

Tax Management Portfolios  
Estates, Gifts and Trusts Series  
800-1st : Estate Planning

TITLE PAGE

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PORTFOLIO DESCRIPTION SHEET

## PORTFOLIO DESCRIPTION SHEET

Tax Management Portfolio, Estate Planning, No. 800, is designed as an authoritative and practical working tool for attorneys, accountants, and others involved in an estate planning practice. The basic estate, gift, and trust planning concepts are presented in a descriptive and conveniently accessible form. The topics treated include: the development of an estate planning strategy; lifetime asset transfers; property transfers at death; generation-skipping transfers; special property transfer planning considerations (e.g., community property, life insurance, charitable transfers, closely held corporations) and post-mortem planning. Other Portfolios in the Tax Management Estates, Gifts, and Trusts series provide detailed coverage of the various materials surveyed in this Portfolio. These Portfolios are identified at appropriate locations in the text.

Effective estate planning can enable a person to make lifetime and testamentary transfers of wealth to the beneficiaries of choice and, in the process, conserve capital for those recipients. Various methods can be employed to both (i) achieve the estate planning client's objectives regarding these transfers and the post-mortem management and disposition of his property and (ii) minimize income, gift and estate tax liabilities. Effective estate planning, however, requires a working knowledge of both the tax (income, estate, and gift) and nontax reasons for using traditional planning vehicles such as trusts and powers of appointment. A familiarity with various state property, trust and business laws is also essential. This Portfolio provides the practitioner with an overview of the estate planning concepts necessary in advising clients.

The planning discussed in this Portfolio is focused on the period before 2010, when the 2001 Tax Relief Act has scheduled the estate and generation-skipping transfer taxes for repeal and replacement with a new carryover basis regime. In fact, some of the discussion in this Portfolio will continue to be relevant even after 2009, given that the gift tax has not been repealed.

This Portfolio may be cited as Streng, 800 T.M., Estate Planning.

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to render gratuitous services for the duration of the estate administration. The tax results, therefore, will ultimately be determined by the timing, purpose, and effect of the waiver. [FN1781]

## E. Solving Estate Liquidity Problems

### 1. Corporate Section 303 Stock Redemptions [FN1782]

#### a. Purpose of Special Redemption Treatment

Under a stock redemption agreement effective as of death, all the corporate shares would be redeemed and a complete termination would occur for purposes of enabling capital gains treatment of the sales proceeds received. [FN1783] 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 their shares and, consequently, a stock purchase agreement would not have been implemented.

In this situation Section 303 could be a valuable post-mortem estate planning mechanism in permitting a tax preferred corporate stock redemption of a sufficient number of shares to obtain cash to satisfy tax liabilities and to meet funeral and administration expenses. [FN1784] This provision was enacted to enable an estate to avoid ordinary dividend treatment otherwise applicable upon the redemption of the stock necessary to amass these funds. [FN1785]

The tax basis for the stock redeemed will be its estate tax basis as determined under Section 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. [FN1786]

#### b. Structure of Section 303

##### (1) Mathematical Tests

To be eligible for Section 303 treatment the value of the decedent's stock of the closely held corporation held at death must exceed 35% of the value of his adjusted gross estate. [FN1787] 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. [FN1788] 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 death and included in his gross estate can be considered (except for the community property exception) in determining whether the percentage requirements have been satisfied. [FN1789]

#### (2) Limitation on Redemption Amount

Section 303 coverage is available only to the extent of the total of:

(a) Estate, inheritance, legacy, and succession taxes; [FN1790] and

(b) Funeral and administration expenses allowable as deductions to the estate. [FN1791]

#### (3) Parties Eligible to Use Section 303

A redemption under Section 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 Section 2053 deductions. [FN1792] Consequently, sale or exchange treatment is designed to be available under Section 303 only when that party whose shares are redeemed actually has a liability for death taxes or funeral or administration expenses in an amount at least equal to the amount of the redemption proceeds. [FN1793] Consequently, stock used to satisfy the marital deduction bequest would ordinarily not be available for a Section 303 redemption since, if the tax allocation provision is properly constructed, the marital deduction gift should bear no responsibility for these taxes. [FN1794] In the preparation of wills where the estate may need to use Section 303, planners should give careful consideration to the allocation of taxes under state and federal law as well as the tax clause under the will.

#### (4) Time Limitations

A redemption, to qualify under Section 303, must be made after the death of the decedent [FN1795] and

(a) 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; [FN1796]

(b) if a petition has been filed in the U.S. Tax Court, within 60 days after the decision of the Tax Court becomes final, [FN1797] or

(c) before the due date of the last installment, where an election to defer payment has been made under Section 6166. [FN1798] The objective of this additional time provision is to more closely correlate the rules of Section 303 and the extended estate tax payment provisions. [FN1799]

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:

(i) the amount of the qualifying death taxes and funeral and administration expenses which are unpaid immediately before the distribution, or

(ii) the aggregate of these amounts which are paid within one year after the distribution. [FN1800]

#### c. Planning Opportunities

The estate planner will want to assure that a client's estate will meet the percentage requirements of Section 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:

(i) Opportunities for qualification can be improved by gifts of other property which will produce an increase in the percentage of the total estate consisting of the closely held stock. [FN1801]

(ii) Opportunities for qualification can be improved by the contribution of non-business assets to the corporation. [FN1802]

(iii) Where a client holds the stock of several companies, but does not meet the 20% control test with respect to one of the corporations, a personal holding company might be created to enable satisfaction of the percentage tests.

(iv) 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, the corporation might recapitalize through the issuance of preferred stock. After death, the

client's stock can be the subject of a Section 303 redemption. [FN1803]

(v) A slightly higher value for the closely held corporation stock could be reported on the estate tax return than would otherwise normally be reported, so as to permit qualification. [FN1804]

(vi) If the corporation does not have sufficient liquid assets within the time limitation to complete a Section 303 redemption and the estate has not made a Section 6166 election, the executor could exchange the stock for the corporation's promissory installment note.

## 2. Closely Held Business -- Delayed Tax Payment [FN1805]

### a. Purpose of Tax Deferral

As a matter of elective right Section 6166 permits an extension of time for paying estate tax where the estate consists largely of an interest in a closely held business. [FN1806] The basic purpose of Section 6166 is to enable the retention of a business enterprise where the death of one of the larger owners of a business results in the imposition of a significant estate tax. Consequently, a "distress sale" of all or parts of a business is not necessary to generate sufficient funds to pay the federal estate tax liability. By extending the payment period the estate tax can often be paid from post-death earnings (i.e., dividends received by the estate). At a minimum, the heirs have more time during which to raise funds to pay the estate tax, thereby enabling retention of the business within the family group. [FN1807] The alert estate planner should recognize the possible availability of tax deferral [FN1808] and should try to posture the client's assets to assure that the statutory criteria will be met at the time of death. [FN1809]

### b. Elective Deferral

The executor of an estate which qualifies may elect to pay in up to 10 annual installments that estate tax liability attributable to an interest in a closely-held business. [FN1810] The first installment is payable no later than five years after the original due date of the estate tax return. [FN1811] During the five years after the filing of the estate tax return, the executor's obligation with respect to the deferred estate tax is limited to the payment of interest in four annual installments of the interest on that deferred tax liability. [FN1812] For estates of decedents dying before 1998, the interest charged on the first \$345,800 in estate tax (which is attributable to \$1 million in value of an interest in closely held business) is 4%. [FN1813] The 4% rate was reduced to 2% for estates of decedents dying after 1997 and the