methodologies can be described as:

- Income Capitalization Method
- Net Asset Value Method
- Market Method
- Excess Earnings Method

b. Income Capitalization Method

Using the "income capitalization method", an appraiser should accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public. The stock is valued by determining the present value of the business's future income stream. The income capitalization method focuses on determining the anticipated future benefits to be derived from the business and then determining the present value of that future stream of income. Because this method is based on future earnings, it is most useful when valuing corporations that are actively engaged in a business (as opposed to those that are holding companies or primarily hold investments). To apply the income approach, first, future income must be projected and, second, a capitalization rate or discount rate must be selected and used to determine the present value of the future income stream. Future income projections can be based on any economic benefit, such as earnings, net cash flow, or dividends; however, be aware that if the need to value the stock in a business is triggered by the death of a key person, anticipated future income must be reduced to reflect the loss of the person.

The capitalization rate (sometimes derived from the discount rate) incorporates the time value of money and the risk that the assets will not produce the expected income. No standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

c. Net Asset Value Method

Under the "net asset value" method, the corporation is valued using the aggregate fair market value of all assets less the aggregate amount of liabilities. In general, the net asset value method is used to value corporations that do not have an active business but instead are investment activities; corporations that are holding companies; and corporations with an operating business but who are planning to liquidate. The theory behind the net asset value methodology is that the buyer is intending to purchase the underlying assets. Thus, the value of the corporation is not based on its income-producing capacity. In those situations where there is minimal business activity or the business utilizes a large amount of assets, the net asset value method may be useful. In addition, the relative weight to be given net asset value and other valuation approaches for valuing a corporation will depend on the extent to which the company is engaged in producing income as opposed to simply holding property for investment. If the corporation holds real estate, earnings are considered important where the corporation actively engages in a real estate management business. Additionally, the value of intangible assets should be included in the valuation of the business holding the asset.

d. The Market Approach

Under the "market approach", the corporation is valued by comparing it to corporations with readily ascertainable values. Comparable companies, called guideline corporations, are usually those whose stock is publicly traded, though privately-held corporations may also be used for comparison provided that the sales were arm's length. If there are no comparable corporations engaged in the same or similar business for which there is evidence of recent stock sales, or if there are not guideline companies that are sufficiently comparable, the market method cannot be utilized. The most important factors to consider when locating comparable corporations are the economic factors that impact revenue and profits. Other factors to consider include product lines, capital structure, earnings, dividend-paying capacity, and size and position in the industry. In addition, sales volume may also be relevant in determining if a corporation can be used as a comparable. Once a starting point is determined, the value of the comparison corporation must be adjusted to reflect any differences between the corporation and the corporation being valued.

If the corporation has both operating assets and nonoperating assets, a combination of methods could be used; the capitalization of income method could be used for the operating assets and the comparable sales method or net asset value for the nonoperating assets. When different methods are combined, it is sometimes referred to as the segregated technique. Finally, a fourth method, the excess earnings, capitalization method, or the formula valuation approach, may be used to value intangible assets of a business only if there is no better basis available for valuing the asset.

3. Adjustments

Once a valuation is made there are adjustments that can be made to that valuation. These include the following:

a. Control Premium:

In some situations, a block of stock will be valued above what the stock is trading for because it represents a controlling interest. A controlling interest gives the shareholder the ability to control the corporation by dictating its policies, procedures, or operations. When determining the value of a controlling interest, whether a control premium is justified depends on the method used to value the stock. If the valuation method valued the stock as if it were a controlling interest, no further adjustment needs to be made as the methodology has already accounted for the control element.

b. Additional Rights:

If stock has additional rights or privileges attached, the rights and privileges must be taken into consideration in determining the value of the stock.

c. Discounts

In valuing stock in a closely held corporation, discounts are usually warranted. A minority interest discount reflects the minority shareholders' inability to compel liquidation and inability to realize a pro rata share of the corporation's net asset value. The minority interest discount is intended to reflect the decreased value of shares that do not convey control of a closely held corporation. Some minority shares can have elements of control and, when present, those elements can reduce, but usually not eliminate, a discount for lack of control. The lack of marketability discount is designed to reflect the fact that there is no ready market for shares in a closely held corporation. In determining if a marketability discount is applicable, the Tax Court has listed some factors to consider: the cost of a similar company's stock; an analysis of the corporation's financial statements; the corporation's dividend-paying capacity and dividend payment history; the nature of the corporation, its history, its industry position, and its economic outlook; the corporation's management; the degree of control transferred with the block of stock to be valued; restrictions on transferability; the period of time for which an investor must hold the stock to realize a sufficient return; the corporation's redemption policy; and the cost and likelihood of a public offering of the stock to be valued.

d. Discount for Nonvoting Stock

Generally, shares described as nonvoting shares do not have the right to vote for the board of directors. However, they may have the right to vote on proposed fundamental changes, such as a merger of the corporation, liquidation, and sale of substantially all of the corporate assets. In several instances courts have held that hypothetical buyers will pay a premium for shares with voting privileges or conversely apply a discount for nonvoting stock.

e. Key Person Discount

When a business loses the services of a person on whom they are substantially dependent, the key person, with no succession plan in effect and no person qualified to succeed the key person, the loss can have a negative impact on the value of the business. An investor would expect to pay below fair market value for the stock as compensation for the loss of the key employee.

f. Portfolio Discount

A corporation may hold an investment portfolio. A discount may be permitted for a lack of diversification in the portfolio and for the difficulties inherent in marketing stock in an investment company.

g. Associated Taxes

The Tax Court previously held that no discount is allowed for potential tax at the corporate level where there is no evidence that a liquidation of the investment was planned or that it could not have been accomplished without incurring tax at the corporation level. Rather, it is one of the factors a willing buyer would consider in the process of price formulation. However, the courts have also held that a willing buyer and willing seller would have taken into consideration any potential built-in gains tax, even when no liquidation was contemplated. Accordingly, the net asset value of the corporation can reflect any potential tax liability that might be incurred upon the sale of the corporate assets. An S corporation can be valued using the income approach. "Tax-affecting" is the term generally applied when the income taxes, computed at C corporation rates, are subtracted to compute the net income.

h. Hindsight

When determining the value of property, subsequent post-valuation date events relating to the property being valued generally are disregarded. However, the courts, in determining the weight to give to post-valuation date events, have divided post-valuation date events into two general categories - First, events subsequent to the valuation date are considered only if the expectation of the subsequent event existed on the valuation date and the expectation was reasonable and intelligent. Such events are considered because, to the extent they were reasonably foreseeable, they would have affected the valuation of the property as of the date of death. Second, subsequent market activities may provide helpful comparable sales that can be used as evidence of fair market value on the valuation date. To be relevant the subsequent sales must be of comparable property. Appropriate adjustments must be made to account for differences between the valuation date and the dates of the later-occurring events.

i. Sales Restrictions

In general, if the stock is valued before the public offering and the public is not aware of the potential for a public offering, the lower value is the fair market value. If a public offering is anticipated, it may increase the price at which the stock is traded, even before the offering is made. In Estate of Freeman v. Commissioner, the corporation had discussed the potential for a public offering several months before the valuation date and completed the offering several months after the valuation date. In determining the fair market value of the stock, whether the public would pay a premium due to the anticipated public offering had to be considered. Stock that is subject to a transfer restriction may have a lower value than stock freely traded on the exchange because it is less marketable. To the extent a buyer who purchases the stock would take the stock subject to the restriction, the courts may allow a discount to be applied to the publicly traded value of the stock.

In Revenue Ruling 77-287 the Service provided guidance on valuing securities subject to a resale restriction. There is no set formula or mechanical rule for calculating the value of restricted stock, but the following factors should be considered in determining the discount that should be applied to the stock: the earning patterns (which determine the degree of risk of an investment); the dollar amount of sales of issuer's securities; the market in which publicly traded securities are traded; and resale agreement provisions and the respective bargaining strengths of the parties. Unregistered or restricted stock is not always subject to a discount. Whether a discount is permitted depends on the facts and circumstances.

C. The Relevance of the Buy Sell Agreement

1. Fixing the Value for Estate Planning Purposes.

a. A buy sell agreement may be used to fix the value of the business interest for estate tax purposes. Generally, this will require that the agreement fix the price by agreement of the parties or formula rather than by appraisal. See the discussion of the various methods of how value and price can be determined within the agreement.

b. In order for the agreement to fix the estate tax value the following requirements must be met: (i) the decedent's estate must be obligated to sell, (ii) the agreement must prohibit the owner during life from disposing of the interest or stock without first offering it to the prospective purchaser at the contract price (i.e., a right of first refusal), and (iii) the purchase price at death must have been established through an arm's-length business bargain (and not as a device to pass the decedent's shares to the natural objects of his or her bounty for less than an adequate and full consideration in money or money's worth).

2. IRC Sec. 2703.

a. Under § 2703, in spite of meeting the requirement stated above any agreement may be disregarded for valuation purposes, unless the agreement: (i) is a bona fide business arrangement; (ii) is not a device for transferring property to members of the transferor's family for less than full and adequate consideration; and (iii) has terms that are comparable to similar arrangements entered into by persons in an arms' length transaction. See §2703(b); Regs. §25.2703-1(a), (b).

b. These requirements are deemed satisfied if more than 50% by value of the property subject to the right or restriction is owned directly or indirectly by individuals who are not members of the transferor's family. Regs. §25.2703-1(b)(3).

D. The Case Law

Although Rev. Rul. 59-60 is the accepted road map for the valuation process, a review of the above cases evidences that it is an imprecise road map at best. That is, the taxpayer typically presents evidence applying the various factors of Rev. Rul. 59-60 to achieve a lower value than that arrived at by government experts, who are presumably applying the same factors to achieve a higher value. In the end, many courts appeared to merely be “splitting the difference” between the two values.

UNIT FOUR – DEVELOPING THE DISPOSITIONAL PLAN

I. Overview.

The transfer of a business to a family member will either take the form of an inter vivos or transfer on the death of the primary owner, and the transfer will be either by sale or by gift. In any case the transfer will have income tax consequences and either gift or estate tax consequences as well. In determining whether a transfer of the business to a family member or members is recommended some or all of the following issues should be considered:

– Is the potential transferee ready and willing?

– What is the timeline?

– How does the owner feel about issue of "control"?

– What are the primary owner's thoughts in regard to the "equalization" issue?

– What are the transfer options?

– Should the transfer be a life transfer or a testamentary transfer?

II. Identify the Transferee or Transferees of the Business

A. Who?

If a transfer to a family member or members is contemplated the first issue is to identify the potential transferee or transferees and access the appropriateness of the choice. If the transfer is to more than one family member, remember the old adage "Poverty to poverty in three generations." In the context of the history of a closely held business this generally results because second and third generation owners either lack the interest, the experience, the expertise or the compatibility with each other to allow the business a reasonable chance of continued viability.

B. Involvement

As a result, it is important, to review the level of the potential transferee's current involvement in the business, together with an evaluation of their level of interest. In addition, there should be a realistic assessment of their qualifications to accept responsibility for ownership of the business. If a potential family member transferee lacks the requisite interest in taking over the business, it is a recipe for disaster to force that individual into a role of responsibility for the business.

C. Experience

If the issue is lack of experience or expertise that is generally a more solvable problem. This may create the need for a longer timetable to effectuate the transfer however. Inexperience can be overcome with time and an opportunity to grow into the job, and a lack or expertise can be supplemented with proper training or by hiring the right support staff.

D. Compatibility

Another concern may be whether the potential transferee will be compatible with existing personnel when placed in a position of authority. Valued employees may resent family members succeeding to control positions if they are perceived to have attained them on the basis of nepotism rather than merit. If the proposed transfer is to be made to more than one family member, their compatibility with each other is an important consideration. Siblings for example who work well together as long as a parent is in a position of control in the business, may become incapable of working together after the parent is no longer involved.

III. What is the Timeline to Complete the Transfer?

The timeline to complete the family member transfer should an essential part of the succession plan. Whether that entails a transfer of ownership over time or a complete transfer at a selected point in time may depend on the owner's readiness to make the transfer and the family members readiness to accept the responsibilities of ownership.

IV. Providing for Owner and his or her Spouse

An owner may decide to transfer the interest in his or her closely held business by gratuitous inter vivos or testamentary transfer to a family member other than the surviving spouse. If the business has provided a source of financial support to the owner and his or her spues during the lifetime the question should be asked

V. The "Control" Issue

Many owners, particularly those who have created a business and been in control of that business since its inception, have difficulty relinquishing control of the business to next generation owners. The question of when it is appropriate to relinquish control may depend on the readiness of the transferees to accept responsibility of ownership. Also, to be considered is the level of risk which remains with current ownership post transfer. If the current ownership is depending on the continued success of the business in order to sustain their lifestyle through payment of continued compensation, health benefits, or deferred purchase price, they may be well advised not to relinquish control of the business too quickly.

In a corporation, generally the party holding a majority of the voting stock holds absolute control. In a limited partnership the general partner controls, and in a limited liability company the operating agreement will determine how control is allocated among the members. It should be kept in mind that there are ways to share control. One mechanism to share control is for day to day management decisions to be vested in the owners who actually operate the business on a daily basis while the major decisions must be approved by a majority vote of all of the owners.

VI. The "Equalization" Issue

If the owner has designated one family member to be the transferee of his or her interest in the business to the exclusion of others who may feel equally entitled, you should consider ways to equalize the scales so to speak. One way is to have the designated transferee actually purchase the business, either with their own funds or by using the future profits of the business. More commonly, however, the business will be transferred by lifetime or testamentary gift. In those cases, the current owner may wish to transfer equivalent value to those in the family not benefiting from the transfer of the business.

If the remaining estate is not of sufficient value to provide for such equalization, then an insurance policy on the life of the owner paid outright or in trust to those family members should perhaps be considered.

VII. Inter Vivos vs. Testamentary Transfer

A. The Case for Inter Vivos Transfers

The tax case for making inter vivos gift transfers of interests in the business, whether held in the form of stock, partnership interests, or membership interests in a limited liability company, lies in the opportunity to reduce the value that is ultimately subject to transfer tax.

Lifetime transfers can achieve a meaningful and permanent reduction of that value in several ways. First, is the availability of the $15,000, per donee per year (the "annual exclusion") for gifts of "present interests. Second, if the property is appreciating property, a lifetime transfer will remove any post transfer −

Land acquired at death is subject to a qualified conservation easement, it is excluded from the decedent's gross estate (an executor may elect (on Form 706, Schedule U) to exclude from the gross estate up to 40% of the value of land subject to a qualified conservation easement meeting certain requirements and subject to a dollar cap of $500,000, and its basis (to the extent that it's subject to the easement) is the basis in the hands of the decedent. appreciation from the taxable estate. In addition, if the property is income producing property, the post transfer income will also be removed. Another aspect of the gift tax that is often not considered is the fact that the tax paid on inter vivos gifts is effectively removed from the tax base, while in the case of the estate tax, the tax is included and taxed in the tax base. Finally, there is the ability to discount the taxable value transferred by taking advantage of the annual exclusion and certain discounting techniques, discussed below.

B. The Case Against Inter Vivos Transfers

The primary disadvantage in making lifetime gifts to be considered is the loss of the step up in basis to fair market value that occurs when assets are retained in the taxable estate until death. The donee of property gifted during the donor's life takes a carryover of basis from the donor, increased by any gift tax attributable to the amount by which the fair market value of the gifted property exceeds basis at the time of the gift. In situations where the estate tax incurred is less than the tax benefit of a step up in basis, an inter vivos transfer may not be advisable.

C. Step Up in Basis

The basis of property acquired from a decedent by inheritance, bequest, devise, etc., that hasn't been sold, exchanged, or otherwise disposed of before the decedent's death, is generally equal to its fair market value ("FMV") at the date of the decedent's death.

However, if:

- The fiduciary elects for estate tax purposes to value the decedent's gross estate at the alternate valuation date, the basis of the property is its FMV at that date;
- The fiduciary elects for estate tax purposes the special use valuation method of valuing farm or other closely held business real property included in the decedent's gross estate

under IRC § 2032A, the basis of the real property is its value determined for purposes of the special use valuation election (rather than its FMV);

Fair market value on the date of the decedent's death (or the alternate valuation date, if applicable) doesn't apply to determine the basis of property:

- That's appreciated property acquired by the decedent by gift in the 1-year period ending on his death, and that is reacquired by the donor (or the donor's spouse) from the decedent,
- Included in the decedent's estate but disposed of by the taxpayer before the decedent's death,
- That's stock in a domestic international sale corporation (DISC) or former DISC, or of certain foreign entities; or
- That is a right to receive income in respect of a decedent.

The fair market value (FMV) of property at the decedent's death or at the alternate valuation date is the FMV as determined by an appraisal for federal estate tax purposes. If no federal estate tax return is required to be filed, the FMV of the property appraised as of the date of death for purposes of state inheritance or other transmission taxes (e.g., legacy taxes) is used to determine FMV. However, if no federal estate tax return is filed, the alternate valuation date cannot be used to determine FMV. The executor can elect (irrevocably, on Form 706) to use an alternate valuation date rather than the decedent's date of death to value the property included in the gross estate. This alternate date is generally six months after decedent's death or earlier date of sale or distribution. The alternate valuation can be elected only if its use decreases both the value of the gross estate and the combined estate and GST tax liability.

D. Basis Adjustment for Gifted Property

The donee's basis for property acquired by gift or transfer in trust is usually the same as the donor's adjusted basis at the time of the gift plus all or part of the gift tax paid on the gift. Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in the property. If property was acquired by inter vivos gift (i.e., by reason other than the death of the donor), whether the gift was made outright or in trust, the basis in the hands of the recipient-donee, at the date of the gift, may be the same basis as it would be in the hands of the donor or it may be the fair market value of the property at the time of the gift. Which basis applies depends on the purpose for which it is determined, namely: . . . for determining gain, and for depreciation, depletion, or amortization, the donee's basis is the same as the donor's adjusted basis, for loss purposes the donee's basis is the lower of the donor's basis or the fair market value, when the gift was made.

The donee's basis for property acquired by gift is increased by all or a portion of the federal gift tax paid on the gift. Any basis increases for gift tax paid is treated as an adjustment to the basis of the property. Thus, the gift tax paid can increase the donee's basis for determining depreciation, depletion, or amortization, as well as for determining gain or loss. The amount of the increase in basis for gift tax paid is the amount of the gift tax attributable to the net appreciation in value of the gift. The tax attributable to the net appreciation is determined by multiplying the gift tax paid with respect to the gift by the net appreciation in value of the gift and dividing the result by the amount of the gift. Net appreciation in value is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift. For purpose of the above computation, the "amount of the gift" is the value of the gift as finally determined for purposes of the gift tax. This means that in making the above computation the value of the gift is to be reduced by any portion excluded or deducted under the applicable: (a) annual exclusion of Code Sec. 2503(b); (b) charitable deduction of Code Sec. 2522; and (c) marital deduction of Code Sec. 2523.

E. Analysis

This makes the essential question "Are the estate tax savings resulting from making a gift greater than the value of a basis step up?" It is an oversimplification to assume that since gifts result in loss of the opportunity to realize a basis step up to fair market value, that lifetime gifts should never be recommended. Rather a careful analysis should be made in order to determine the relative benefit of making the gift in terms of transfer tax savings as compared to the benefit of basis step up.

UNIT FIVE – IMPACT OF THE OWNER'S DEATH ON THE BUSINESS

I. Overview

In the event of the owner death his or her interest in the business will become an asset of the owner's estate subject to administration by the executor. The initial question for the executor should be *"How is the business to be disposed of in the estate?"* The answer will essentially dictate the duties and responsibilities the executor in deal with the business interest during the period of estate administration:

– If the business interest is subject to a specific gift provided in the will either outright or in trust the executor may be required to manage the business during the period of the estate's administration.

– For example, if the business is subject to a buy sell agreements which requires the estate to sell its interest in the business, the estate may be bound to sell the business according to the terms of the that agreement.

– If the business interest is subject to disposition in the residuary the executor may actually be under to duty to liquidate the business.

In this Unit we will discuss the various issues which arise when the business interest is subject to the estate administration as an asset of the estate.

II. How Does Death of an Owner Impact the Business Entity or the Ownership Interest?

A. Overview

In planning an owner's estate, a fundamental starting point should be to determine what impact, if any, the death of the owner will have on the business entity, and second on the ownership interest itself. Specifically, will the death of the owner cause the entity to wind up its business and dissolve. Does the death of the owner cause the ownership to morph into something else? From a general partnership interest in a limited partnership interest into an interest stripped of managerial control, for example.

In all cases agreements made between the owners of the entity, whether it be a corporation, general or limited partner, or limited liability company, the rights of the owners, and the disposition and restrictions on transfer of the ownership interests can be controlled by the governance documents of the entity. Only to the extent the governance documents do not provide for the rights and duties of the owner, will the Pennsylvania Associations Code as have been provided in Title 15 of the Pennsylvania Consolidated Statutes control.

B. Impact of the Governance Documents

1. In General

The first point of reference in determining the impact of the death of the owner on the legal viability of the entity itself and the ownership interest itself should be the entity governance documents. By "governance documents" we are referring to the legal document(s) by which the legal existence of an entity is established, and which govern its internal affairs. For example, the "governance documents" of a corporation are its Articles of Incorporation and its by-laws. For a limited partnership they are its limited partnership agreement and Certificate of Limited Partnership, and for a limited liability company they are its operating agreement and Certificate of Organization.

2. What to Look For

a. Term of Existence

Corporations, limited liability companies and limited partnerships are perpetual entities the legal viability of which is not impacted by the death of the owner. However, a general partnership may be established to carry on business transactions until the expiration of a definite term or the completion of a particular undertaking, the termination of which causes the partnership to be dissolved. Alternatively, the partners may create the partnership for an indefinite period, in which case the partnership agreement need not specify any time for termination. If no duration is specified, the partnership is a "partnership at will." A partnership at will may be dissolved at any time by a partner serving notice on the other partner(s). Check the partnership agreement of a general partnership for a statement as to the term of the partnership in order to determine if the entity terminates upon the death of the owner or some related event.

Here are some sample partnership provisions:

Continuation Until Terminated

3.01. The Partnership shall begin on January 1, 2020 and shall continue until December 31, 2050 and after that from year to year unless sooner terminated as specifically provided in this Agreement.

Continuation Until Death of Partner

9.01. (a) On the death of any Partner, the Partnership business shall be continued until the end of the fiscal year in which death occurs. At that time, the surviving Partners shall have the right either to continue the Partnership business with the estate of the deceased Partner continuing as a member in the Partnership or to liquidate the Partnership business and terminate the Partnership.

b. Form of Ownership

The form of ownership, whether it be stock in a corporation, a limited or general partnership interest, or membership interest in a limited liability company possesses both economic rights and governance rights.

Economic rights generally consist of the right to current distributions, and the right to the net proceeds in liquidation of the entity. Such distributions are generally made on the basis of relative percentage ownership in the entity, i.e. a holder of 10% of the issued and outstanding stock of a corporation would generally be entitled to 10% of the dividend distributions, and net proceeds in liquidation. That being said, it is not uncommon for a class of ownership interest to be entitled to a preference in regard to current distributions or distributions in liquidation.

Governance rights generally consist of voting rights, but they may also include management rights, consent rights, or rights to information. In addition, partnerships and limited liability companies taxed as partnerships also provide for allocations of taxable income and loss.

Provided the requirements of IRC Sec. *704* are met so called "special tax provisions" may allow allocation of tax losses to partners in a manner which is different from the partner's percentage interest in the partnership or LLC.

c. Change to the Ownership Interest

By agreement, the nature of the ownership interest may change upon the death of an owner. Here are some sample provisions:

<u>*Conversion from voting to non-voting stock*</u>

"2.01 Upon the death of a holder of Class A, voting stock, any shares of Class A, voting stock owned by such deceased holder shall be converted into an equal number of shares of Class B, non-voting stock without the requirement that such shares be formerly exchanged."

<u>*Conversion from General Partnership Interest to Limited Partnership Interest*</u>

"1.15 Upon the death of a General Partner, such Person shall cease to be a General Partner and his or her interest shall be converted to a Special Limited Partner of the Partnership."

<u>*Conversion from Partner to Transferee*</u>

"9.02. Any transferee or assignee to whom an interest in the Partnership has been transferred and who is not at the time of the transfer a party to this Agreement shall be entitled to receive, in accordance with the terms of the assignment, the net profits to which the assigning Partner would otherwise be entitled. Except as provided in the preceding sentence, the transferee or assignee shall not be a Partner, and shall have any of the rights of a partner, unless and until the transferee or assignee shall have accepted and assumed the terms and conditions of this Agreement by a written agreement to that effect."

Check the governance documents to determine the economic and governance rights to which the ownership interest is entitled and whether those rights are impacted by the death of the owner.

c. Restrictions on Transfer/ Buy Out Provisions

(1) In General

The personal representative is responsible to honor the contractual obligations of the decedent incurred in his or her lifetime. This would include the contractual obligation to sell the interest pursuant to a buy sell agreement, included in a stand-alone agreement or in a governance document. We will be discussing buy sell agreement in some detail later in this program. However, if the business interest is a part of the estate, the executor whether a buysell obligation exists provided in the governance documents or as a stand alone document. If such an agreement does exist, you should examine the document to determine the following pertinent facts:

– Does the governance document place restrictions on the transfer of the ownership interest?

- Does the agreement allow for transfer free of restrictions to so-called "Permissible Transferees" such as family members or trusts which benefit family members?
- What are the events that trigger a buyout of the ownership interest?
- Does the agreement provide for an option or an obligation of purchase?
- How is the purchase price determined?
- How is the purchase price to be paid?
- How is payment of the purchase price funded and secured.

(2) Limitation on Corporate Restrictions

Note: 15 Pa.C.S. § 1529(a) provides a general rule that restriction on the transfer of the stock of a business corporation may be imposed by the bylaws of the corporation or by an agreement among the shareholders within certain limitations. Under 15 Pa.C.S. § 1529(b), a restriction is permitted if it:

- Obligates the shareholder to offer to the corporation or to any other shareholders or to any other person or to any combination of the foregoing a prior opportunity, to be exercised within a reasonable time, to acquire the restricted stock;
- Obligates the corporation or any shareholder or any other person or any combination of the foregoing, to purchase the stock that are the subject of an agreement respecting the purchase and sale of the restricted stock;
- Requires the corporation or the shareholders of the corporation to consent to any proposed transfer of the restricted stock or to approve the proposed transferee of the restricted stock; or
- Prohibits the transfer of the restricted stock to designated persons or classes of persons and the designation is not manifestly unreasonable.[1]

C. The Pennsylvania Associations Code

1. Relevance of the Statute

As stated above, agreements made between the owners of the entity, whether it be a corporation, general or limited partner, or limited liability company, control the rights of the owners, and any restrictions on transfer of the ownership. Only to the extent the governance documents do not provide for the rights and duties of the owner, will the Pennsylvania Associations Code control. In this section we will discuss the provisions of the Statue when the governance documents are silent as to a particular issue.

[1]Note: Any restriction on the transfer of the shares of a business corporation for the purpose of maintaining its status as an electing small business corporation under Subchapter S of the Internal Revenue Code of 1986 or a comparable provision under state law shall be conclusively presumed to be for a reasonable purpose.

2. Corporations

a. Duration of the Entity

In the absence of a provision in the Articles setting forth a limited term, the duration of a corporation is perpetual. As a result, the death of an owner will not impact the legal viability of the entity.

b. Nature of the Ownership Interest

(1) Rights of the Transferee

A purchaser of a stock in a business corporation acquires all rights in the stock that the transferor had or had power to transfer. If those rights are limited in any way a purchaser of a limited interest acquires rights only to the extent of the interest purchased.

(2) Restrictions on Transfer

15 Pa.C.S. § 1529(a) provides a general rule that restriction on the transfer of the stock of a business corporation may be imposed by the bylaws of the corporation or by an agreement among the shareholders within certain limitations. Under 15 Pa.C.S. § 1529(b), a restriction is permitted if it:

– Obligates the shareholder to offer to the corporation or to any other shareholders or to any other person or to any combination of the foregoing a prior opportunity, to be exercised within a reasonable time, to acquire the restricted stock;

– Obligates the corporation or any shareholder or any other person or any combination of the foregoing, to purchase the stock that are the subject of an agreement respecting the purchase and sale of the restricted stock;

– Requires the corporation or the shareholders of the corporation to consent to any proposed transfer of the restricted stock or to approve the proposed transferee of the restricted stock; or

– Prohibits the transfer of the restricted stock to designated persons or classes of persons and the designation is not manifestly unreasonable.[2]

As a result, the corporate governance documents, i.e., the bylaws of the corporation, or any agreement among the shareholders, should be examined to determine if there are any provisions which would result in a liquidation of the corporate stock held by the estate in the event of the owner's death.

c. Statutory Close Corporations

Under Chapter 23, of the Pennsylvania Associations Code a business corporation may elect to become a "statutory close corporation". If the election is made the business and affairs of the corporation maybe managed by or under the direction of the shareholders of the corporation

[2]Note: Any restriction on the transfer of the shares of a business corporation for the purpose of maintaining its status as an electing small business corporation under Subchapter S of the Internal Revenue Code of 1986 or a comparable provision under state law shall be conclusively presumed to be for a reasonable purpose.

rather than by a board of directors. Unless otherwise provided in the bylaws shares of a statutory close corporation may not be transferred, voluntarily or involuntarily, by operation of law or otherwise. This general restriction on transfer does not apply to including the following exempt transfers:

– Transfers to the corporation or to any other shareholder of the same class of shares.

– Transfers to members of the immediate family of a shareholder or to a trust all of whose beneficiaries are members of the immediate family of a shareholder.[3]

– Transfers that have been approved by the unanimous vote of the holders of the most junior shares of the corporation having voting rights for the election of directors.

– Transfers to an executor or administrator upon the death of a shareholder or to a trustee or receiver as the result of a bankruptcy, insolvency, dissolution or similar proceeding brought by or against a shareholder.

– Transfers by merger, consolidation or share exchange that becomes effective pursuant to section 2336 (relating to fundamental changes) or a share exchange of existing shares for other shares of a different class or series in the corporation.

– Transfers by a pledge as collateral for a loan that does not grant the pledgee any voting rights possessed by the pledgor.

– Transfers made after termination of the status of the corporation as a statutory close corporation.

Under 15 Pa.C.S. § 2322, a shareholder who wants to transfer shares in a non-exempt transaction is free to obtain an offer from a certain qualified third parties, and subject to the corporation's right of first refusal, may then sell the shares to a third part buyer.

d. Professional Corporations

Except as otherwise provided by a statute, rule or regulation applicable to a particular profession, all of the ultimate beneficial owners of shares in a professional corporation must be licensed persons and any issuance or transfer of shares in violation of this restriction shall be void. Unless a lesser period of time is provided in a bylaw adopted by the shareholders or in a written agreement among the shareholders of the corporation, the estate of a deceased shareholder may continue to hold shares of the professional corporation for a reasonable period of administration of the estate, but the personal representative of the estate shall not by reason of the retention of shares be authorized to participate in any decisions concerning the rendering of professional service.

e. S Corporations

Eligibility requirements for an S corporation include that it must be a domestic corporation; have no more than 100 eligible shareholders. Under Sec. 1361(c)(1) all members of a family and their

[3] The "immediate family of a shareholder" includes only his or her spouse, parents, brothers, sisters, lineal descendants (including descendants related by adoption) and spouses of any lineal descendants.

spouses and estates are treated as one shareholder. An S corporation election may be jeopardized when a shareholder dies and his or her interest is transferred to a shareholder that is not eligible to be a shareholder of an S corporation. Eligible shareholders include only individuals, estates, certain types of exempt organizations, and certain types of trusts. Partnerships, corporations and non-resident alien shareholders are not eligible shareholders.

As will be discussed below, when the decedent's stock in the S corporation is properly subject to the possession of the executor or administrator of his or her estate for purposes of administration, the estate is an eligible shareholder even if under state law legal title to the stock passes directly to the legatees under the decedent's will or to his or her legal heirs. However, only certain types of trusts are eligible S corporation shareholders. They include: (1) a voting trust; (2) a “grantor” trust (3) a qualified subchapter S trust (“QSST”); (4) a testamentary trust with respect to stock transferred to it pursuant to the terms of a will (a “will recipient trust”) or (5) an electing small business trust (“ESBT”).

3. General Partnerships

a. Overview

A partnership may be established to carry on business transactions until the expiration of a definite term or the completion of a particular undertaking, the termination of which causes the partnership to be dissolved. Alternatively, the partners may create the partnership for an indefinite period, in which case the partnership agreement need not specify any time for termination. If no duration is specified, the partnership is a “partnership at will.” The death of an individual general partner does not necessarily result in a winding up of a general partnership but rather results in the “disassociation” of the partner from the partnership. Under Pennsylvania Associations Code the business of the partnership must either be wound up and the partnership dissolved, or the partnership interest of the deceased partner must be redeemed by the partnership.

b. Election to Wind Up the Partnership Business

Under 15 Pa.C.S. § 8471, within 90 days after a partner’s death, the remaining partners may by majority vote elect to wind up the partnership business. In that event, the partnership shall apply its assets to discharge the partnership’s obligations to creditors. If there is a surplus after payment of the partnership creditors, including partners, that surplus shall be distributed in the following order: (1) to each partner an amount equal to the value of any unreturned contributions to the partnership; and (2) then the balance to each partner in proportion to their respective rights to share in distributions immediately before the dissolution of the partnership. If there are insufficient assets to satisfy creditor obligations, each partner, including the estate of the deceased partner, when the obligation was incurred must contribute a proportional amount based on the partner’s right to distributions to the partnership in order to enable the partnership to satisfy those obligations.

c. Required Purchase in Lieu of Winding Up

If the remaining partners do not elect to wind up the business of the partnership as provided above, the partnership is required under 15 Pa.C.S. § 8471, to purchase the partnership interest of the deceased partner. The required buyout price is an amount equal to the amount that would have been distributable to the person if, on the date of dissociation, the assets of the partnership were sold and the partnership were wound up, assuming a sale price equal to the greater of (1) the liquidation value of the partnership; or (2) the value based on a sale of the entire business as a going concern without the deceased partner.

4. Limited Partnerships

a. In General

A limited partnership is an entity distinct from its partners, and has a perpetual duration. A partner's transferable interest, that is, the partner's right to receive distributions from the partnership, is personal property. A transfer of that interest, in whole or in part, is permissible and does not by itself cause the dissociation of the transferor as a partner or a dissolution and winding up of the partnership's business.

b. Death of an Individual General Partner

Upon the death of a general partner that person's estate or transferee loses their right to participate as a general partner in the management and conduct of the limited partnership's activities and affairs terminates.

c. Death of a Limited Partner

If a limited partner dies the estate of the limited partner or any transferee ceases to have any further rights as a limited partner.

d. Transferable Interest

One of the most fundamental characteristics of limited partnership law is its fidelity to the "pick your partner" principle. 15 Pa.C.S. § 8672 is the core of Chapter 15's provisions reflecting and protecting that principle. The provisions of this section apply regardless of whether the interest pertains to a general partner or a limited partner in a limited partnership. A partner's rights in a limited partnership are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention). Unless the partnership agreement provides otherwise, a person may not transfer to a person not a partner any rights in a limited partnership other than a transferable interest. This is because a partner acting without the consent of all other partners lacks both the power and the right to transfer to a non-partner anything other than some or all of the partner's "transferable interest." The rights of a transferee are quite limited – i.e., to receive distributions; and, if the limited partnership dissolves and winds up, to receive specified information pertaining to the limited partnership from the date of dissolution.

5. Limited Liability Company

a. Duration of the Entity

A limited liability company is an entity distinct from its member or members and has perpetual duration. Therefore, the death of the owner should not impact the legal viability of the entity.

b. Nature of the Ownership Interest

If a person is dissociated as a member that person's rights as a member terminate. If the company is member-managed, the person's duties and obligations as a member end with regard to matters arising and events occurring after the person's dissociation. In general, any transferable interest owned by the person in the person's capacity as a member immediately before dissociation as a member is owned by the person solely as a transferee

D. Collateral Issues

The death of the owner may also have other collateral consequences. Among those areas which should be addressed are the following:

1. Due on Sale in Contracts and Loan

A "due-on-sale clause" is a contract provision which authorizes a lender, at its option, to declare sums secured by the lender's security instrument immediately due and payable, if the property securing the loan is sold or transferred without the lender's prior written consent. Such a provision may also provide that the transfer of a majority of the ownership interests in a borrowing entity will trigger the acceleration of such sums. Due on sale clause may also appear in lease agreements, and result in a termination of the lease.

2. Corporations

a. Election of Officers

If an owner dies who was also a corporate officer the vacancy should be addressed as provided in the corporate bylaws.

b. Election of Board of Directors

Likewise if an owner dies who was a member of the corporation's board of directors.

c. Update Stock Register

The Stock Register should be updated to provide for a new stock ownership which result may result from a shareholder's death.

d. Maintaining the S Election

If the shares of an S corporation pass to a legatee ineligible to hold S corporation stock, the S election of the corporation may be jeopardized. See section II.C.2.e., above for a discussion of eligible shareholders of an S corporation.

3. Partnerships

a. Amending Certificates of Limited Partnership

In the event the death of an individual general partner in a limited partnership the Certificate of Limited Partnership must be amended to reflect the admission of the new general partner.

b. Amending the Partnership Agreements

The Partnership Agreement should be amended to reflect the configuration of the partners after the death of a partner. If the partnership interest is redeemed or sold to existing partners the partnership interests of the remaining partners should be adjusted accordingly. If the partnership is transferred the status of the transferee should be reflected in the Agreement either as a fully admitted partner or as a transferee.

4. Limited Liability Companies

a. Managers

If the deceased owner is the manager of a manager managed LLC then that vacancy must be filled according to the terms of the Operating Agreement.

b. Amending the Operating Agreement

The Operating Agreement should be amended to reflect the configuration of the partners after the death of a partner. If the membership interest is redeemed or sold to the current members, the membership interests of the remaining members should be adjusted accordingly. If the membership interest is transferred the status of the transferee should be reflected in the Agreement either as a fully admitted partner or as a transferee.

UNIT SIX - THE BUSINESS AS AN ASSET OF THE ESTATE

I. Overview

As an asset of the owner's estate the business interest becomes the responsibility of the executor of the estate. As a result, the executor has certain duties and responsibilities regarding the asset. In this section we will discuss those duties and responsibilities.

II. The Duty of the Executor

A. General Fiduciary Duty

In every estate the personal representative is under a duty to take custody of assets of the estate and administer them in such a way as to preserve and protect those assets for distribution to the heirs within a reasonable time.[4] In the discharge of all his or her duties, the personal representative acts as a fiduciary and is required to exercise the care and diligence which prudent persons ordinarily exercise in their own affairs. A personal representative who fails to use common skill and ordinary business caution may be held liable for losses to the estate which result therefrom.[5]

B. Fiduciary Duty as it Relates to a Business

If a business interest is part of the estate, the personal representative is under no duty to carry on a business conducted by the decedent. To the contrary, a personal representative may actually be held to have breached his or her fiduciary duty, if he or she continues to operate a trade or business on behalf of an estate in the absence of testamentary direction, court order, or the consent of all interested persons. If he does so, he or she will be liable for any loss thereby resulting to the estate.

In fact as a general rule, the executor or administrator actually required to diligently liquidate the assets of the decedent's estate, including the business interest, in order to pay the debts of the decedent, and prepare the estate for distribution. This duty is subject to the limitation that the personal representative may continue operating a business of the decedent for a limited time without liability for the purpose of selling the business as a going concern or winding up the business by converting the assets into cash or performing existing contracts of the decedent.

III. Possible Conflicts of Interest

A. Overview

As discussed, the executor of an estate occupies has a fiduciary duty in relation to the estate, but if a business interest makes up part of the estate, the executor may also have other fiduciary duties which may conflict. For example, the majority shareholders of a corporation, as well as its officers and directors, also have a fiduciary duty to those holding minority interests. In this section we discuss those possibilities for conflict.

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[4] In re Wallis' Estate, 421 Pa. 104, 218 A.2d 732 (1966); Miller's Estate, 345 Pa. 91, 26 A.2d 320 (1942).

[5] Miller's Estate, supra; Istocin's Estate, 126 Pa.Super. 158, 190 A. 382 (1937). See also 33 C.J.S. § 184; 31 Am.Jur.2d, Executors and Administrators, §§ 216-218. Cf. Scott on Trusts, Vol. 2, § 201 et seq. (1939); Restatement of Trusts 2nd § 205 (1959).

B. Corporations

1. Majority Shareholders

Ordinarily, the will of the majority of the stockholders should be the controlling factor in determining when the property of a solvent corporation is to be sold. For example, minority stockholders cannot prevent a sale of the corporate assets, even in the case of a solvent corporation, unless there is fraud or collusion. On the other hand, majority stockholders occupy a quasi-fiduciary relation toward the minority stockholders, and may not, as against minority stockholders, dissipate or waste the corporate funds, or fraudulently dispose of them in any way. Also, the majority stockholders of a solvent corporation cannot hold the corporate property from the market indefinitely when they do not intend to carry out the corporate business; yet the minority stockholders cannot insist on a sale of the corporate property when the fair value thereof cannot be obtained.

2. Officers and Directors

a. Directors

A director of a domestic corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he or she may serve, in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

b. Officers

Except as otherwise provided in the articles, an officer shall perform his or her duties as an officer in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances. A person who so performs his duties shall not be liable by reason of having been an officer of the corporation.

C. Partnerships

Partners stand in a fiduciary relationship to each other, each being under a duty to act for the benefit of all.

D. Limited Liability Companies

Members acting as Managers of a limited liability company act in a fiduciary capacity.

IV. Authority of the Executor

A. Overview

An executor holds the powers conferred by the terms of the will, by statute, and the common law. A authority or power differs from a duty. As discussed above, a duty imposes an obligation or a mandatory prohibition. A power, on the other hand, empowers the executor to do something. The authority of the executor are discussed in this section.

B. Authority to Incorporate

After giving due regard to the provisions of the will and any other factor that the court deems relevant, under PEF Code sec. 3315, the court may authorize the personal representative to organize a corporation, or form a partnership, limited liability company or other entity, to carry on the business of the estate. In addition, the court may authorize the personal representative to invest property of the estate in the corporation, partnership, limited liability company or other entity.

C. Authority to Manage the Business

1. Overview

If it is intended that the business is to be managed by the executor during the period that the estate is being administered it is good practice to authorize such activity by the executor in the will and also obtain a court order.

2. Will Provisions

Where a will provides that it shall be discretionary with the executor and his or her successors as to whether the testator's business shall be continued, power is conferred on the executor to carry on the business and also to subject the assets of the estate to debts contracted for that purpose. The representative cannot be surcharged for making substantial expenditures if such are made in good faith and with reasonable care. Even in this case however, clear language is necessary to subject the general assets of the estate to liabilities for debts contracted in a business and continued by the representative. A mere direction that the business is to continue or that capital is to remain therein has been held insufficient.

3. Court Authorization

The PEF Code in 20 Pa.C.S. § 3314, provides that the court may authorize the personal representative to continue any business *giving due regard to the provisions of the governing instrument* and any other factor that the court deems relevant aided by the report of a master if necessary. Under Sec 3314, the order may authorize:

– The conduct of business, by the personal representative alone or jointly with others, or, unless restricted by the terms of the governing instrument, as a corporation, partnership, limited liability company or other entity to be formed;

– The extent of the liability of the estate or any part thereof, or of the personal representative, for obligations incurred in the continuation of the business;

– Whether liabilities incurred in the conduct of the business are to be chargeable solely to the part of the estate set aside for use in the business or to the estate as a whole;

– The period of time the business may be conducted.

– The compensation of a personal representative actively managing, supervising or engaging in the operation of an entity or business, from the estate's assets or from the entity or business, as appropriate, provided that the compensation is reasonably based upon the actual responsibilities assumed and performed; and

– Such other regulations, including accountings, as the court shall deem advisable.

4. Unauthorized Carrying On of the Business

Unless the will expressly authorizes the carrying on of the decedent's business or such continuation of the business is authorized by an order of the court, neither an executor nor an administrator has any power to continue the estate of the decedent in the trade or business enterprise engaged in by decedent at the time of his or her death, except for the purpose of disposing of the stock in trade in order to settle the estate, or of disposing of the business of a going concern. The representative is obligated, if without testamentary or judicial authority, to liquidate the business of the decedent and pay the debts.

Unauthorized conduct of business by a personal representative is a breach of trust whether it be a continuance of the decedent's sole business or one in which the representative has been a partner. Such conduct cannot, in the absence of authority, and renders the representative liable for losses resulting from prolongation of the period of the distribution of the estate, as well as making it necessary for the personal representative who continues the business at a profit, but without authorization, to account for or be surcharged with all the profit, although the representative is entitled to credit for the expenses of operation. However, there will be no surcharge for the unauthorized carrying on of a testator's business where the heir's consent.

5. Liability of Personal Representative on Contracts.

The PEF Code provides in sec. 3331, that unless he or she expressly contracts otherwise, in writing, a personal representative is not personally liable on any written contract which is within his or her authority as personal representative, provided he or she disclosed that he or she is contracting as personal representative of a named estate. The section goes on to provide that any action on such a contract shall be brought against the personal representative in his or her fiduciary capacity only, and execution upon any judgment obtained therein shall be had only against property of the estate.

D. Authority to Liquidate or Sell the Business

1. In General

If the liquidation or sale of the business interest is being considered the power should be granted to the personal representative in the will. Under PEF Code § 3354, a power in the governing instrument to sell, pledge, mortgage, lease, or exchange, or to grant an option for a purchase, lease, or exchange of property may be exercised without court approval, and is deemed to include the power to sell at public or private sale or to pledge or mortgage for any purpose of administration or distribution. In the case of personal property this is true even if the property is specifically bequeathed.[6] A private sale may be made, with court approval even though the governing instrument has directed a public sale.

2. Authority to Sell or Liquidate

It should also be kept in mind that if the sale or liquidation of the business is contemplated, will provisions which empower the executor to sell or liquidate the business may not be sufficient to actually effectuate the transaction. The sale or liquidation must also be properly approved as

[6] Unless provided otherwise by will, the personal representative may sell, without court order real property of the decedent unless it has not been specifically devised

provided for in the relevant governance documents, or where applicable the Pennsylvania Business Law.[7]

Even when the personal representative is not authorized by the PEF Code or the terms of the will, if any, or when it is advisable that a sale have the effect of a judicial sale, the executor may sell any real or personal property of the decedent, including property specifically devised, at public or private sale, under an order of the Orphans' Court, whenever the court finds such sale or other transaction to be desirable for the proper administration and distribution of the estate

V. Business Executor.

The question of whether to sell or manage a business held in an estate can be intimidating for an executor. This is particularly true if the appointed executor lacks the requisite skill set to effectuate a sale at fair market value or manage business during the period of estate administration. Therefore, in any estate which holds a business as an asset, consideration should be given to appointing a business executor who is solely responsible for the business intertest. Ideally this should be someone who familiar with the business and has the background and experience to properly manage that business.

VI. Dealing with Liquidity Issues

A. The Irrevocable Insurance Trust

1. The irrevocable insurance trust or "ILIT" can prove a valuable estate planning tool and a source of funding for estate taxes and other costs of s dying. If properly structured, the ILIT can effectively remove life insurance form an insured's taxable estate with very little or no gift tax consequence.

2. If an individual dies owning the incidents of ownership on a life insurance policy, the face value of the policy is fully includable in their federal gross estate.

3. As an alternative to naming one or more individuals or the insured's estate as the beneficiary of the life insurance policy, consideration should be given to having the policy owned by an irrevocable life insurance trust.

4. An individual who already owns a life insurance policy may transfer that policy to an inter vivos trust or, if an individual has not already acquired a policy, he or she could create a trust and have the trustee acquire one or more policies on his or her life.

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[7] General Partnerships - In general, every partner is an agent of the partnership for the purpose of its business, and any act of a partner, including execution of any instrument in the partnership name, that is apparently for the transaction of partnership business in the usual manner generally binds the partnership.
Limited Partnership - Except as otherwise provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners. A limited partnership may be dissolved in the event of the death of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so.
Limited Liability Companies - Except vested in a manager in the certificate of organization, management of the business and affairs of a limited liability company shall be vested in its members.

5. Under either scenario, the life insurance policy will be the property of the trust.

6. The trust will be both the owner of the life insurance policy and the beneficiary of the proceeds, and therefore it will not be taxed as part of the insured estate.

7. In the case of an existing policy, this does require that the transferor survives for three years after the transfer. From a gift tax point of view, the transfer of the policy is generally a taxable gift, but its value is based on the cash surrender value of the policy and not is face value.

8. The trust instrument then designates the intended beneficiaries of the policy and the nature and extent of their interests in the proceeds. This allows the insured to control the use and enjoyment of the funds through the trust.

B. Corporate §303 Stock Redemptions

1. Purpose of Special Redemption Treatment

Under a stock redemption agreement effective as of death, all the corporate shares held by the decedent would be redeemed and a complete termination would occur for purposes of enabling capital gains tax treatment of the sales proceeds received. Since the tax basis for the redeemed shares will have been stepped up to fair market value at death, no gain would ordinarily be realized under these circumstances. The decedent shareholder's heirs may wish, however, to retain the decedent's shares and, consequently, a stock purchase agreement would not have been implemented by the decedent.

In this situation, IRC §303 could be a valuable post-mortem estate planning mechanism to permit a tax preferred corporate stock redemption of a sufficient number of shares to obtain adequate cash to satisfy tax liabilities of the estate and to pay funeral and administration expenses. Section 303 was enacted to enable an estate to avoid ordinary dividend treatment otherwise applicable upon the redemption of only that stock necessary to amass these funds.

The tax basis for the stock redeemed will be its estate tax basis as determined under §1014. Therefore, notwithstanding that the redemption transaction is a sale for federal income tax purposes, if the stock is redeemed at its estate tax value, no actual gain or loss is realized for income tax purposes.

2. Structure of §303

a. Mathematical Tests

To be eligible for §303 capital gains redemption treatment, the value of the decedent's stock of the closely held corporation held at death must exceed 35% of the value of his or her adjusted gross estate. For purposes of this eligibility rule, the stock of two or more corporations can be treated as the stock of a single corporation if 20% or more in value of the outstanding stock of each such corporation is included in determining the value of the decedent's gross estate. For purposes of the 20% test, if the decedent and the surviving spouse hold stock as community property, the surviving spouse's interest in stock is treated as having been included in determining the value of the decedent's gross estate. Only the value of stock of each redeeming corporation owned directly by the decedent at the date of his or her death and included in his or her gross estate can be considered (except for the community property exception) in determining whether the percentage requirements have been satisfied.

b. Limitation on Redemption Amount

Section 303 eligibility is available only to the extent of the total amount of: (a) estate, inheritance, legacy, and succession taxes; and (b) the funeral and administration expenses allowable as deductions to the estate.

c. Parties Eligible to Use §303

A redemption under §303 qualifies for sale or exchange treatment only to the extent that the interest of the shareholder is reduced either directly (or through a binding obligation to contribute) by any payment of an amount relating to death taxes or §2053 deductions. Consequently, sale or exchange treatment is designed to be available under §303 only when the party whose shares are redeemed has an actual liability for death taxes or funeral or administration expenses in an amount at least equal to the amount of the stock redemption proceeds. Consequently, stock used to satisfy the marital deduction bequest would ordinarily not be eligible for a §303 redemption since, if the tax allocation provision is properly constructed, the marital deduction gift should bear no responsibility for these taxes. In the preparation of a will where the estate may want or need to use a §303 redemption after death to obtain funds, planners should give careful consideration to the potential allocation of taxes under state and federal law, as well as the tax clause under the will, so that §303 is actually available.

d. Time Limitations

A stock redemption, to qualify under §303, must be made after the death of the decedent and

– Before the expiration of the three-year period of the statute of limitations for assessing an estate tax deficiency or within 90 days after the running of the three-year period of the statute of limitations;

– If a petition has been filed in the U.S. Tax Court, within 60 days after the decision of the Tax Court becomes final; or

– Before the due date of the last installment, where an election to defer payment has been made under §6166.

The objective of this additional time provision is to more closely correlate the rules of §303 and the extended estate tax payment provisions. For any redemptions made more than four years after the decedent's death, sale or exchange treatment is available, however, only for a distribution in an amount which is the lesser of:

– The amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution, or

– The aggregate of these amounts that are paid within one year after the distribution.

3. Planning Opportunities

The estate planner will want to assure that a client's estate will satisfy the percentage requirements of §303 if a client holds a sizable block (or blocks) of stock in a corporation (or corporations). The following planning possibilities should be examined in this context:

- Opportunities for §303 qualification can be improved by gifts of other property that will thereby produce an increase in the percentage of the total estate consisting of the closely held business stock.
- Opportunities for qualification can be improved by the contribution of non-business assets into the corporation.
- Where a client holds the stock of several companies, but does not satisfy the 20% control test with respect to one of the corporations, a personal holding company (holding the stock of those several corporations) might be created to enable satisfaction of the percentage tests.
- If the client's stock interest is only slightly more than a majority (e.g., 51%), and the client's children wish to retain control after the client's death, the corporation might recapitalize itself through the issuance of preferred stock. After death, the client's stock can be the subject of a §303 redemption without any loss of voting control occurring.
- A slightly higher value for the closely held stock could be reported on the estate tax return than would otherwise normally be reported, so as to permit §303 qualification.
- If the corporation does not have sufficient liquid assets within the time limitation to complete a §303 redemption and the estate has not made a §6166 election, the executor could exchange the stock in the redemption transaction for the corporation's promissory installment note.

C. Estate Tax Deferral – Sec 6166

1. Overview.

a. Section 6166 provides for an extension of time for the payment of estate tax where an estate consists of a specified percentage of one or more interests in a closely held business.

b. The payment of estate tax can be deferred for as long as 14 years from the date the estate tax return is due to be filed if the benefits of Section 6166 are elected in a timely manner by the taxpayer and the IRS approves the election.

2. Requirements of Section 6166.

a. If the gross estate of a U.S. citizen or resident includes an interest in a closely held business valued at more than 35% of the adjusted gross estate, the executor may elect to pay part or all of the estate tax in two or more (but not more than 10) equal installments. 26 U.S.C. §6166(a)(1). The "adjusted gross estate" is the value of the decedent's gross estate reduced by deductions allowable under §2053 and §2054 of the Internal Revenue Code. Interests in two or more "closely held business" may be combined and treated as a single business interest for the purposes of the 35% test if at least 20% of the total value of each business is included in the decedent's gross estate. Section 6166(c).

b. In general, such an estate may defer that portion of the estate tax, as reduced by the credits against the estate tax, in proportion that the amount of the interest in the closely held business bears to the adjusted gross estate. The first installment payment of estate tax may be made on or before a date selected by the executor; however, the date selected cannot be more than 5 years after the due date for the payment of estate tax.

c. Each succeeding installment payment must be made on or before the next anniversary of the initial payment date selected by the executor. The deferred estate tax can always be prepaid without penalty at any time before it is due. However, if an election is made for a period that is less than the maximum allowable deferral period, a longer period cannot be elected after the election has passed.

d. The estate's payment of the first required installment five years after the decedent's death is allocated proportionately in the following order: (1) first to the required installments of deferred tax; (2) next to the interest on the deferred tax; and (3) finally to any unpaid balance of deferred tax. An election under Section 6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions.

e. If an election was made under Section 6166(a) to pay estate tax in installments and a deficiency is later assessed, under Section 6166(e) that part of the deficiency attributable to the closely held business interest qualifying for Section 6166 deferral is payable pro rata with the installments of the estate tax that has not then been paid on the respective due dates of such installments. Section 6166(e) only applies if the deficiency is not due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.

f. Section 6166(g) sets forth the rules for determining when an estate forfeits the right to continue to defer the payment of estate tax under Section 6166. There are four situations that can accelerate the deferred obligation of an estate to pay estate taxes. These situations are: (1) a disposition of the business interest or a withdrawal of funds from the business; (2) a distribution of insufficient income by the estate; (3) a default in the payment of installment amounts or interest; and (4) a violation of a lien condition under Section 6324A. Section 6166(g).

g. If an executor did not previously make an election under Section 6166, but the estate qualifies under Section 6166 after a deficiency in the estate tax is assessed, the executor may elect to pay the deficiency in installments under Section 6166(h)(1). Section 6166(h) only applies if the deficiency is not due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax. This election must be made no later than sixty days (60) after a notice and demand for payment of the deficiency has been issued.

3. The "Closely Held Business" Requirement Under Section 6166(b)(1)

a. Under Section 6166(b)(1), "closely held business" is defined as (i) an interest in a trade or business carried on as a sole proprietorship; (ii) an interest in a partnership carrying on a trade or business if either the partnership has 45 or fewer partners or 20% or more of the total capital interest in the partnership is included in the decedent's gross estate; or (iii) an interest in a corporation carrying on a trade or business if either the corporation has 45 or fewer shareholders or 20% or more in value is included in the decedent's gross estate.

b. Section 6166(b)(1). The business interest does not have to be included in the probate assets to qualify for Section 6166.

4. The "Trade or Business" Requirement Under Section 6166(b)(1)

a. As stated above, the definition of "closely held business" includes a requirement that the partnership, corporation or sole proprietorship carry on a "trade or business." Section 6166(b)(1).

b. There is no definition of "trade or business" in Section 6166. However, "passive investments", as defined under Section 6166(b)(9)(B), will not qualify as a business. Here, Section 6166 is interpreted to mean that for an interest in a business to qualify as interest in a closely held business, the decedent must conduct an active trade or business, or must hold an interest in a partnership, limited liability company, or corporation that itself carries on an active trade or business

c. To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the IRS will consider all the facts and circumstances, including the activities of agents and employees, the activities of the management companies or other third parties, and the decedent's ownership interest in any management company or other third party.

d. In Revenue Ruling 2006-34 ("Rev. Rul. 2006-34"), the IRS stated that it will consider the following non-exclusive factors in determining whether the decedent's interest in real estate was an active trade or business immediately before his death: (1) the amount of time devoted to the trade or business; (2) whether an office was maintained during regular business hours; (3) involvement in finding new tenants and negotiating leases; (4) the provision of landscaping, grounds care, and other services; (5) involvement in repairs and maintenance; and (6) handling tenant repair requests and complaints.

e. The IRS indicated that, in evaluating these factors, it would look to the involvement of the decedent, as well as that of the employees and agents of the decedent and any management company. Rev. Rul. 2006-34. No single factor is dispositive of whether a decedent’s activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166.Rev. Rul. 2006-34.

f. Rev. Rul. 2006-34 also contains five hypothetical situations that are used to illustrate the use of the guidelines. In Situation 2, the IRS determined that the decedent was not carrying on an active trade or business with respect to a small office park, because all services to the tenants were provided by a management company in which the decedent had no ownership interest.

g. In the other four situations, the IRS concluded that the decedent had been carrying on an active trade or business, because the services to tenants were provided by the decedent or by the employees and agents of entities in which he had a 20% or greater ownership interest. Rev. Rul. 2006-34.

h. No single factor is dispositive of whether a decedent's activities respecting the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business under Section 6166.

5. Making the Section 6166 Election

a. In order to make a Section 6166 election, the individual preparing the estate tax return may check "Yes" on line 3 of Part 3 of IRS Form 706. Attached to the timely filed Form 706 must be a notice of election containing the following information: (1) the decedent's name and taxpayer identification number as each appears on the Estate Tax Return; (2) the amount of the estate tax to be paid in installments;(3) the date selected for the payment of the first installment;(4) the number of annual installments, including the first installment, in which tax is to be paid; (5)the property shown on the estate tax return that constitutes a closely held business, identified by schedule and item number; and (6) the facts that serve as the basis for executor's conclusion that the estate qualifies for payment of the estate tax in installments.

b. An election under Section 6166 must be made no later than the date prescribed by §6075(a) for filing the estate tax return, including extensions. In many estates consisting of closely held business interests, an executor will not know if the IRS will accept the valuations originally set forth in an estate tax return.

c. These returns typically have a high probability of audit because such estates consist of substantial interests in one or more closely held businesses. Any adjustment by the IRS in the value originally reported on an estate tax return could affect the ability of an estate to qualify for Section 6166 deferral. Thus, if the IRS increases the value of a closely held business interest it will increase the likelihood that the interest will qualify under the 35% of adjusted gross estate limitation previously discussed.

d. On the other hand, if the IRS includes assets in an estate not included by the executor, such as a transfer with certain retained interests (under Sections 2036-2038), it could decrease the likelihood that the closely held business interest will meet the threshold 35% limitation. Similarly, an adjustment in the value of another asset in an estate, such as an interest in a limited partnership consisting of marketable securities and cash, could also decrease the likelihood that a closely held business interest will meet the threshold 35% limitation.

e. Therefore, an executor may make a protective election to defer estate tax payments under Section 6166 if the values originally reported on an estate tax return do not qualify under the threshold 35% limitation or the estate tax return as originally filed shows that no tax is due.

f. The IRS decides in examination whether an election meets the requirements of Section 6166. An executor will be notified of a determination only if an election is not accepted by the IRS. If the election is rejected, the executor may request consideration by the Appeals Office. The appellate determination will be regarded as the IRS's final decision.

g. While the election is under consideration in examination of Appeals, an executor may request that the case be referred to the National Office for technical advice, either because a lack of uniformity exists as to the disposition of the issue or the issue is so unusual or complex as to warrant review by the National Office.

D. Other Means of Deferral

1. IRC. Sec. 6161

a. The IRS can exercise discretion in permitting the deferral of estate tax liabilities in circumstances that do not qualify for postponement under the elective provisions described above. The IRS can extend the time for paying the tax for a “reasonable period” not to exceed 12 months.

b. The effect of a 12-month extension is to make the tax due 21 months after death. Upon the expiration of the extension period, the estate may apply for another extension. The IRS can grant an extension of the time to pay estate taxes for up to 10 years if “reasonable cause” exists.

c. Reasonable cause might exist, for example, because estate assets cannot produce sufficient present cash to pay estate tax liabilities and a significant economic loss would be inflicted on the estate if these assets were required to be sold at distress prices.

d. The assets might be located in several different jurisdictions and not be otherwise immediately subject to the control of the executor. Alternatively, a claim to substantial assets might not be collectible without litigation, thereby postponing liquidity in the estate and the availability of cash for estate tax payments. The Service will want to examine all the relevant facts and circumstances to verify that reasonable cause does exist for a payment extension.

2. Reversions and Remainders

a. An extension of the time for the payment of estate tax attributable to inclusion of the value of a reversionary or remainder interest in property is available.

b. The right to elect this tax payment extension is limited to reversionary and remainder interests. It does not apply, for example, to any post-mortem installment payments of deferred compensation (although the same policy considerations would seem to be pertinent).

c. At the election of the executor, the estate tax payment can be postponed until six months after the precedent interest in property is terminated. The postponement is limited to the estate tax attributable to the interest in the property. A further deferral is permitted for no more than three years.

UNIT SEVEN - WILL PROVISIONS

I. Overview

If this Unit we will discuss the necessary provisions which should be included in the will of the owner in terms of disposition and administration of the ownership in the estate. Also included are certain additional provisions which should be considered.

II. Dispositional Provisions

A. Overview

1. In General

a. If the owner has determined that the business interest is to be given to a particular individual, or trust, at the time of his or her death it is recommended that the gift be specifically provided in the will.

b. Making a specific gift of the ownership interest is important for the following reasons:

- A specific gift makes the intensions of the testator clear
- A specific gift is the last to abate
- In the gift adeems the heir is entitled to the proceeds
- A specific gift is not reduced by taxes and administrative expenses
- A specific gift does not carry out DNI

2. Intentions of the Testator

a. If the business interest is disposed of as a part of a residuary gift, absent an expression of a different intention expressed in the will, each residuary beneficiary will be entitled to an equal share of the ownership interest.

b. Making a specific gift of the ownership interest will serve to make the intentions of the testator clear regarding how and to who the ownership interest is to be disposed of in the estate.

c. An alternative would be for the will to provide that the executor is directed to allocate the ownership interest to a particular share of the residue.

3. Anti-lapse

a. At common law, in absence of a contrary provision, a legacy to one dying in the lifetime of the testator lapsed.

b. 20 Pa.C.S. § 2514 (9) provides certain exceptions. A devise or bequest to a child or other issue of the testator or to a brother or sister or to a child of his or her brother or sister, whether designated by name or as one of a class, does not lapse if the beneficiary fails to survive the testator and leaves issue surviving the testator, but passes to such surviving issue.

4. Ademption -

a. A specific testamentary gift "adeems" when the thing given is not a part of the testator's estate at the time of his or her death, whether sold, exchanged or converted into another form.

b. This means if the property specifically gifted doesn't exist in the estate the gift will lapse.

c. There are exceptions.

(1) A bequest of securities described by the corporation or obligor, or by value or quantity, but not indicating any specifics, will ordinarily be considered a general legacy.

(a) In the absence of any indication of an intent to the contrary, a bequest of securities described by the corporation or obligor, or by value or quantity, but not indicating any specific lot, is considered a general legacy.`

(b) If the bequest is determined to be a general one, the court will award the legatee a sum in cash equal to the present redemption value of the securities.

(2) Pursuant to 20 Pa.C.S. § 2514(17) provides:

"*Change in securities. — If the testator intended a specific bequest of securities owned by him at the time of the execution of his will, rather than the equivalent value thereof, the legatee is entitled only to:*

(i) as much of those securities as formed a part of the testator's estate at the time of his death;

(ii) any additional or other securities issued by the same entity thereon and owned by the testator by reason of a stock dividend, stock split or other action by the entity, excluding any acquired by exercise of purchase options for more than a fractional share; and

(iii) securities of another entity received thereon or in exchange therefor and owned by the testator as a result of a merger, consolidation or reorganization of the entity or other similar change.

(3) Pursuant to 20 Pa.C.S. § 2514(18), unless the will provides otherwise, if an assets specifically bequeathed is any balance of the purchase price or balance of property to be received in exchange, together with any security interest, owing from a purchaser to the testator at his death by reason of a sale or exchange of the property by the testator.

d. As a result it is important when drafting the testamentary gift of an ownership interest in a closely held business to make the intentions of the owner know as to whether the gift will lapse if the ownership interest is not held by the estate. See discussion below.

5. Abatement -

a. “Abatement” refers to the use of property otherwise gifted under the will to satisfy the debts and expenses of the administration of the estate.

b. Except as provide in the will, specific gifts are the last to “abate”, if the assets are insufficient to pay the debts and expenses and fund testamentary gifts.

c. Under 20 Pa.C.S. § 3541, the shares of distributes, are reduced or “abated” in the following order:

- Property not disposed of by the will.
- Property devised or bequeathed in a residuary clause.
- Property disposed of by general devise or bequest and not included in a residuary clause.
- Property disposed of by will in the form of a general bequest of cash, stocks or bonds.
- Property specifically devised or bequeathed to or for the benefit of other distributees.
- Property specifically devised or bequeathed to or for the benefit of the decedent’s issue.
- Property specifically devised or bequeathed to or for the benefit of the surviving spouse.

6. Impact Taxes and Administration Expenses

Another reason to provide for a specific gift of the ownership interest is to avoid having the burden of administration expenses or death taxes falling on the interest. A specific gift is generally not reduced by taxes and administrative expenses. Absent a will provisions providing a different allocation, the residuary estate funds such expenditures.

7. Distributable Net Income

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under section 661 and is not included in the gross income of a beneficiary under section 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.

B. Specific Gift of the Business Interest

1. In General

In drafting a will provisions disposing of an interest in ownership interest in a closely held business the scrivener should take into account the following general drafting principles:

a. Identify the Property

Identify the nature of the ownership interest in precise terms. Remember in the absence of any indication of an intent to the contrary, a bequest of securities described by the corporation or obligor, or by value or quantity, but not indicating any specifics, may be considered a general legacy.`

b. Provide for What Happens if the Property Doesn't Exist

Indicate the testator's intentions in regard to what happens if the ownership interest gifted changes it form because of the reason of a stock dividend, stock split or other action by the entity, or as a result of a merger, consolidation or reorganization of the entity or other similar change. Even though the PEF provides for these changes in circumstances, the testator may wish a different result.

c. Provide for What Happens if the Heir Predeceases the Testator

Never allow the provisions of the Ant-lapse statute apply. Rather ask the testator what happens if the named beneficiary does not survive the testator, and express that intent. This is particularly important when disposing of an interest in a closely-held business.

For example, instead of *"I give 1,000 shares of ABC, Inc. to my son, John", provide "I give 1,000 shares of ABC, Inc. to my son, John, if he survives me, otherwise this gift shall lapse." Alternatively, "I give 1,000 shares of ABC, Inc. to my son, John, if he survives me; otherwise to my daughter, Mary."*

2. Sole Proprietorship

A specific gift of a business operated as a sole proprietorship is generally intended to pass the business as a going concern. Since the assets which make up that concern are owned by the testator individually it is important to specifically identify those assets which are to be considered a part of that going concern. This is particularly important if some of those assets, for example a truck or service vehicle, are used both personally and in the business. Therefore it is recommended that all tangible personal property and real property that is to pass with the business should be specifically set forth either in the will itself or in a schedule to be incorporated into the will by reference. If the property is encumbered, it should also be provided as to whether to debt giving rise to the lien is to be paid by the estate from other property, or whether it is to pass subject to the lien.

"I give my son, Robert Doe all of my interest in that certain business known as "John Doe & Sons", the principal office of which is located at 1234 Main Street, Media, Pennsylvania. This gift includes all of the property, tangible or intangible, used in connection with the business, including, without limitation, the good will, accounts receivable, inventory, machinery, furniture and fixtures, real property, contracts, and all other kinds of property, tangible or intangible, used as part of that business and the enterprises connected with it. It also includes all insurance on the business property and the proceeds, if any, from all insurance if there is a claim against that insurance at the time of my death.

This gift does not include any property of any kind or nature that is not used in connection with the business.

If my son, Robert Doe does not survive me, I direct my executor to liquidate this business, and all net proceeds of sale, after paying all claims and obligations allowed against my estate on account of this business, shall become part of my residuary estate."

3. General Partnership Interest in a General Partnership

As discussed, in a General Partnership, the remaining partners have the option to either to wind up the partnership and distribute the net liquidation proceeds to the partners, including the deceased partner, or continue the partnership and buy out the interest of the deceased general partner. There is also the possibility that the partnership agreement will allow partnership interest to be transferred or provides for a buy out of the interest which is different than the statutory scheme. In any case the gift should make clear whether the gift is limited to the interest or includes the liquidation or buy out proceeds.

> *"I give to my son, Edward Moran, all of my interest under an agreement executed January 1, 2006 as a partner in the partnership known as the Land Investment Company, a Pennsylvania Partnership.*
>
> *The partnership interest that is the subject of this gift consists of: (i) the right to receive the value of my interest in this partnership, valued as of the date of my death, plus either interest or profits attributable to the use of my rights in partnership property as my executor shall elect, from a successor partnership to be formed by my surviving partners for the purpose of carrying on the partnership business, (ii) my right to a distributive share of partnership property, under the partnership agreement, after a winding up of affairs, accounting, and liquidation of the partnership business, and (iii) the proceeds of any buy out of the partnership interest.'*

4. Partnership Interest in a Limited Partnership/Membership Interest in an LLC

In the case of a general or limited partnership interest in limited partnership, or a membership interest in a limited liability company, the interest will either transfer to the heir as a transferee, the interest will be bought out pursuant to the terms of the partnership or operating agreement or in some cases the partnership or LLC may actually be wound down and liquidated. Again, the gift should make clear whether the gift is limited to the interest or includes the liquidation or buy out proceeds.

5. Shares of a Closely held Corporation.

Frequently, shares in a closely held corporation are subject to transfer restrictions arising from an agreement entered into among the shareholders alone or between the shareholders and the corporation. Under such an agreement, the other shareholders, the corporation, or both, are given an option or are required to purchase the shares of any deceased shareholder. If the shares are subject to such a restriction, the gift should provide that either the shares or the proceeds from the sale of the shares are to pass to the beneficiary.

Closely held corporations, can merge, change names, or go out of business. As noted the PEF Code provides that if a specific bequest of securities was intended and the securities are not held by the estate at the time of death, then unless the will provides otherwise, the legatee is only entitled to: (i) as much of those securities as formed a part of the testator's estate at the time of his death; (ii) any additional or other securities issued by the same entity thereon and owned by the testator by reason of a stock dividend, stock split or other action by the entity, excluding any acquired by exercise of purchase options for more than a fractional share; and (iii) securities of another entity received thereon or in exchange therefor and owned by the testator as a result of a merger, consolidation or reorganization of the entity or other similar change.

As a result, the drafter must be sure to a statement that it is the testator's intent that all indices of ownership in the corporation are to be within the scope of the gift of shares. If the corporation has more than one class of stock, the drafter must be sure that the stocks to be bequeathed has been properly identified. As noted, absence of any indication of an intent to the contrary, a bequest of securities described by the corporation or obligor, or by value or quantity, but not indicating any specifics, may be considered a general legacy.`

"I give my brother, Robert Smith all shares in ABC, Inc. that I may own or in which I may have any interest or right, legal, equitable, or otherwise, at the date of my death. If Robert Smith does not survive me, I give these shares to my sister, Mary Miller.

For the purposes of this Paragraph, the term "shares" means (1) all shares of stock of [name of corporation] of all classes, common and preferred, voting and nonvoting, together with all shares of stock that I may receive between the date of this Will and the date of my death by reason of any gifts, stock splits, or stock dividends, and (2) all shares of stock of all classes, common and preferred, voting and nonvoting, together with all shares of stock (including, without limitation, shares of stock acquired through gifts, stock splits, and stock dividends), securities, debentures, stock options, stock rights, and other evidences of debt or ownership in any firm, corporation, or other entity that is a successor in interest to [name of corporation] by reason of purchase, merger, consolidation, change of name, or otherwise. By this Paragraph, it is my intent to pass to my named beneficiary all indices of ownership, whatever the form, that I may have in ABC, Inc. or in any successor corporation at my death."

If the shares are subject to transfer restriction to a buyout agreement a clause like the following should be added:

"If my executor is required to sell or redeem any shares referred to above because of the terms of any agreement to which I am a party or by which I am bound, any beneficiary under this Paragraph shall receive the proceeds of that sale or redemption in place of these shares in ABC, Inc." Corporation."

C. Equalization Provisions

1. In general

In the event that the owners has made either an inter vivos or testamentary gift of an interest in the business, and wishes to “equalize”, other heirs who did not receive such a gift you might consider one or more of the following provisions:

2. At death of Testator under Residuary Clause of Will:

“(a) I direct my Trustee to divide the residue of my estate into shares as follows:

1. To calculate an amount (the "Augmented Residue") equal to the sum of (i) the residue of my estate and (ii) the total of all lifetime gifts of cash, stock certificates, or other property made by me after January 1, 2020 to my children as reflected by my personal financial records (the "Advancements").

2. To divide the Augmented Residue into as many equal shares as are necessary to create one share for each child of mine who survives me and each child of mine who fails to survive me but is represented by descendants who survive me.

3. To reduce each share created under Section 2 above by the amount of the total Advancements made to the child representing such share and/or such child's descendants.

4. To pay each share so calculated to the child for whom the share is created, or if such child fails to survive me, to such of the descendants of such child as survive me.”

3. At Death of Spouse under Trust:

“(a) Upon the death of my said wife [husband] and me, I direct my Trustee to divide the principal [not effectively so appointed by my said wife [husband] into shares as follows:

1. To calculate an amount (the "Augmented Principal") equal to the sum of (i) the principal passing under this subparagraph and (ii) the total of all lifetime gifts of cash, stock certificates, or other property made by me after January 1, 2020 to my children as reflected by my and/or my said wife's [husband's] personal financial records (the "Advancements").

2. To divide the Augmented Principal into as many equal shares as are necessary to create one share for each child of mine who is then living and each child of mine who is then deceased but is represented by descendants who are then living.

3. To reduce each share created under Section 2 above by the amount of the total Advancements made to the child representing such share and/or such child's descendants.

4. To pay each share so calculated to the child for whom the share is created, or if such child is not then living, to such of the descendants of such child as are then living.""

4. Deduction of specified amount.

"I direct that in the distribution of my estate, the share of my son, [S], shall be charged with an advancement of Fifty Thousand Dollars ($50,000) for funds which I have paid to him."

5. Deduction of advancements recorded in book.

"I direct that any sums, securities or other property, which I shall have advanced to or for the use of any of my sons, provided such advancement has been recorded in a record book which I shall keep with my important papers, shall be considered an advancement in calculating the distributive shares of my sons or their respective issue, at the time for distribution to them."

6. Advancements not to be considered.

I direct that any advancements which I have made to my daughters, [D1] and [D2], whether they are evidenced by mortgage, note or other form of indebtedness, shall not be considered as an asset of my estate or deducted from their respective shares.

D. Apportionment of Death Taxes

A tax allocation provision in the will acts to direct the executor in the manner in which death taxes incurred by the estate, both federal and state, are to be charged. Such a provision will insure that such taxes do not fall on the ownership interest causing such interest to be liquidated unnecessarily. The following example of a typical tax provision provides that the death taxes incurred are to be paid out of the residuary estate.

"(a) All death taxes (and interest and penalties thereon) imposed as a result of my death shall be paid out of my residuary estate."

E. Business Executor

Consider appointing an executor with the sole responsibility to manage the business during the period of estate administration.

"X. Business Executor

I appoint Joseph Smith, as my Business Executor, with all the powers provided in paragraph XI. Such powers shall be exercisable exclusively by the Business Executor, and as long as there is a Business Executor then serving, not by the Executor appointed under paragraph IX."

F. Business Powers

The power to operate the business should be provided:

"XI. Powers of the Business Executor

My Business Executor shall have the right to during the period of administration of my estate to:

A. With respect to any interest the Settlor may have at his death in any closely-held business whether as partner, stockholder or otherwise and any business with which such closely-held business may merge or consolidate, the Trustee is given the authority to deal with any business interest as freely as the Settlor could have done during his lifetime. This authority shall be subject to any Agreement binding upon this Trust which affects such interest.

B. To do anything the Trustee considers advisable with respect to the incorporation, operation or liquidation of any such business and with respect to any change in its purpose, nature or structure, including but not limited to the following:

1. To enter into partnership agreements and amendments thereto.

2. To organize a corporation, without leave of court, to carry on any business alone or with others, and to contribute all or part of the assets of such business as capital to such corporation and to accept stock in the corporation in exchange therefore.

3. To vote the shares of any closely-held corporate stock and to determine the advisability of, fix the terms of, and participate in, any corporate reorganization, merger, consolidation, dissolution, public offering, pooling of interest, exchange of stock or similar transaction.

C. To elect or employ as director, officer, employee or agent of any such business, any person, including the Trustee, or any employee of a corporate Trustee, and to delegate authority to, compensate and remove or discharge any such person.

D. To create or cause to be created within any such business such deferred compensation or other employee benefit plan as the Trustee considers advisable.

E. To extend to any employee of any such business an option to participate in the ownership thereof, or profits therefrom, upon such terms and conditions as the Trustee considers advisable.

F. To cause to be made and to consent to the making or the continuation of any loans to such business, and to pledge assets of such business as collateral therefor, with any bank or other financial institution.

G. The Trustee is hereby released from any liability for any depreciation in value or loss by reason of the retention of any such business interest except for depreciation or loss resulting from fraudulent acts of the Trustee in connection therewith."

UNIT EIGHT - THE BUSINESS AS AN ASSET OF A TRUST

I. Overview

It is a common occurrence that as the dispositional plan will provide that the business interest of the owner pass to a trust. When a business interest is held by a trust there several issues which should be addressed:

- When is there a potential for conflicts of interest?
- Does the trustee have the power to manage the business within the trust?
- Does the trustee have the requisite skill set to operate the business within the trust?
- Does the trustee have the power to sell the business within the trust?
- Under what circumstances can the trustee be surcharged?

II. The Duty of the Trustee

When a valid trust is created, the “trustee” holds legal title to the trust property but manages that property for the sole benefit of the trust beneficiary or beneficiaries. In that capacity, the trustee stands in a “fiduciary relationship” to the trust property and the trust beneficiaries. Fundamental to that fiduciary relationship is under a duty to act for the benefit of the beneficiaries within the scope of the relationship, i.e., in performing its duties the trustee is held to a “fiduciary standard” of conduct. The fiduciary standard requires a duty of loyalty and a duty of prudence – that is the trustee must act for the sole benefit of the trust beneficiaries and in a prudent manner in administering the trust.

III. Possible Conflicts of Interest

A. In General

When a busines is held by a trust there is a significant exposure to potential conflicts of interest. Particularly if the trustee has dealings with the business either in his or her role as trustee, and even in situations when the trustee is engaged in a transaction with a trust beneficiary that does not concern trust property or when a trustee usurps an opportunity belonging to the trust. The PEF Code even provides, presumably to avoid conflicts of interest, that if the trust is the sole owner of a corporation or other form of enterprise, the trustee is required to elect or appoint directors or other managers who will manage the corporation or business enterprise in the best interests of the trust beneficiaries. In this section we will review how the PEF Code addresses the potential for conflicts of interest.

B. PEF Code Provisions

1. The Duty of Loyalty

The duty of loyalty is fundamental to the fiduciary standard of conduct for trustees. Under 20 Pa.C.S. § 7772, the trustee is required to administer the trust solely in the interests of the trust beneficiaries.

2. Presumed Conflicts

As a result, 20 Pa.C.S. § 7772 provides that a sale, purchase, exchange, encumbrance or other disposition of property is presumed to be affected by a conflict between personal and fiduciary interests if it is entered into by the trustee with:

- The trustee's spouse;
- The trustee's parent or a spouse of the parent;
- A descendant of the trustee's parent or a spouse of the descendant;
- An agent of the trustee unless the trustee is a corporation and the agent is an affiliate of the corporation, or the transaction is authorized by 20 Pa.C.S. § 7209 (relating to mutual funds);
- A corporation or other person or enterprise in which the trustee or a person that owns a significant interest in the trustee has an interest that might affect the trustee's judgment, but this paragraph does not apply to an affiliate of a corporate trustee or to a transaction authorized by 20 Pa.C.S. § 7209; or
- The trustee personally.

3. Voidable Transactions

Further, a sale, purchase, exchange, encumbrance or other disposition of property between a trust and the trustee in the trustee's individual capacity or any one or more of the persons listed in the previous section is voidable by a court upon application by a beneficiary affected by the transaction unless:

- The transaction was authorized by the trust instrument;
- The transaction was approved by the court;
- The beneficiary did not commence a judicial proceeding within the time allowed by 20 Pa.C.S. § 7785 (relating to limitation of an action against trustee);
- The beneficiary consented to the trustee's conduct, ratified the transaction or released the trustee in compliance with 20 Pa.C.S. § 7789 (relating to beneficiary's consent, release or ratification); or
- The transaction involves a contract entered into or claim acquired by the trustee before the person became or contemplated becoming a trustee.

4. Transactions between trustee and beneficiary.

Under 20 Pa.C.S. § 7772(d), a transaction between a trustee and a beneficiary that does not concern trust property but that occurs during the existence of the trust or while the trustee retains significant influence over the beneficiary and from which the trustee obtains an advantage is voidable by a court upon application by the beneficiary unless the trustee establishes that the transaction was fair to the beneficiary.

5. Conflict regarding trust opportunity.

Under 20 Pa.C.S. § 7772(e), a transaction not concerning trust property in which the trustee engages in the trustee's individual capacity involves a conflict between personal and fiduciary interests if the transaction concerns an opportunity properly belonging to the trust.

6. Business Enterprises.

As provided in 20 Pa.C.S. § 7772(g), the trustee, in voting shares of stock or in exercising powers of control over similar interests in other forms of business enterprise, must act in the best interests of the beneficiaries. If the trust is the sole owner of a corporation or other form of enterprise, the trustee is required to elect or appoint directors or other managers who will manage the corporation or business enterprise in the best interests of the trust beneficiaries.

7. Permissible Transactions.

20 Pa.C.S. § 7772 does not preclude the following transactions if they are “fair” to the beneficiaries:

- An agreement between a trustee and a beneficiary relating to the appointment or compensation of the trustee;
- Payment of reasonable compensation to the trustee and payment of reasonable compensation to affiliates of a corporate trustee if the compensation is disclosed to the current beneficiaries;
- A transaction between a trust and another trust, decedent's estate or guardianship, of which the trustee is a fiduciary or in which a beneficiary has an interest;
- A deposit of trust money in a regulated financial-service institution operated by the trustee;
- An advance by the trustee of money for the protection of the trust; or
- A transaction authorized by 20 Pa.C.S. § 7209.

IV. Potential Liability of the Trustee

A. Overview

When can a Trustee be held liable. i.e., surcharged, for operating a business within a trust? One who seeks to surcharge the trustee for a breach of trust must bear the burden of proving the particulars of the trustee’s alleged wrongful conduct. The propriety of an action of the trustee must be judged as it appeared at the time it was made and not as viewed in the light of subsequent events; hindsight is not the test of liability for a surcharge. Nevertheless, a fiduciary who has negligently caused a loss to an estate may properly be surcharged for the amount of such loss. In order to sustain a surcharge action the beneficiary must prove that the trustee committed a breach of duty and that a related loss occurred, the burden shifts to the trustee to prove that the loss would have occurred in the absence of the breach of that duty.

B. Prudent Man Standard

The Uniform Trust Act requires a trustee subject to the Act to administer the trust as a prudent person would, by considering the purposes, provisions, distributional requirements, and other circumstances of the trust and by exercising reasonable care, skill, and caution. The preexisting common law requires that a trustee exercise the same measure of diligence that a man of ordinary prudence could be expected to exercise in the care of his own property under the same circumstances.

However, under both the Uniform Trust Act, and the preexisting common law, if the trustee has greater skill than that of a person of ordinary prudence, he or she is under a duty to exercise such skill as he or she has. A trustee is not an insurer of trust property or results, and all that is required of a trustee is common skill, common prudence, and common caution. However, he or she must act with the utmost good faith in administering the trust, and, in the performance of his obligations, is required to act with the highest fidelity. The duty imposed upon a trustee depends upon the facts of each particular case, and there is no standardized or inflexible rule that can be applied in all circumstances to determine the exact responsibility under various conditions. If the action of a trustee is properly questioned, he or she must sustain the burden of showing the wisdom or propriety of his or her conduct. A corporate trustee has no greater duty or responsibility than an individual acting in the same capacity.

C. Remedies for Breach of Trust

1. Standing

For an action to be brought for breach of trust, there must first be a violation by a trustee of a duty that the trustee owes to a beneficiary. Under the PUTA, only a trust beneficiary or a co-trustee, successor trustee, or other person acting on behalf of one or more beneficiaries has standing to bring an action to remedy a breach of trust.

2. Remedies

The court has a broad range of remedies available to remedy a breach of trust, including any of the following:

– Compelling the trustee to perform the trustee's duties;

– Enjoining the trustee from committing a breach of trust;

– Compelling the trustee to redress a breach of trust by paying money, restoring property, or other means;

– Ordering the trustee to account to the court;

– Appointing a special fiduciary to take possession of the trust property and administer the trust;

– Suspending or removing the trustee;

– Reducing or denying the trustee’s compensation;

– Subject to the duty of the court to protect persons who deal in good faith with the trustee, voiding an act of the trustee, imposing a lien or a constructive trust on trust property, or tracing trust property wrongfully disposed of and recovering the property or its proceeds; or

– Ordering any other relief, it deems appropriate.

D. Damages for Breach of Trust

When a trustee commits a breach of trust, the trustee may be liable in damages to the beneficiaries affected. This is sometimes referred as a "surcharge." If a loss has occurred, a court can hold the trustee liable for the amount necessary to compensate fully for the consequences of the breach. This may include recovery of lost income, capital gain, or appreciation that would have resulted from proper administration. Alternatively, the beneficiaries may affirm the transaction which caused the breach. Even if no loss has occurred, a trustee is not permitted to benefit from an improper action and may be held accountable for any profit the trustee made by reason of the breach.

E. Accountability for Profit

Even absent a breach of trust, a trustee is accountable to an affected beneficiary for any profit made by the trustee arising from the administration of the trust. Absent a breach of trust, the trustee is not liable to a beneficiary for a loss or depreciation in the value of trust property or for not having made a profit for the trust.

F. Limitation of Action Against the Trustee

Under the PUTA there are limitations to an action against a trustee.

1. Imposed by Trustee’s Written Reports

Under 20 Pa.C.S. § 7785(a)(1), a beneficiary is barred from challenging a transaction or asserting a claim against a trustee for breach of trust if:

− The trustee provided the beneficiary at least annually with periodic written financial reports concerning the trust;

− The transaction was disclosed in a report in such a periodic written report, or such report provided sufficient information so that the beneficiary knew or should have known of the potential claim or should have inquired into its existence;

− In the 30 months after the report was sent by the trustee to the beneficiary, the beneficiary did not notify the trustee in writing that the beneficiary challenges the transaction or asserts a claim and provides in writing the basis for that challenge or assertion; and

− All such reports were accompanied by a conspicuous written statement describing the effect of the requirements of 20 Pa.C.S. § 7785(a)(1).

2. Five – Year Absolute Bar

A claim not barred by 20 Pa.C.S. § 7785(a)(1) may nevertheless be barred by 20 Pa.C.S. §7785(a)(2). If the required report was sent, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:

– The removal, resignation, or death of the trustee;

– The termination of the beneficiary's interest in the trust; or

– The termination of the trust.

A beneficiary who has challenged a transaction or asserted a claim which relates to the termination of a trust may not challenge the transaction or assert the claim against the trustee in a court or an arbitration proceeding commenced more than five years after the date the trustee sent the beneficiary the reports described in 20 Pa.C.S. §7785(a)(1) The foregoing notwithstanding, such a claim is not barred if, prior to that date, the trustee has filed an account with the court or the beneficiary has petitioned the court to compel the trustee to file an account.

G. Reliance on Trust Instrument.

A trustee who acts in reasonable reliance on the "terms of the trust" as expressed in the trust instrument is not liable to a beneficiary for a breach of trust to the extent the breach resulted from that reliance. This bar to a claim based on such reliance is consistent with the principle that a trust should be administered in accordance with the settlor's intent, and protects a trustee who relies on a reasonable interpretation of the terms of the trust instrument, even if that interpretation later proves to be misplaced.

H. Exculpation of Trustee.

1. Overview

Trust provisions which attempt to relieve a trustee from liability for breach of trust are unenforceable to the extent that they:

– Relieve the trustee from liability for breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or

– Were inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.

Any exculpatory trust provision drafted by the trustee is invalid which attempts to excuse an abuse of a fiduciary or confidential relationship unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor. Even if the terms of the trust attempt to completely exculpate a trustee for the trustee's acts, the trustee must always comply with a certain minimum standard, and must always act in good faith with regard to the purposes of the trust and the interests of the beneficiaries.

In order to overcome a presumption of abuse, the trustee must establish that the clause was fair and that its existence and contents were adequately communicated to the settlor. In determining whether the clause was fair, the court may wish to examine:

– The extent of the prior relationship between the settlor and the trustee.

– Whether the settlor received independent advice.

– The sophistication of the settlor with respect to business and fiduciary matters.

– The trustee's reasons for inserting the clause; and

– The scope of the particular provision inserted.

2. Trust Provision

A provision like the following should be also considered.

“No rule of law against self dealing, divided loyalty, or conflict of interest shall be applied to render any transaction effected by the fiduciaries void, voidable, or otherwise subject to attack solely for violation of such rule, nor shall the fiduciaries incur any liability, nor shall any fiduciary's commissions for acting hereunder be reduced, solely for violation of such rule. Any transaction which involves self-dealing, divided loyalty, or conflict of interest by the fiduciaries shall be judged by the rules of law which would apply to the same transaction at arm's length between strangers free of any element of self dealing, divided loyalty, or conflict of interest. Thus, by way of illustration and not of limitation, all fiduciaries are authorized, without giving any notice required by statute, to:

(1) Employ and compensate any fiduciary or any affiliate as broker, agent, or professional advisor for any purpose.

(2) Borrow from the commercial department of any corporate fiduciary or any affiliate at current interest rates.

(3) Buy, retain, and sell any debt or equity security issued or underwritten by any corporate fiduciary or any affiliate and any debt security secured, supported, and/or otherwise enhanced by a letter of credit issued by any corporate fiduciary or any affiliate.

(4) Buy, retain, and sell any security of any investment company or trust registered under the Investment Company Act of 1940 to which any corporate fiduciary or any affiliate renders services for compensation.

(5) Buy any property from or sell property to any beneficiary or fiduciary acting hereunder or otherwise on arm's length terms.

An "affiliate" means any entity which owns, directly or indirectly, an interest in any corporate fiduciary, any entity in which any corporate fiduciary owns an interest, directly or indirectly, and any entity in common control with any corporate fiduciary.

If the trust is the sole owner of a corporation or other form of enterprise, the trustee is required to elect or appoint directors or other managers who will manage the corporation or business enterprise in the best interests of the trust beneficiaries.”

I. Beneficiary's Consent, Release, or Ratification.

A trustee is not liable to a beneficiary for breach of trust if the beneficiary consented to the conduct constituting the breach, released the trustee from liability for the breach, or ratified the transaction constituting the breach, unless:

- The consent, release, or ratification of the beneficiary was induced by improper conduct of the trustee; or
- At the time of the consent, release, or ratification, the beneficiary did not know of the beneficiary's rights or of the material facts relating to the breach.

A consent, release, or affirmance under this section may occur either before or after the approved conduct. This requires an affirmative act by the beneficiary. A failure to object is not sufficient.

J. Delegation of Operation to Others

If the trust provides that a named trustee shall hold the testator's estate, but that the someone else shall continue the operation of the testator's business, imposes the duty of operation on another party and allows the trustee no discretion therein, and the trustee is not responsible for that parties defalcations in the operation of the business.

Here is an illustrative provision, enabling such a delegation:

"The trustee shall be permitted hereunder to delegate the authority to make investments on behalf of the trust provided the trustee exercises reasonable care, skill and caution in selecting the investment agent, and in establishing the scope and specific terms of the delegation, and the further that the trustee retains responsibility for reviewing periodically the investment agent's actions in order to monitor the investment agent's performance and compliance with the scope and specific terms of the delegation. Any such investment agent so appointed shall be required to comply with the scope and terms of the delegation and must exercise reasonable care, skill, and caution."

K. Limitation on Personal Liability of Trustee.

The personal liability of the trustee is further limited under the PUTA, as follows:

- Except as otherwise provided in the contract, a trustee is not personally liable on a contract properly entered into in the trustee's fiduciary capacity in the course of administering the trust if the trustee in the contract disclosed the fiduciary capacity.
- A trustee is not personally liable for torts committed in the course of administering a trust, or for obligations arising from ownership or control of trust property, including liability for violation of environmental law unless the trustee is personally at fault.
- A claim based on a contract entered into by a trustee in the trustee's fiduciary capacity, in regard to an obligation arising from ownership or control of trust property, or on a tort committed in the course of administering a trust, may be asserted in a judicial proceeding against the trustee in the trustee's fiduciary capacity, whether or not the trustee is personally liable for the claim.

V. Trustee's Authority to Operate/Sell the Business -

A. Overview

The PEF Code provides that, except as otherwise provided in the trust instrument or in other provisions of this title, a trustee has all the powers over the trust property that an unmarried competent owner has over individually owned property and may exercise those powers without court approval from the time of creation of the trust until final distribution of the assets of the trust. Specifically, PEF Code § 7780.6.(29) provides that trustees have the power to continue or participate in the operation of any business or other enterprise and to effect incorporation, merger, consolidation, dissolution or other change in the form of the organization of the business or enterprise.

Under the common law, where authorized to do so by the instrument creating the trust, a trustee may carry on or continue a trade or business, and the power to continue a business includes the right to take any steps necessary for its preservation and continuation.

B. Trust Provisions

It should be noted that that the PEF Code provides that the trustee has the requisite power to operate a business held by a trust "…*except as otherwise provided in the trust instrument..*" However, where the trust instrument confers no authority to continue a business, a trustee may not, as a general rule, properly do so, and if such power is not given, and the trustee carries on the business, he or she is responsible for any loss to the estate occasioned thereby. To remove any doubt as to the intent of the settlor, the trust documents should also contain specific provisions empowering the trustee to continue the operation of the business within the trust.

C. Trustee's Right to Operate the Business

Here is a comprehensive provision empowering the Trustee to operate the business within the Trust:

1. Trustee's Power to Operate the Business -

"Trustee shall have the broadest authority in dealing with any business interest of settlor that may be received by it as a part of settlor's estate, including the following powers; subject, however, to any Agreement binding upon settlor or settlor's estate that affects such interest:

A. To disregard the principle of investment diversification and to retain any part or all of such interest or acquire any business interest, as long as trustee shall consider it advisable to do so, even if such interest constitutes all or a large portion of the trust;

B. To distribute any part or all of any such business interest in kind;

C. To sell any part or all of any such business interest at such time or times, to such persons for such prices, and on such terms as trustee may consider advisable;

D. To do anything that trustee may consider advisable with respect to the operation, incorporation or liquidation of any business interest and to make any changes in the purpose, nature or structure;

E. To elect or employ any director, manager, partner or employee, and to delegate authority to such person, and to pay from the income of any business adequate compensation to any such person even though he may also be a trustee or a director, officer, agent or employee of such trustee, and to pay for liability insurance for that person out of principal;

F. To make additional investments in any business of settlor's in which trustee has an interest for any purpose whatsoever, including, but not limited to, expansion and entry into new fields of business; provided that only assets actually invested in such business shall be liable for the debts incurred in its operation.

G. To make and consent to such elections with respect to an S Corporation as provided in the Internal Revenue Code of 1986 as amended, or any successor, as trustee in its absolute discretion may deem appropriate;

H. To create or cause to be created within any such business created such deferred compensation or other employee benefit plan as trustee considers advisable;

I. To enter into any shareholder agreement with respect to any S Corporation as trustee in its absolute discretion may deem appropriate, including any agreements for the holding of stock certificates by an escrow agent, the level of dividends, distributions, any restriction on transfer of any stock, or any other agreement as trustee in its discretion may deem appropriate;

D. Trustee's Authority to Sell the Business

Again, the PEF Code provides that trustees have the power to continue or participate in the operation of any business or other enterprise and to effect incorporation, merger, consolidation, dissolution or other change in the form of the organization of the business or enterprise. Specifically, PEF Code § 7780.5. provides as follows:

"(a) Exercise of power. — Except as otherwise provided in the trust instrument or in other provisions of this title, a trustee has all the powers over the trust property that an unmarried competent owner has over individually owned property and may exercise those powers without court approval from the time of creation of the trust until final distribution of the assets of the trust."

In addition, PEF Code § 7780.6, in listing illustrative powers of that a trustee may exercise pursuant to section 7780.5, provides the following:

(10) To sell or exchange any real or personal property at public or private sale, without obligation to repudiate an otherwise binding agreement in favor of better offers.

VI. Separate Trust and a Business Trustees

If a controlling interest in an operating business will be held by a trust, it is generally good idea to provide in the trust that that interest be held in trust separate from the other assets of the trust, with a trustee with the requisite expertise to manage the business. As discussed above, if the trust is the sole owner of a corporation or other form of enterprise, the trustee is required to elect or appoint directors or other managers who will manage the corporation or business enterprise in the best interests of the trust beneficiaries.

VII. Other Issues

A. Preserving the S Election

1. General Eligibility Requirements

An S corporation is a corporation that satisfies all of the requirements of §1361 and makes a §1362(a) election. The corporation must be a domestic corporation and, as required by §1361(b)(1), may not: (i) have more than 100 shareholders; (ii) have as a shareholder a person who is not an individual, an estate during the period of administration, a trust of a specified type, and (in taxable years beginning after 1997) an exempt organization of a specified type; (iii) have a nonresident alien as a shareholder; and (iv) have more than one class of stock.

These are the types eligible S corporation shareholders: (i) an individual, other than a nonresident alien; (ii) an estate during the period of administration; (iii) a qualified retirement plan trust described in §401(a) or a §501(c)(3) charity, in taxable years beginning after 1997; and (iv) certain types of trusts.

2. An Estate during the Period of Administration

Where the decedent's stock in the S corporation is properly subject to the possession of the executor or administrator of his or her estate for purposes of administration, the estate is an eligible shareholder even if under state law legal title to the stock passes directly to the legatees under the decedent's will or to his or her legal heirs.

3. Trusts as S Corporation Shareholders: Generally

Only five types of trusts are eligible S corporation shareholders: (i) a voting trust; (ii) a "grantor" trust (iii) a qualified subchapter S trust ("QSST"); (iv) a testamentary trust with respect to stock transferred to it pursuant to the terms of a will (a "will recipient trust") or (v) an electing small business trust ("ESBT").

a. A Will Recipient Trust

Under §1361(c)(2)(A)(iii), a testamentary trust can qualify as an S corporation shareholder for a period of up to two years beginning on the date it received the S corporation's stock from the decedent's estate or from an electing "qualified revocable trust".

b. Qualified Subchapter S Trusts

Under Sec. 1361(d)(3), for a trust to qualify as a QSST, its terms must require that during the life of the current income beneficiary, the trust will have only one income beneficiary; and all of the trust's accounting income must either be required by the terms of the trust instrument to be distributed, or actually be distributed, to the income beneficiary at least annually. The trustee must distribute trust accounting income directly to the beneficiary or to a custodial account for the benefit of a minor beneficiary. In addition, the trust's terms must require that corpus distributions during the current income beneficiary's life can be made only to that beneficiary; the current income beneficiary's income interest terminates at the earlier of the current beneficiary's death or the termination of the trust; and, if the trust terminates during the current income beneficiary's life, the trust's assets are all distributed to the current income beneficiary.

Under Regs. Sec. 1.1361-1(j)(3), a trust that has multiple beneficiaries can meet the QSST single-beneficiary requirement if each beneficiary has a separate and independent share of the trust, each of which is treated as a separate trust for federal income tax purposes. Spouses who are both income beneficiaries of a QSST will be treated as a single beneficiary if they are U.S. citizens or residents and they file a joint income tax return.

The trust's current income beneficiary must make the QSST election under Sec. 1361(d)(2), by filing a statement with the information and in the manner prescribed by Regs. Sec. 1.1361-1(j)(6) and Rev. Proc. 2013-30. If the S corporation transfers its stock to the QSST on or before the date the corporation makes its S election, the QSST election may be made on Part III of Form 2553, Election by a Small Business Corporation.

c. Electing Small Business Trusts

Unlike QSSTs, ESBTs may have multiple beneficiaries, and trust income can be accumulated and/or sprinkled among the multiple beneficiaries. The tax treatment of an ESBT is different from, and more complicated than, that of a QSST. An ESBT has at least two portions: an S portion consisting of the S stock, and a non-S portion consisting of all other property. An ESBT may also have a grantor portion. Different tax rules apply to each portion of an ESBT. One shortcoming of an ESBT is that its S corporation portion is subject to the highest rate of income tax on ordinary income (currently, 39.6%).

The trustee must make the election to treat a trust as an ESBT within the two-month-and-16-day period beginning on the date of the trust's receipt of the S corporation stock (see Regs. Secs. 1.1361-1(m)(2)(iii) and (j)(6)(iii)). The trustee makes the election by completing and filing the election statement described in Regs. Sec. 1.1361-1(m)(2). Where a corporation whose stock the trust holds makes an S election, the trustee must make the ESBT election within the two-month-and-16-day period beginning on the day the S election is effective.

d. Choice of Trust

The decision to elect to be a QSST or ESBT may hinge on the structure of each particular trust. Under Regs. Sec. 1.1361-1(m)(7), an ESBT may convert to a QSST and, under Regs. Sec. 1.1361-1(j)(12), a QSST may convert to an ESBT; but when making the choice between a QSST and an ESBT, the trustee must weigh tax costs of an ESBT against the benefit of its ability to accumulate income to the trust.

e. Trust Provision

A trust provision like the following will allow the trustee to allow a trust to qualify as an eligible S corporation shareholder by either making an election to have the trust treated as an Electing Small Business Trust or by creating a sub-trust which meets the requirements of a QSST.

"XII. Special Provisions for S Stock.

A. The Trustee may at any time hold stock of an S Corporation as defined in the Internal Revenue Code (hereinafter "S Stock"), make an election to have any corporation treated as an S Corporation, enter into agreements with other shareholders relating to transfers of S Stock or the management of the S Corporation, and allocate amounts received and the tax on undistributed income between income and principal.

B. The Trustee may allocate the tax deductions and credits arising from ownership of S Stock between income and principal. In making any such allocations, the Trustee shall consider that the *income beneficiary is to have the enjoyment of the property at least equal to that ordinarily associated with an income interest and in all events shall provide the required beneficial enjoyment to the income beneficiary.*

C. The Trustee may make an election to have the Trust, or any trust share provided hereunder that is eligible to make an affirmative election to be treated as an Electing Small Business Trust as defined in Sec. 1361(e)(1) of the Code.

D. Notwithstanding anything herein to the contrary, as an alternative to subparagraph C, above, the Trustee in its sole discretion may elect at any time to divide any trust hereunder which has a single income beneficiary into two separate trusts, one trust consisting of all S Stock and the other trust consisting of the remaining assets.

(1) Each such trust shall be held under the terms hereunder applicable to the trust so divided, except that (i) there shall be no power in the trust consisting of S Stock to make payments of principal during the lifetime of the income beneficiary to any person other than the person then entitled to receive the income, (ii) all income of the trust consisting of S Stock shall be paid to the income beneficiary at least annually and (iii) all income of such trust accrued or undistributed at the death of the income beneficiary shall be payable to his or her estate.

(2) The trust consisting of S Stock shall at all times have only one current beneficiary and shall not be recombined with the other trust upon the exchange of any S Stock for other assets but shall at all times after its creation permit payments of principal only to the then-current income beneficiary.

E. Except as provided in subparagraph C in regard to the Trustee's discretion to elect make an affirmative election in regard to any trust or trusty share held hereunder to be treated as Electing Small Business Trust; any provision of this Agreement which may appear to conflict with my intention that any trust containing S Stock qualify as a Qualified Subchapter S Trust as defined in Sec. 1361(d) of the Internal Revenue Code shall be construed so as to accomplish that intention.

F. If the Trustee, in the Trustee's sole discretion, determines that such intention might not be accomplished, the Trustee shall have the power to amend the trust to accomplish said intention, subject to the following conditions and limitations:

(1) No such amendment shall be made except to accomplish the intentions set forth in this subparagraph F.

(2) All such amendments shall be in the form of a decree of the court having jurisdiction over the trust, upon petition by the Trustee and after such notice to the parties in interest as such court may direct.

(3) The Trustee shall have the power to request that any such amendment take effect as of the effective date of this trust, or any subsequent date, in the Trustee's sole discretion."

B. Trust Protectors

1. Overview

The concept of the so-called “trust protector” first developed in the area of “off-shore” trusts but has been more recently been adapted for use in more conventional domestic trusts, particularly irrevocable trusts. The trust protector may be an individual or a corporation. A corporate protector might also take the form of a small, regulated trust company, or it could be a corporate protector organized by the settlor. Alternatively, or in addition, a protectorship committee staffed a combination of advisors could be appointed.

If a trust protector is contemplated in the document, the trust agreement should describe the protector's powers in detail. The “trust protector” can be granted broad or narrow authority over the trust depending on the intent and the circumstances surrounding the trust. In some cases, the protector is not empowered to take action affirmatively but is given the right to block certain acts taken, or powers exercised, by the trustee. In the other, the trust protector might be empowered to take affirmative actions, such as the right to remove and replace the trustee, consent to alter the class of beneficiaries and change the situs of the trust. The type of authority granted to the trust protector could include the following:

- The power to change trustees,
- The power to change the situs of administration,
- The power to clarify or modify trust terms for purposes,
- The power to add or eliminate beneficiaries or rearranging their rights.
- The power to approve trustee’s decisions in regard to the distribution of income or corpus.
- The power to approve trustee’s decisions in regard to the investment of trust assets.

2. Trust Provision

The following is an example of a comprehensive protector provision:

“ARTICLE IV

A. There shall be a protector of each trust created by or pursuant to this Settlement. The initial protector (herein referred to as the Protector) is Protector. If Protector fails or ceases to serve as Protector, then Successor Protector shall serve as Protector in his or her place.

B. Notwithstanding the provisions of Article VII, the Protector shall have the power from time to time and at any time by deed or other written instrument delivered to the Trustee:

1. to remove any Trustee of any trust created by or pursuant to this Settlement;

2. to appoint an additional trustee or additional trustees, whether within or without Country, as Trustee of any trust created by or pursuant to this Settlement;

3. to appoint a successor or successors to any Trustee hereof, whether within or without Country, as Trustee of any trust created by or pursuant to this Settlement (in the event any Trustee is removed, resigns, or otherwise ceases to act); and

4. to designate the law of any jurisdiction (under which the terms of any trust created by or pursuant to this Settlement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Settlement, and to declare that such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated. The Protector shall also have the power to declare that the courts of such jurisdiction may or shall become the forum for the administration of such trust. Such a designation and declaration shall be set forth in a deed or other written instrument that shall contain the powers and provisions that are necessary to enable such trust to be capable of taking effect under the laws of such jurisdiction, and that may also contain such other powers and provisions as the Protector may determine to be in the best interest of the beneficiaries, provided that such powers and provisions do not infringe upon any rule against perpetuities that is applicable to such trust.

C. The Protector shall have the power, exercisable at any time, to demand an accounting by the Trustee, setting forth the receipts, disbursements, and distributions of both principal and income during the period of accounting and the invested and uninvested principal and undistributed income that is in existence at the beginning and at the end of such accounting period."

Given the broad range of powers which are sometimes vested in the trust protector, there is a question as to how the courts will view the protector's standard of conduct in relation to the trust, the settlor, and the beneficiaries. The issue of whether the protector stands in the role of a fiduciary is an interesting one since there is very little in the way of judicial. It can be generally assumed however that a trust protector who has been granted powers normally reserved for a trustee will be treated as a fiduciary by the courts. This issue is more settled in Pennsylvania. Pennsylvania has adopted section 808 of the Uniform Trust Code in 20 Pa.C.S. § 7778(d). That section provides the following:

"A person other than a beneficiary who holds a power to direct certain actions of a trustee is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of the holder's fiduciary duty."

UNIT NINE – CONTINGENCY PLANNING

I. Overview.

A large portion of your estate is comprised of closely held business interests and partnership interests. The management and disposition of these business interests should ultimately be the subject of a plan to determine how you wish to dispose of this business property in the event of your retirement, death, or disability. The planning in regard to your business interests should be focused in two areas: Contingency Planning and Succession Planning.

A Contingency Plan is intended to provide direction as to how your business interests are to be run if you are not able to make business decisions either on a temporary or permanent basis. A Succession Plan on the other hand, is intended to be a more expansive approach than estate planning, addressing not only the question of how to reduce or avoid transfer taxes but also the questions of how, when, and to whom the business interest should be transferred. In addition, depending on the exit strategy, the question of retirement from the active participation of the business may also be a part of succession planning.

II. The Contingency Plan

A Contingency Plan is intended to provide direction as to how your business interests are to be run if you are not able to make business decisions either on a temporary or permanent basis. The Plan should cover at least for four possible contingencies:

(1) Out of the Office on a Temporary Basis – You are out of the office on a temporary basis anticipated to last no more than 30 days, and are incapable of making management decisions for 48 hours (by reason of your absence).

(2) Short Term Disability – You are out of the office on a temporary basis due to illness or short term disability anticipated to last more than 30 days, and are incapable of making management decisions for 48 hours (by reason of your condition); but it is reasonably anticipated that you will return within a reasonable period of time, but has not been deemed to be incapacitated as provided in section (4), below.

(3) Long Term Disability - It is anticipated that you, because of a physical or mental disability, will not be returning to the office on a permanent basis; but have not been deemed to be incapacitated as provided in section (4), below.

(4) Permanent Disability or Death – You have died or has been deemed to be incapacitated pursuant to a certificate executed by two (2) licensed physicians, one of whom is your personal physician, stating that you are physically or mentally incapable of managing your financial affairs.

Immediate attention should be given to the question of who should be given the authority to manage and perhaps dispose of your various business interests in the event of your death or disability. Your estate planning documents should include special provisions for these business interests. You should consider appointing: (1) a business power of attorney; (2) a business executor; and (3) a business trustee. Also, you should consider adoption of a formal Contingency Plan.

III. Business Power of Attorney

A "business power of attorney" is a legal document that appoints someone to make business decisions on your behalf. A business power of attorney should be considered separate and apart from the general power of attorney or medical power of attorney discussed previously because the person appointed should have the expertise and knowledge necessary to make business decisions in your place.

A business power of attorney can be very specific in terms of the agent's authority, and it can contain language that makes it effective only upon the occurrence of a specified event (e.g., the business owner's incapacity). As a business owner, you want to make sure that your power of attorney is extremely clear in both of these respects. You do not want your agent purporting to make decisions he or she is not authorized to make, and you do not want there to be any question as to whether and when the agent's decision will be binding. The same issue, i.e., who will manage your business interest, should also be addressed in the context of when those business interests pass through your estate and into your revocable trusts.