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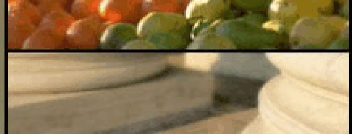

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## An Agricultural Law Research Article

# The Farm Corporation As an Estate Planning Device

by

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Originally published in NEBRASKA LAW REVIEW
54 NEB. L. REV. 217 (1975)

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By Donald H. Kelley*

# The Farm Corporation As an Estate Planning Device

*"Yesterday the farmer was a manager of labor; today he is a manager of capital."*[1]

## I. INTRODUCTION

The farmer and rancher in the United States have departed from the era when the fruits of agricultural enterprise were primarily the product of one's hands, and have entered an era of declining labor input and continually expanding employment of capital.[2] Very few agricultural units were subject to estate tax when the $60,000 federal estate tax exemption was adopted in 1942.[3] Since that time the average investment per farm in the United States has increased almost 1,000 per cent, while the exemption remains at the same level.[4] During the same period, Nebraska farm vaules have increased more than eightfold, with the compound rate of increase since 1941 exceeding seven per cent.[5]

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1. Fleming, *An Overall Look at Estate Planning*, 45 ILL. B.J. 452 (Supp. 1957).
2. Hines, *Special Problems in Planning the Agricultural Businessman's Estate*, 1973 EST. PLAN. INST. 73-11. *Contemporary Studies Project: Large Farm Estate Planning and Probate in Iowa*, 59 IOWA L. REV. 794 (1974) (a major empirical study statistically tabulating the use of various estate planning devices in the state of Iowa, and discussing their advantages and disadvantages in terms of the individual farm estate and in terms of farm economics) [hereinafter cited as *Large Farm Estates*].
3. Hopkin, *Agricultural Farm Growth and Liquidity Dimensions of Two Proposed Changes in Federal Estate Taxes*, 12, APPENDIX TO THE STATEMENT OF NATIONAL LIVESTOCK TAX COMM., COMM. ON WAYS & MEANS, U.S. CONG., March 29, 1973.
4. *Id.* Specifically, gross capital employed in United States agriculture increased from $52.9 billion in 1940 to $478.8 billion in 1974. U.S. DEP'T OF AGRICULTURE, THE FARM INDEX 16 (1974).
5. UNIV. OF NEBRASKA EXTENSION SERVICE, CORNHUSKER ECONOMICS (March 6, 1974). Land values rose an additional 28 per cent in north-

This vast increase in employed capital is the result of inflation and increased land investment.[6] Agriculture has become highly capital intensive. More and more dependence is placed on economies of size, and a climate which encourages increasingly large capital concentrations is required.

On the other hand, the average rate of return on assets invested in agriculture has been relatively low, averaging scarcely 3 per cent.[7] This is extremely low in relation to the market value of the capital assets employed in agriculture, and thus the predominant element in the increased family farm wealth has been the long run inflationary rise in land values.[8] The nature of modern agricultural activity thus subordinates present financial benefit to the growth of future capital wealth.

The income tax treatment of both agricultural income and capital enhances and exagerates this aspect of agricultural economies. The availability of cash basis income tax accounting[9] encourages the development of wealth through increased (but income tax deferred) inventories of grain or livestock, at the sacrifice of immediate spendable income. The Internal Revenue Code ("Code") provision creating a step-up in the income tax basis of property to its market value at the owner's date of death[10] provides an additional incentive for retaining property having an inflated value.

These factors reflect, and in turn are reflected by, the farm family's tendency to develop the family enterprise instead of purchas-

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ern plains states in 1974. Wall Street Journal, Dec. 16, 1974, at 26, col. 1. The 22 per cent increase in the 12 months ending November 1, 1973, was one of the sharpest rises in history. *Id.*

6. *See* Hines, *supra* note 2, at 11-2, *citing* CENTER FOR AGRICULTURAL & ECONOMIC DEVELOPMENT, U.S. AGRICULTURE IN 1980, 3 ISU 5 (1966), to the effect that "[i]t is likely that in 20 years or less, capital will represent more than 90% of all input used in U.S. farming, and labor no more than 10%."

   An example of increased land values is the development of irrigated land. From 1968 through 1972, the average yearly increase in irrigated acreage in Nebraska was 234,000 acres. U.S. DEP'T OF AGRICULTURE, NEBRASKA STATE-FEDERAL DIVISION OF AGRICULTURAL STATISTICS. Assuming an enhancement in value of only $300 per acre, the resulting increase in land values would exceed $70,000,000 a year.

7. INTERNAL REVENUE SERVICE, BUSINESS INCOME TAX RETURNS, STATISTICS OF INCOME (1965 & 1966). *See* Estate of Ethel C. Dooly, 31 CCH Tax Ct. Mem. 814, 820 (1972).
8. *See* THE FARM INDEX, *supra* note 4, showing an increase in real estate gross values from 33.6 billion in 1940 to 325.3 billion in 1974.
9. Treas. Reg. § 1.162-12 (1969). *See* Branscomb, *The Cash Method as Applied to Agriculture—A Reexamination*, 25 TAX LAWYER 125 (1971).
10. INT. REV. CODE OF 1954, § 1014(a) [hereinafter cited as CODE].

ing other need-satisfying items. The serpentine form of the federal estate tax has intruded into this delicately balanced (if not idyllic) complex of economics, tax incentives, and emotion. At former asset values, the relationship of the value to the estate tax exemption, the availability of the marital deduction,[11] and the ability to avoid capital gain once a generation[12] left little tax impact on the accumulation of capital on a multi-generational basis. However, as the impact of the estate tax has increased because of inflating asset values, the ability to preserve capital from one generation to the next is seriously jeopardized.[13] Even when the optimal sequence of deaths allows full credit for previously taxed property coming into the hands of the surviving spouse, liquidation ultimately may be required because the taxes increase more rapidly than the ability to pay them. Further, succeeding operators may have to fund legacies to absentee heirs because the parents believed these legacies necessary to assure fair treatment of their children. As a result, the farm or ranch unit which has not been organized to anticipate the problems of transfer at death tends to become overburdened with debt, sold, or drastically reduced in size with a resulting loss of economies achieved by the parents.[14] As one author has noted,

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11. CODE § 2056.
12. Gain can be avoided on operating inventory as well as capital assets. *See* note 52 and accompanying text *infra*.
13. The increasing problem of farm fragmentation, and its destructive influence on economic operation of agricultural enterprises is discussed in *Large Farm Estates, supra* note 2, at 934.
14. In a study of the impact of federal estate taxes on agriculture, Epp and Perry used a financial model based on a 330 breeding cow ranch with a gross value of $510,000 on January 1, 1973, and all ownership in joint tenancy. Even with an optimum sequence of deaths, the resulting estate tax was approximately one-fourth of the gross asset value, and the ultimate liquidation of the ranch was projected. UNIV. OF NEBRASKA DEP'T OF AGRICULTURE, THE SAND HILLS RANCH BUSINESS, 1970 and COMPARISONS WITH 1960 AND 1965 (1972). Extending this model ten years into the future, with a 7 per cent yearly increase in asset value, illustrates the rapid increase in estate taxes. In 1983 there would a gross estate of $867,000 representing a 70 per cent increase in value over the 10 years. With ever increasing inflation of operating costs, this probably does not represent a proportionate increase in income. The estate tax approximately doubles to roughly $254,000, representing 32 per cent of the family's net worth. Assuming that 25 per cent of the net worth is represented by livestock, the estate tax would require the use of all the personal property and the sale of about $50,000 of land. The need for proper estate planning is obvious. It has been noted:

    > . . . the agricultural estate planner has a special obligation to utilize those techniques for the intergenerational transfer of farm wealth which are most consistent with preserving the economies of size which are becoming essential to

"when an efficient farm unit must be liquidated to meet estate taxes, society tends to be the loser."[15]

The problems resulting from inflationary tendencies[16] are compounded by the changes in the Code made by H.R. 421, recently passed which increases the interest rate on deferred estate taxes under section 6166 and 6161 from four per cent to nine per cent effective July 1, 1975.[17]

In the present economic and tax atmosphere, incorporation of the family agricultural unit is an increasingly popular method of accomodating both death taxes and family inheritance.[18] To some degree the advantages of incorporation are inherent advantages of thoughtful organization of the agricultural business and the creation of vehicles for the ownership of agricultural assets capable of facilitating necessary estate planning transfers.[19] But certain attri-

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> survival of the family farm unit. More specifically, estate planning devices which allow transfer of farm assets without fragmenting the farm operation should be given high priority by the agricultural estate planner".

*Large Farm Estates, supra* note 2, at 934.

15. *Supra* note 3, at 12.
16. U.S. DEP'T OF AGRICULTURE, ECONOMIC RESEARCH SERVICE, NO. 242, INCREASING IMPACT OF FEDERAL ESTATE AND GIFT TAXES ON THE FARM SECTOR (July, 1973). This study shows that total death taxes as a per cent of total farm capital reached 19 per cent in 1968 for cattle ranches in the northern plains.
17. In recent years the Committee has also intensively studied consolidation of gift and estate taxes (thus effectively eliminating the advantage of lifetime gifts) and eliminating the step-up in income tax basis of assets passing through the estate. Covey, *Estate and Gift Tax Revision, Part I*, 4 TAX ADVISOR 218 (April 1973) and *Part II*, 4 TAX ADVISOR 274 (May 1973).
18. *See* Harl, *The Farm and Ranch Corporation—Business Organizational Form of the Future*, 43 NEB. L. REV., 365, 367 (1963). *See also Large Farm Estates, supra* note 2, at 799. One author has summarized the advantages of using the corporate entity as an estate planning device:

    > The corporate entity is the most protective cloak in which the farm assets can be enveloped. Most existing family farm corporations are estate-planning inspired, in the sense that they were created to facilitate the intergeneration transfer of the farm business . . . . In contrast to the partnership, the corporate farm offers much greater stability and the interests in the enterprise are more divisible than with a trust. Yet, functionally, the farm may have the same degree of control as a sole proprietorship . . . . Separate interests in the business may be transferred by a gift or the sale of stock without disturbing the working control over the operation.

    Hines, *supra* note 2, at 73-11 to -30.
19. The 1969 Census of Agriculture showed that of the 1,733,683 commercial farms in the United States, 1,480,565 were operated as sole proprietorships, 221,535 as partnerships, 19,716 as corporations with ten

butes of holding assets in the corporate form provide unique estate planning advantages unobtainable through other means of asset holding and transmission.[20]

This article will not compare the estate planning advantages of incorporation with income tax or other disadvantages of an incorporated operation. Rather, the purpose of this article is limited to an examination of the ways in which incorporation may help achieve the basic objectives of the estate planning process which may be summarized as follows:

1. Optimization of the marital deduction;
2. Reduction of the gross estate through gift-giving;
3. Reduction of asset values for the purpose of estate tax valuation;
4. Stabilization of asset values for purposes of estate tax valuation;
5. Preservation of the family operating unit;
6. Reconsolidation of operating unit ownership in the operating successors; and
7. Formulation of an effective means of estate administration and post mortem estate planning.

## II. THE CLOSE CORPORATION

To optimize the use of the close corporation, an understanding of its unique nature is necessary.[21] The close corporation is not merely a method of facilitating the holding of undivided fractional interests in the capital property of the corporation. The properly formed close or family corporation is a distinct and separate legal entity from its shareholders. The corporate assets are owned, not by the shareholders, but by the corporation.[22] The shareholders'

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or fewer shareholders, and 1,797 as corporations with more than ten shareholders. BUREAU OF THE CENSUS REPORT, 1 (May 1972) cited in Hines, *supra* n. 2, at 73-11 to -37.

20. The estate planner should be fully conversant with the capabilities of trusts, *see* Note, *Use of Intervivos Trusts in Agricultural Estate Planning,* 55 IOWA L. REV. 1328 (1970), partnerships, *see* Wright, *Estate Planning for Agricultural Interests,* 25 OKLA. L. REV. 1, 23 (1972), and family contractual relationships, *see Estate Planning Through Family Bargaining,* 8 REAL PROPERTY PROBATE & TRUST J. 223 (1973) (discussing the many types of intrafamily bargains which may be used in estate planning); Eckhardt & Allen, *Planning for the Farmer,* 3 U. ILL. L.F. 367, 393 (1963), as well as corporations, and be prepared to apply these devices imaginatively in patterns and combinations that will be most responsive to the goals and needs of the individual client.
21. *See* F. O'NEAL, CLOSE CORPORATIONS § 1.01, *et seq.* (1958).
22. C. ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES 179 (Supp. 1974).

"ownership" is only that complex of rights and duties between the shareholders *inter sese*, and the shareholders and the corporation, which is defined by the statutes and decisions of the jurisdiction where the corporate entity is formed. These rights vary depending upon the aggregate fraction of the corporate stock owned by the individual shareholder, the types and classes of corporate stock created, local law requirements relating to the stockholders' voting power in selecting management[23] and property disposition.

The above principles have been recognized in English and American common law at least since 1896 when the House of Lords decided *Salomon v. Salomon & Co.*[24] The owner of a business had incorporated, taking back certain secure debentures and all the common stock except one share each issued to his wife and children. Arguments by corporate creditors that the corporation was only a sham or Salomon's alter ego were rejected. The case held that given proper de jure formation, a distinct legal person is created by incorporation, regardless of the family relationship or mutual interdependence of the incorporators. The principles laid down by this decision are fundamental to an appreciation of the essential property rights arising in corporate shareholders,[25] and may form the basis for establishing constitutional protection against family attribution among shareholders in the estate tax context through extension of the income attribution concept.[26]

The trend of state law decisions, tax law decisions, amendments to the Code, and statutes in some states has been toward recognition of the unique legal status of the close corporation.[27] As stated by the Supreme Court of Illinois in *Galler v. Galler*,[28] "there has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*."

The Code expressly recognizes and separately treats the type of

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23. *See, e.g.*, NEB. CONST., art. XII, § 5 (cumulative voting requirement).
24. [1896] 22 A.C. 22, *rev'g*, Broderip v. Solomon (1895).
25. Essentially, such attribution is the Government's position in Rothgery v. United States, U.S. TAX CAS. (73-1, at 81,242) ¶ 12-911 (Ct. Cl. 1973). Under the particular circumstances of the case, stock held by a family group was valued as a unit in Estate of David J. Levenson, 18 CCH Tax Ct. Mem. 535 (1959). Such an argument was advanced but not decided upon in Estate of Robert Hosken Damon, 49 T.C. 108 (1967). As stated in Jeannette Fitzgibbon v. Commissioner, 19 T.C. 78, 84 (1952) "Transactions within a family group are subject to special scrutiny in order to determine if they are in economic reality what they appear to be on their face."
26. *See, e.g.*, CODE § 318.
27. O'NEAL, supra note 21, at § 1.09.
28. 32 Ill .2d 16, 28, 203 N.E.2d 577, 584 (1965).

corporation having a single class of stock and ten or fewer shareholders. This concept is found in subchapter S, allowing a small business corporation to elect not to be taxed at the corporate level,[29] section 1244 allowing an issue of stock to qualify for ordinary loss treatment rather than capital loss treatment,[30] section 6166 confining the ten year installment payment election for estate taxes to the shareholders of such corporations in some circumstances[31] and section 311(d) providing that distributions of appreciated property do not have gain recognized at the corporate level.[32]

The general trend of legislation, as reflected in the Model Business Corporation Act,[33] has been to allow increasing flexibility in the organization of the family corporation.[34] For example, the Nebraska Business Corporation Act now allows incorporation by one or more incorporators[35] and allows the number of directors to be as small as desired.[36] Some state statutes even permit managerial acts by shareholder agreement, without the possibility of partnership liability, in variously defined "close corporations."[37] Even the Kansas act[38] attempting to restrict agricultural land holding to small corporations having ten or less shareholders recognizes the essential difference between the family corporation and the publicly held corporation.

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29. CODE § 1371 *et seq.*
30. CODE § 1244.
31. CODE § 6166.
32. CODE § 311(d)(2)(A).
33. NEB. REV. STAT. §§ 21-2001 *et seq.* (Reissue 1970).
34. O'NEAL, *supra* note 21, at § 1.14(a).
35. NEB. REV. STAT. § 21-2051 (Supp. 1972).
36. NEB. REV. STAT. § 21-2036 (Supp. 1972).
37. *E.g.*, MD. ANN. CODE art. 23, §§ 100-11 (1973); PA. STAT. ANN. tit. 15, §§ 1371-1386 (Supp. 1974).
38. KAN. STAT. ANN. § 17-5901 (1974). The Nebraska Legislature is currently considering several bills and a possible constitutional amendment concerning the regulation of corporate farming in the state. L.B. 203, L.B. 214, and L.B. 363 all seek to prohibit corporate farming with exceptions, *inter alia*, for "family farm or ranch corporations." L.R. 8 was a resolution proposing an amendment to Article XII of the Nebraska Constitution which would prohibit corporate farming. The resolution also contained a "family farm corporation" exclusion. L.B. 214 and L.B. 363 were indefinitely postponed. 1975 NEB. LEG. JRNL. 1462 (April 25, 1975). A hearing on L.R. 8 was delayed until 1976. 1975 NEB. LEG. JRNL. 860 (March 12, 1975). L.B. 203 was amended by the Committee on Agriculture and Environment to remove the prohibition. Substituted were amendments to sections 76-407 and 76-408, NEB. REV. STAT. §§ 76-407, -408 (Reissue 1971), dealing with alien ownership of land. The bill would also require corporate owners of agricultural lands to file annual reports with the Secretary of State. The amended bill was passed May 23, 1975, by a vote of 34-0. 1975 NEB. LEG. JRNL. 2073 (May 23, 1975).

The last bastion of resistance to recognition of both the legally unique nature of the close corporation, and its undoubted characteristics as a true corporation, has been the Internal Revenue Service. A classic confrontation between the Service and the courts has been the prolonged battle over the validity of professional corporations. The firm posture taken by substantially all the courts passing upon this question is that de jure formation under local law of the professional corporation and proper compliance with legal formalities result in full recognition of the corporate form. The ultimate surrender of the Service in response to this judicial action illustrates the legal vitality of the close corporation.[39]

Based upon basic state corporate and property law concepts, tax law decisions have established fundamental differences between the treatment of corporations as property holding mechanisms and corporations used to effect the flow of taxability of the income from incorporated assets.

Since *Gregory v. Helvering*,[40] it has been recognized that a corporation formed or availed of for the purpose of concealing the real substance of a business transaction, and thereby avoiding an otherwise appropriate income tax, may be disregarded. This principle has not, however, been extended to the reallocation of property interests protected by state law as opposed to the income from such property.[41] In *Moline Properties v. Commissioner*,[42] the United States Supreme Court stated that the purpose of incorporation is immaterial and said, "so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."[43]

The Service has continually attempted to establish that a corporation must carry on an "active business" for judicial recognition of its valid and independent existence. This position was rejected by the Second Circuit in *Commissioner v. State-Adams Corp.*[44] The question presented was whether a corporation, the only asset of which was a long term lease to a department store, should be

39. *See* Weinberg, *A Brief Look at the Advantages and Disadvantages of Professional Incorporation*, 6 CREIGHTON L. REV. 17 (1972).
40. 293 U.S. 465 (1935).
41. *Cf.* Brooke v. United States U.S. TAX CAS. (72-2, at 85,399) ¶ 9594 (9th Cir. 1972) where the court refused to tax income to the grantor from a gift lease-back situation because of substance supplied to the transaction by state law duties.
42. 319 U.S. 436 (1943).
43. *Id.* at 439.
44. 283 F.2d 395 (2d Cir. 1960); *cert. denied*, 365 U.S. 844 (1961).

recognized for income tax purposes. The lease had been assigned to the corporation in return for its promissory note payable to the prior lessor for life, with the interest being equivalent to the amount of the net rent. The only activities of the corporation were holding the lease and taking steps necessary to continue its corporate existence. The Fifth Circuit later characterized this in *Britt v. United States:*[45] "The Court held that a corporation *formed to facilitate the devolution of property*, which merely holds title, collects rent from lessees, and distributes the income, is engaged in business and will be taxed as a separate entity."[46]

A somewhat similar situation arose in *Howell v. Commissioner.*[47] There, the only corporate assets consisted of a tract of unimproved real estate the sale of which resulted in realized capital gain. The Service attempted to prevent passthrough of this capital gain under the subchapter S election for taxation at the shareholder level. The Tax Court held there was no active business requirement imposed upon subchapter S corporations by statute, and that the conduct of an "active business" was not necessary for recognition of the corporate form.

The use of the words "formed to facilitate the devolution of property" in the *Britt* case is significant. If a valid corporation may be formed under tax law for the sole purpose of holding property and transferring stock ownership to a succeeding generation, the entire complex of corporate/shareholder rights, duties, and state law remedies comes into play. This will inevitably affect the taxability and valuation of the corporate shares in the hands of the shareholders.

The corporate form may be used purely for estate planning purposes. In *Harrison Property Management Co.*,[48] two brothers and a sister having equal interests in oil properties transferred the properties to a corporation primarily to facilitate the continued operation of the business in the case of the death of one of them. The shareholders paid over all the profits to themselves and reported the profits on their individual returns. They did not file corporate returns but reported the corporation's activities on a fiduciary return. The court held the corporation was organized for a legitimate business purpose, the avoidance of continuity problems in the case of death of a shareholder.

45. 431 F.2d 227 (5th Cir. 1970), *reversing* Britt v. United States 292 F. Supp. 6 (M.D. Fla. 1968).
46. 431 F. Supp. at 237.
47. 57 T.C. 546 (1972), *acquiescing.*
48. 475 F.2d 623 (Ct. Cl. 1973).

In *Britt v. United States*[49] the taxpayers, who were partners in a citrus grove business, formed three corporations into which they distributed certain percentages of their partnership shares. Stock of the corporations was given to two children of one of the partners and a sister of the partners. The corporations maintained complete records and received distributions from the partnership. The corporations were admittedly formed for the sole purpose of facilitating the transfer to the children of interests in the partnership. The Service argued that the corporation should be disregarded and the income taxed to the shareholders as if they were individually business partners. The Fifth Circuit held that the holding of property for the purpose of passing it to a succeeding generation is a sufficient business purpose and such a corporation is not a sham to be ignored for tax purposes.

Recognition that the complex of legal rights between the corporation, the majority shareholder, and the minority shareholders establishes legally separate property relationships which are not to be lightly disregard was apparent in *Byrum v. United States.*[50] The donor transferred a block of common voting stock to an irrevocable trust for his children, but retained the power to vote the stock and veto the sale of shares by the trustee. The Court held that neither the reservation of powers of management alone nor the retention of the right to vote the transferred shares constitutes a reservation of possession and enjoyment or a transfer with the right to designate the persons who will enjoy the property under section 2036.[51] The question of whether *Byrum* will be extended to reservations of voting control under circumstances where there are no non-family minority shareholders, as there were in *Byrum*, remains unresolved.

## III. MARITAL DEDUCTION PLANNING

Achieving the optimum federal estate tax marital deduction in the agricultural estate presents some unique difficulties. The desire to hold the operating unit intact, however, is fully compatible with the necessities of planning the non-marital share of the estate. Since the family farm or ranch properties are generally to be passed to the successor operators at the end of the surviving spouse's lifetime, the family goals are furthered by restricting the surviving spouse's interest in the non-marital portion to income. The prob-

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49. 292 F. Supp. 6 (M.D. Fla. 1968).
50. 408 U.S. 125 (1972), *rehearing denied*, 409 U.S. 898 (1972).
51. *E.g.*, Covey, 3 TAX ADVISER 644 (1972), which contains a thorough discussion of the implications and limitations of the *Byrum* case.

lem is how best to achieve the necessary apportionment of assets.

If land comprises substantially all the assets involved, the devise of an undivided one-half interest to the suriving spouse in fee, and a legal life estate with gift over to the children (or a limited power of appointment in the surviving spouse) in the residue will suffice.[52] Generally, however, substantial chattel property in the form of livestock and machinery is involved. Such short-lived items do not conveniently lend themselves to legal life estate and remainder treatment. If it is necessary to channel such property to the portion of the owner's estate not qualifying for the marital deduction (with the converse elimination of such property from taxation in the survivor's estate) some ownership vehicle allowing for separation of lifetime and remainder interests is necessary. The corporation will serve this purpose in the same manner as a trust or limited partnership.[53]

If substantially all the assets are incorporated and there is little life insurance or other property passing outside the probate estate, corporate stock may be bequeathed one-half to the surviving spouse outright and one-half to the surviving spouse for life with remainder to designated children or subject to a limited power of appointment.[54] If a more complex asset mix is involved, corporate stock, because of its incremental nature, lends itself to the application of a pecuniary formula marital deduction clause. Real estate, on the other hand, requires the use of a fractional share marital deduction clause if the situation requires formula-type distribution. Fractional share clauses may present some disadvantages since the ultimate fractional interest in the subject assets cannot be determined until conclusion of the federal estate tax audit.[55]

Livestock, grain or other property subject to price changes on a readily ascertainable public market may have disadvantages in

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52. Logan, *Problems of the Farmer in Dispositions by Will*, 32 ROCKY MT. L. REV. 329 (1960), develops in detail the uses, problems and forms for nonmarital legacies by means of life estate and limited power of appointment.
53. *See* Kelley, *Estate Planning for Farmers and Ranchers*, 20 PRAC. LAW. 13 (1974); *Large Farm Estates*, *supra* note 2, at 876.
54. The marital portion should, of course, be exonerated from the payment of federal estate tax in order to preserve the optimum deduction.
55. Tarbox, *The Pregnant Marital Deduction*, 1973 TRUSTS & ESTATES 414. This article includes a discussion of the problems and methods of administering marital deduction clauses. In the estate involving agricultural land, delay in ascertaining the exact fractional shares of ownership between the marital and non-marital portions may not be a significant disadvantage where there is no intention to sell or borrow against the real estate involved.

funding a pecuniary formula marital deduction clause, because a pecuniary formula clause drawn to avoid the impact of Revenue Procedure 64-19[56] will result in the realization of gain on any increase in value between the estate tax valuation date and the distribution date.[57] In these situations the realized gain may be substantial if the alternate valuation date is not elected.[58] This problem may be avoided by using incorporated assets. Stock has a wide range of debatable value, is not subject to any particular market and there is little likelihood of value fluctuation between the date of death and distribution.

Pecuniary formula clause distribution problems are avoided when all personal property is left outright to the wife and the balance of the marital fraction is carved out of real estate by using a fractional share formula. This, however, results in a difficult funding situation since the only available resource for paying the estate tax is the non-marital share of the real estate. If corporate stock is used for the marital portion, the residue may include liquid assets suitable for estate tax funding, or the estate tax may be paid by redeeming corporate shares from the stock remaining after the marital share is funded.[59]

Conventional stock may be used in typical marital deduction trust arrangements. Shares of stock in a subchapter S corporation may not, however, be bequeathed in trust without causing termination of the election.[60] Similar restrictions apply to section 1244 stock.[61] But stock readily lends itself to the creation of various legal estates, including a legal life estate in the surviving spouse with remainder passing pursuant to a special power of appointment given the life tenant. If such an approach is taken, provisions should be included for handling the proceeds of the sale of stock

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56. Rev. Pro. 64-19, 1964 INT. REV. BULL. at 682.
57. *Id.* Dalton, *General View of Marital Deduction Planning*, 45 NEB. L. REV. 414, 427 (1966).
58. If distribution occurs within the first 6 months it may be that short term gain treatment of Code § 1231 livestock assets may be avoided following the Tax Reform Act of 1969. *See* note 201 and accompanying text *infra*.
59. The basics of tax free stock redemption under Code § 303 are discussed in Miller, *Several Routes Are Available to Obtain an Extension of Time for Payment of Estate Taxes*, 1974 TAXATION FOR LAWYERS 96, and *see* Rev. Rul. 72-188, 1972-1 CUM. BULL. 383. Stock redeemed from the marital trust is eligible for waiver of family attribution under Code § 318(5)(c). Estate of Crawford, 59 T.C. 830 (1973). *See also* Estate of Pearl Gibbons Reynolds, 55 T.C. 172 (1970).
60. CODE § 1371(a)(2).
61. CODE § 1244(a)(4).

if the life tenant is given the power to sell.[62] If there are not directions for applying the proceeds of the sale, the life tenant may be taxed on the proceeds as having the equivalent of fee ownership.[63] Preferably, it should be directed that the proceeds be placed in trust with typical non-marital trust provisions.[64]

Where more than one corporation is involved, and sufficient shares of a corporation not requiring subchapter S election are available, the subchapter S shares may be given outright as the marital share and conventional shares may be passed into a typical nonmarital trust.[65] If the corporation has both common and preferred stock, a subchapter S election is not available, and either class of stock may be placed in trust. In such a situation it may be preferable to pass the preferred stock as part of the marital legacy, either outright to the wife or to a full ownership trust, with the common shares passing to the non-marital trust. This prevents any growth of the common shares from being taxed in surviving spouse's estate.

If a marital trust with a general power of appointment is desired for purposes of avoiding probate of the surviving spouse's estate, or otherwise, funding with close corporation stock without a dividend history should be avoided. Such stock may be non-income producing property under Regulation 20.2056(b)(5),[66] and therefore would not qualify as marital deduction property. A similar result can be achieved, however, by giving the surviving spouse a legal life estate with a general power of appointment over the remainder by lifetime instrument.[67] If a marital trust is considered indispensible and must be funded with such stock, the trust should be drawn as an estate trust (legal life estate in the surviving spouse with remainder passing to the spouse's estate) or the surviving spouse should have a complete power to withdraw the stock during lifetime.[68]

Stock may be used to channel ownership into both spouses to create asset ownership to provide a hedge against the sequence of

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62. Generally as to the handling of the sale of property subject to legal life estates and remainders *see Casner, Legal Life Estates and Powers of Appointment Coupled with Life Estates and Trusts*, 45 NEB. L. REV. 342, 347 (1966).
63. *See* Draper v. Piedmont Trust Bank, 214 Va. 59, 197 S.E.2d 178 (1973). *See* Dalton, *supra* note 57, at 419.
64. Casner, *supra* note 62.
65. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ESTATE PLANNING FOR THE OWNER OF A CLOSELY HELD ENTERPRISE 1-42 (1973).
66. Casner, ESTATE PLANNING 844 (Supp. 1974).
67. *Id.* at 1575.
68. *Id.*

death. If joint tenancy property or property held in common forms part of the capital contributions to the corporation, the stock reflecting these assets may be issued proportionately to each spouse. This may be used to work toward equalization of property holdings when no gift tax consequences result.[69] Each spouse may then by-pass the estate of the other with all or a portion of the owned stock, thereby hedging against the sequence of deaths. Corporate stock forms an ideal medium for such by-pass bequests since the surviving spouse will have the power to vote both marital and nonmarital portions and to receive all the dividends.

If joint tenancy real estate is contributed to the corporation, certain unanticipated gift tax consequences may arise. Creating such a joint tenancy between husband and wife does not result in a taxable gift unless an election to that effect is made.[70] Termination of the joint tenancy results in a taxable gift to the extent of one-half the amount by which the contributions of one spouse to the joint tenancy exceed the contributions of the other.[71] The transmutation of the joint tenancy real estate into joint tenancy stock is a termination of the real estate joint tenancy and constitutes a taxable event. Such a situation should, therefore, be approached with the same precautions as any termination of joint tenancy real estate ownership between husband and wife.[72] The respective contributions of the spouses should be ascertained to determine whether a significant gift would be made. If so, a decision must be made concerning whether gift tax exemptions should be used in this transaction or for gifts to children. The latter use is generally a preferable application of the exemption. If fact situations comparable to the cases of *Estate of Everett Otte*[73] or *Rose v. Commis-*

69. Jointly held chattel property is already owned equally by the joint tenants for gift tax purposes. Treas. Reg. § 25.2511-1(h)(5) (1958). Care should be exercised when using property such as joint checking accounts or joint savings accounts, as corporate contributions, as to which there is no completed gift until withdrawal by the non-contributing joint tenant. Treas. Reg. § 25.2511(h)(4) (1958). Issuance of corporate stock in one-half interest each to the joint tenants would be the equivalent of withdrawal from the account.
70. Treas. Reg. § 25.2515-1(b) (regarding transfers after 1954).
71. Treas. Reg. § 25.2515-1(d) (1954).
72. Nebraska Probate Code, NEB. REV. STAT. § 30-2352 (Supp. 1974) allows disclaimer by a surviving joint tenant of interest received upon the death of a joint tenant after January 1, 1977. It also allows, for the first time, post-mortem planning when joint tenancies are involved.
73. 31 CCH Tax Ct. Mem. 301 (1972). The full time services of a farm wife during the period of acquisition of joint tenancy real estate were held to constitute contributions in money or moneys worth of a sufficient amount to eliminate one-half the value of that real estate from estate taxation in the estate of the husband.

*sioner*[74] are involved, the termination of the joint tenancy may not result in a gift even if cash contributions were not made. These cases indicate the services of the wife during the course of acquisition of the joint tenancy property may constitute contribution in money or money's worth to the acquisition. The decedent in *Otte* had purchased a tract in his name in 1932, and placed it in joint tenancy with his wife in 1958. The court held that her activities throughout the years of the marital community represented a contribution to the joint tenancy property in money's worth to the extent of half its value, without regard to the delay in placing the property in joint tenancy. The court stated:

> Although the home place was held by the decedent in his own name until 1938, we believe the enhanced value of the home place resulting from decedent's and Laura's efforts working together as a "team" constitutes jointly acquired property subject to equal division for estate tax purposes.[75]

The court emphasized that the small amount of equity in the property prior to existence of the marital community was also important.

If substantially all the property of the parents is in joint tenancy ownership, and no significant gift problem arises upon termination of the joint tenancy, the opportunity is presented to issue 50 per cent of the stock to each, and by making small gifts of stock to the children the property holding of each spouse may be reduced to a minority position. Thus a substantial reduction of estate tax values[76] may be achieved in both estates.[77]

Finally, the case of *Winkle v. United States*[78] raises a consideration to be aware of when close corporation stock is used for all or part of a marital deduction legacy. In that case, a stock sale restriction agreement required that stock owned by the surviving

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74. 32 CCH Tax. Ct. Mem. 207 (1973). Taxpayer's husband operated a coal mining company as sole proprietor. After the husband's death, the taxpayer's wife endeavored to deduct one-half of the carry forward net operating loss of the business against her later income. It was held that the taxpayer's activities constituted participation in the business and the court held for the taxpayer. A factor in the decision was that the taxpayer released her marital rights in the husband's property when pledged for business borrowing.
75. 31 CCH Tax Ct. Mem. at 307.
76. *See* Section V *infra*.
77. *Cf.* Sundquist v. United States, U.S. TAX CAS. (74-2, at 85,868) ¶ 13,035 (E.D. Wash. 1974) holding that a husband and wife owned 50 per cent each of a 55 per cent block of stock in a family corporation, that the same was not community property, and that the stockholding of each should be valued as minority stock and discounted accordingly.
78. U.S. TAX CAS. (74-1, at 84,412) ¶ 12,994 (S.D. Ohio 1974).

wife would have to be sold back to the corporation or given by her will to specified family members. The court concluded that the agreement was incorporated by reference in the testator's will and that as a result, the testator intended to give his wife a terminable life estate only, rather than fee interest in the given stock. Her power of appointment was therefore not exercisable "alone and in all events,"[79] because of the controls imposed by the restriction agreement. In the preparation of stock restrictions agreements in such situations, the problems raised by Winkle should be carefully considered and the agreement and wills prepared accordingly.

## IV. GIFT PLANNING

Assuming that passage of the agricultural enterprise intact to the next generation is a primary objective of the estate plan, the *sine qua non* for achieving this objective is adequate provision for the payment of death taxes. To the succeeding generation the ability to make payment of death taxes from liquid assets, or borrowing which does not create a business handicap, is not merely a desirable enhancement of inheritance, but is indispensable if the employment and life style to which the heir may be irretrievably committed are to be maintained.[80]

The liquidity problem may be approached either by increasing the liquid composition of the estate through savings or insurance, or by planning toward the reduction of the estate tax. Marital deduction optimization,[81] is the first step in planning for such reduction. Normally, the next step is to make gifts to members of the succeeding generation.

Historically, agricultural families have been reluctant to undertake lifetime intergeneration transfers.[82] Because federal estate tax law allows gifts not made in contemplation of death to escape estate taxation,[83] and because significant asset value may be removed from the highest marginal estate tax bracket to the lowest marginal gift tax bracket, after gift tax exemptions have been exhausted, farm families have been compelled to revise radically their attitudes concerning lifetime transfers. A tendency toward making substantial intergeneration transfers during the parents' lifetime, rather than confining gifts to testamentary activity only, is appearing. This has resulted in the transferees participating more exten-

79. CODE § 2056(b)(5).
80. Hines, *supra* note 2, at 11-6.
81. *See* Section III *supra*.
82. Fleming, *supra* note 1, at 454.
83. CODE § 2035.

sively in management during the parent's lifetime, and in a tendency for the parent to move toward retirement or semi-retirement in later years.[84] The estate tax has thus indirectly stimulated lifetime successions to supersede wholly testamentary successions. The severity of the federal estate tax, and the incongruity of the federal estate and gift tax law as it presently exists has thus resulted, paradoxically, in a changing pattern which may be socially and economically desirable in its contribution toward preserving the family farm by ameliorating the "family farm cycle."

If the liquidity of the estate, when coupled with adequate marital deduction planning, is sufficient to discharge death taxes, a substantial gift program is unnecessary from the tax point of view. However, in terms, of the present minimum capital needs of the typical family farm or ranch enterprise, compared with the federal estate tax structure, such a situation is becoming less and less common.[85] Generally, it is neither desired nor desirable to force the heirs into a situation of borrowing the necessary estate tax funds, since the economic health of the enterprise may be critically dependent upon achieving the minimum possible fixed debt load. Agriculture's typically low income to asset ratio, the volatility of the markets for its products, and the ever increasing cost of overhead and interest tend to make the prudent operator believe that his debt load is never as low as it should be. Quite possibly the parent would prefer to reduce estate tax through a lifetime gift program rather than leave the property to the heir to "pay for the place twice."

Assuming the operator conceives the farm or ranch to be an integrated unit, and assuming the case in which the operating unit encompasses subsantially all the net worth of the operator, the problem in gift planning is to find a way to "divide an asset that is functionally indivisible."[86] Gifts of specific items of machinery, specific livestock, and tracts of land or undivided interests in land, may be made. Even when made to apparent successor operators, the gift of such assets, to the extent they are included in an integrated unit, involves a generally unacceptable loss of control. Such gifts are generally unsuitable for estate beneficiaries who will not be involved in the ongoing operation. Neither can gifts be made which would involve an unacceptable diversion of excess income from contributions to the ever increasing capital needs of agriculture.

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84. Boehlje, *Intergeneration Transfers: Is Agriculture Unique?*, 1973 TRUSTS & ESTATES 172.
85. Hines, *supra* note 2, at 11-6.
86. *Id.* at 11-8.

A common approach where gifts to successor owners are desired, particularly coincident with the retirement of the parent, is to make a contract sale to the successor followed by regular gifts in the form of cancellations of indebtedness to the extent the parent does not need income for living expenses. Careful thought to the estate tax problems created by this approach is necessary since *Hudspeth v. Commissioner*.[87] There the Tax Court disallowed an interest deduction taken by a son who was purchasing assets from his parent, where a regular pattern of gifts back to the son in the amount of the installment payments was being made. Further, it has been suggested that such a situation may be subject to estate tax under section 2036 where the arrangement is arguably without contractual substance.[88]

Gifts of undivided interests in real estate, although possible,[89] must be treated carefully. Where the income from the donated fraction is diverted to the donee and there is a coincident arrangement to return the income to the donor, the "gift" is subject to estate tax.[90] Further, death of the donee may result in the fractional interest passing to persons other than the donor's descendants with potentially disastrous results through exposure to partition.

The better solution to the lifetime gift dilemma is the creation of an artificial legal vehicle to hold title to the assets from which gifts are to be made, and then to make gifts of interests in this vehicle. The corporation is ideally suited to this purpose.[91] Indeed, the gift planning possibilities of farm corporations seem to be the predominant reason for their creation. Compared with transfers of land, for example, the transfer of corporate stock is much more convenient.[92] All that is required is the endorsement of the stock certificate by the donor, the issuance of the gift certificate to the donee, and the issuance of the certificate for the residue to the donor. Further, the transfer may be made privately and need not be publicly recorded.

The use of stock allows gifts to be made of combinations of assets which would otherwise be awkward to work with, and allows eco-

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87. 31 CCH Tax Ct. Mem. 1254 (1973).
88. Rickerson, *Are the Tax-Saving Characteristics of Piecemeal Giving in Danger*, 27 TAX LAWYER 331 (1974).
89. Such gifts are specifically approved in Haygood v. Commissioner, 42 T.C. 936 (1964). Valuation under Treas. Reg. § 25-2511-1(e) (1958) is of the fractional interest given only.
90. Rickerson, *supra* note 88.
91. Hines, *supra* note 2, at 11-31.
92. Harl, *supra* note 18, at 380.

nomic values of otherwise monolithic units to be transferred without interruption of business activity.[93] If the donor retains a majority of the voting stock he remains in effective control of the corporate assets and can conduct the business. The fact that the majority shares are held by the decedent does not alone subject the gifted stock to estate tax.[94]

Where minors are involved, corporate stock may be transferred under the Uniform Gift to Minors Act.[95] If the donor is not named as custodian, the gift will not be taxed in his estate. Gifts of chattel property or real estate are not eligible for transfer to a minor under custodianship,[96] and are generally unsuitable for gifts to minors, except by irrevocable trust.

The corporation wholly insulates the going business from the economic ownership of the business. Should one of the stock donees die, the business operation will continue. Further, the close corporation stock is readily subject to stock control and reconsolidation agreements which can prevent the stock from leaving the family in the event of death or economic disaster befalling one of the stock holders.[97] The irrevocable gift of chattel property or fractional interests in real estate is subject to the misfortunes of the donee in terms of judgment executions, bankruptcy, loan foreclosures or divorce. Stock may be subject to a repurchase agreement in the event of any of these occurrences, and does not allow the transferee to interrupt the business, regardless of the method of transfer.

There are some caveats which should be considered when making gifts of corporate shares. Although stock of a conventional corporation may be placed in trust, with the resulting flexibility regarding disposition, stock of a subchapter S corporation cannot be held by a trustee,[98] and stock so held does not retain its section

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93. *Large Farm Estates*, *supra* note 2, at 870.
94. This does not appear to have been seriously contended by the Revenue Service, and the holding in United States v. Byrum, 408 U.S. 125 (1972), would seem to foreclose this possibility. *Compare* Rev. Rul. 67-54, 1967-1 INT. REV. BULL. 269, in which the Service takes the position that the retention of all voting stock and gift of a class of nonvoting stock renders the gift taxable to the estate of the donor. Retention of control to this degree in other types of legal vehicles for the ownership of business assets is less clear with regard to the possible estate tax impact.
95. Harl, *supra* note 18, at 380.
96. *Id.*
97. *See generally* Polasky, *Planning for the Disposition of a Substantial Interest in a Closely Held Business*, 46 IOWA L. REV. 516 (1961).
98. CODE § 1371(a)(2).

1244 character.[99] To this extent the use of subchapter S stock as a gift vehicle is less flexible than stock which may be placed in an irrevocable trust. Further, life beneficiaries of close corporation stock without a dividend history may not be allowed an annual exclusion for gifts of this stock placed in trust.[100] Such gifts will likely be taxable if death occurs within three years of the gift, regardless of the apparent predominance of living motives for the gift,[101] because the lack of income is deemed to constitute a predominant testamentary motivation.

Gifts should never be made to individual shareholders by contributing property to the corporation. Under *Herringer v. Commissioner*,[102] this is not a gift of a present interest to the shareholders, and no annual exclusions are allowed.

Finally, when making gifts of corporate stock care should be taken that no overt arrangements exist for the donor to retain dividends;[103] nor should there be understandings regarding salary which would place the salary at a level in excess of income available for dividends.[104] It has been held, however, that the mere fact that the donee regularly returns dividends to the donor does not subject the stock to tax in the absence of a prior contract.[105]

## V. PLANNING FOR REDUCTION OF ESTATE VALUES

The United States Supreme Court in *Byrum v. United States*[106] recognized the integrity of the close corporation as a business form and the separation, under state law, of ownership and economic interest between shareholders. Thus, *Byrum* may have a significant impact on the valuation of the estate.

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99. CODE § 1244(d)(4).
100. Stark v. United States, 345 F. Supp. 1263 (W.D. Mo. 1972), *aff'd*, 477 F.2d 131 (8th Cir. 1973), *cert. denied*, 414 U.S. 975 (1973). This case holds that such gifts are not gifts of present interests under Treas. Reg. § 25.2512-5(c) (1958).
101. Chanin v. United States, U.S. TAX CAS. (68-1, at 87,372) ¶ 12,522 (Ct. Cl. 1968).
102. Herringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956).
103. This would clearly be a gift with possession and enjoyment retained under Code § 2036.
104. Estate of Pamela D. Holland, 47 B.T.A. 807 (1942), *modified*, 1 T.C. 564 (1943). Retention of the right to pledge the donated stock as collateral will also render it taxable under Code § 2036(a)(2). Estate of James Gilbert, 14 T.C. 349 (1950).
105. Guelker v. United States, U.S. TAX CAS. (74-1, at 84,409) ¶ 12,992 (N.D.W. Va. 1973). *Cf.* Barlow 55 T.C. 666 (1972) and Hendry, 62 T.C. No. 92 (1974) dealing with continued use by the donor of donated real estate.
106. 408 U.S. 125 (1972).

The majority opinion recognized both the legal and economic substance of minority share ownership in close corporation: "Even if Byrum had transferred a majority of the stock, but had retained voting control, he would not have retained substantial present economic benefits."[107] The majority opinion also clearly recognized the distinction between holding property through the medium of stock in the closely held, non-public corporation and other types of property, like publicly held stock having a ready market. The Court noted that close corporations do not have regular and dependable earnings flow: "The typical closely held corporation is small, has a checkered earning record, and has no market for its shares."[108] These are the same elements which have been stressed in the many decisions emphasizing the factor of "degree of control" as substantially inhibiting the valuation of close corporation stock not having majority control.[109]

Fundamental to proper valuation of close corporation stock for estate tax purposes, and consequently to proper planning for adjustment of estate values through the use of close corporation stock, is recognition of the state law rights attaching to such stock. The primary aspects of such rights are generally:

1. A stockholding of more than 50 per cent of the issued and outstanding stock may elect a majority of the members of the board of directors and thereby control corporate operating policy.
2. A stockholding of two thirds or more may authorize a sale of substantially all the corporate assets[110] and may authorize liquidation of the corporation.[111]
3. A stockholding of less than one third may have no impact upon the decision making of the corporation.
4. A legal challenge of the dividend policy by dissatisfied minority shareholders will be difficult if dividends are restricted for any legitimate corporate purpose.[112]

A hierachy of stock ownership in relation to stock value is thus created:

1. A holding of 100 per cent of the corporate shares is equivalent to full ownership of the underlying assets

107. 408 U.S. at 149.
108. *Id.*
109. *See* notes 116-17, *infra.*
110. *E.g.*, NEB. REV. STAT. § 21-2078(3) (Supp. 1972).
111. *E.g.*, NEB. REV. STAT. § 21-2083(3) (Reissue 1970).
112. *See* Polasky, *supra,* note 97, at 591. *See also* B. BITTKER & J. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 8.02, 8-6 (3d ed. 1971).

less only the cost of a section 333 liquidation and any tax problem of retained earnings withdrawal.

2. A holding of less than 100 per cent but more than two thirds of the stock allows full control of all aspects of corporate operation and liquidation, subject to some reduction for "marketability" in selling the shares to others, the potential nuisance of minority shareholder suits for dividends, and other potential management harrassment by minority shareholders.[113]
3. A holding of more than 50 per cent but less than two thirds of the shares will result in some impairment of value for lack of ability to liquidate the corporation and reach the underlying assets.[114]
4. A 50 per cent holding creates a deadlock situation where the shareholder is better off than a minority shareholder but cannot control management, salary or dividend policy. Such a deadlock can result in loss of business leadership and disastrous lack of direction for the business enterprise.[115]
5. A holding of less than 50 per cent but more than one third may not control dividends, but may be sufficient to prevent liquidation and thus has a substantial nuisance value to the majority shareholder.[116]
6. A holding of less than one third of the oustanding stock, particularly in an agricultural corporation, is essentially worthless except to the extent that threats of suits to compel dividends or other forms of management harassment may promote an offer by the majority shareholders to purchase the shares.[117]

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113. Estate of Gregg Maxcy, 28 CCH Tax Ct. Mem. 783 (1969).
114. Estate of Ethel C. Dooly, 31 CCH Tax Ct. Mem. 814 (1972). This is particularly important in a farm or ranch corporation since the income, salary and dividend potential to a controlling shareholder is of much less economic importance than the inflationary gain in value, or the enhancement of inventory of the underlying corporate assets.
115. Obermer v. United States, 238 F. Supp. 29 (D. Hawaii 1964). The Government raised the argument in this case that the corporation was the alter ego of the husband and wife shareholders, but this argument was rejected by the court.
116. A 47 per cent stock holding was also valued in Estate of Gregg Maxcy, 28 CCH Tax Ct. Mem. 783 (1969).
117. Estate of Ethel C. Dooly, 31 CCH Tax Ct. Mem. 814 (1972), also involved a small shareholding of 9.69 per cent. Gallun v. Commissioner, 33 CCH Tax Ct. Mem. 1316, 1320 (1974), in valuing a minority shareholding, makes the statement that "[o]ur next step in determining the fair market value of the Gallun stock is to determine the proper dis-

In an arms length situation, given the free application of common valuation principles,[118] the continually lower valuation of the above categories of ownership in relation to the pro rata value of the underlying corporate assets should be recognized.[119] In particular there is, in the words of the *Byrum* Court, "no market" for the minority shares.[120] Common sense questions whether a minority holding in an agricultural corporation could be sold to unrelated shareholders at any price. Revenue Ruling 59-60,[121] which is the basic text for the valuation of close corporation stock, recognizes the problems inherent in marketing minority shares. It is stated that "the size of the block of the stock itself is a relevant factor to be considered"[122] and the ruling admits that a minority holding in an unlisted corporation is "more difficult to sell than a similar block of listed stock."[123]

The obvious inhibition on valuation of these various levels of stockholding at discounts realistically reflecting the true problems of the market place is the factor of ownership of the balance of the stock in closely related family members. The cases contain no precise definition of the theoretical market in which valuation of close corporation stock takes place. The result is an inarticulate compromise whereby such stock is not actually valued at the brutally low levels which dealing with strangers alone would compel, but neither are the shares valued on the assumption that all family

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count to be applied against his net asset value." *See* Estate of Sidney L. Katz, 27 CCH Tax Ct. Mem. 825 (1968).

118. Under Treas. Reg. § 20.2031-1(b) (1965), all estate tax items are to be valued at "the price at which the property would change hands between a willing buyer and a willing seller . . . ."

119. A comprehensive discussion of the valuation of close corporation stock, criticizing the cases for failure to sufficiently discount minority interests, is contained in Moroney, *Most Courts Overvalue Closely Held Stocks*, 51 TAXES 144 (1973). The value of close corporation stock in general, and the effect of minority interests in particular, is discussed in Kelley, *The Utility of the Close Corporation in Estate Planning and Administration*, 49 NOTRE DAME LAWYER 334, 339 (1974). *See generally* STANDARD RESEARCH CONSULTANTS, CORPORATE SECURITY VALUES AS DETERMINED BY THE TAX COURT (1966).

120. 408 U.S. at 149 n.33.

121. Rev. Rul. 59-60, 1959-1 INT. REV. BULL. 237, 243, argues that control of the corporation, either actual or in effect, represents an added element of value which may justify a higher value for a particular block of stock. Rev. Rul. 67-54, 1967-1 INT. REV. BULL. 269, in discussing the degree of control of the value of unlisted stock, suggests that there is additional value inherent in closely held voting shares capable of controlling company policies. *Id.* § 4(g).

122. Rev. Rul. 59-60, 1959-1 INT. REV. BULL. 237, 243.

123. *Id.*

members cooperate at all times to form an effective market for the stock.

The Service has, on occasion, advanced the argument that the shares should be valued upward because the family group controls other stock in the corporation. This argument appears to have been accepted only in unusual fact situations.[124] The typical approach of courts is to value close corporation stock without regarding ownership of other stock in the same corporation by the other family members.[125]

A departure from this attitude does appear in *Rothgery v. United States.*[126] The case involved the valuation of a 50 per cent interest in a family owned automobile dealership, the other 50 per cent being owned by the decedent's son and his wife. The court of claims discussed the effect of the participation of the son as a "willing buyer," in light of his expressed desire to have control of the business, and did not discount the share value. This discussion is essentially dictum, however, because there were other potential buyers for the decedent's shares at the price the court determined to be the value of the shares. *Rothgery* should be compared with *Obermer v. United States* which took no family relationships into account and discounted by one third a 50 per cent holding of an investment company having essentially liquid investments.[127]

As stated by one author:

> [I]ts one thing to say buyers for the . . . minority interest could possibly have been found among the other stockholders. Its quite another thing to take it for granted the other stockholders would have paid a higher price than an outsider would have paid.[128]

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124. *See, e.g.*, United States v. Parker, 376 F.2d 402 (5th Cir. 1967).
125. *See* note 113-15 *supra*. *See also* Estate of Whitney Waterman v. Commissioner, 5 CCH Tax Ct. Mem. 693 (1946) and Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D. Conn. 1954). *Cf.* Rushton v. Commissioner, 498 F.2d 88 (5th Cir. 1974) discussing the application of the blockage principle to individual gifts; Estate of Chloe A. Nail v. Commissioner, 59 T.C. 187 (1972) valuing an undivided interest in mineral rights without regard to family ownership of other fractions of the same; Treas. Reg. § 25.2511-1(e) (1958) indicating that a fractional gift interest valued without regard to the total ownership of the donor. *But see* Whitehead, 33 CCH Tax Ct. Mem. 253 (1974), which adjusted the value of a fractional interest to account for other interests held by family members in the same real estate.
126. 475 F.2d 591 (Ct. Cl. 1973).
127. 238 F. Supp. 29 (D. Hawaii 1964). This case discounted stock value for the factor of deferred capital gain on the underlying corporate assets. *Contra*, Gallun v. Commissioner, 33 CCH Tax Ct. Mem. 1316 (1974).
128. Moroney, *supra* note 119, at 147.

It is hard to improve upon the foundational statement made by the District Court for the Southern District of California that, "minority interests in a 'closed' corporation are usually worth much less than the proportionate share of the assets to which they attach."[129]

The valuation of gifted minority stock without imputation of the value increment remaining in the hands of the donor, even after death, is established by the Fifth Circuit's opinion in *McGehee v. Commissioner.*[130] The court held that stock taxable for estate tax as given in contemplation of death should still be valued as minority stock, and not as stock having a value derived from the total block held by the donor prior to the gift and otherwise included in his estate.

In *Whittemore v. Fitzpatrick,*[131] the government argued that gifts made to close members of the same family at the same time should be lumped together to establish the percentage of stock being valued. The court held that the stockholding given each individual donee is to be valued separately at the percentage of stock represented by each gift.

It may be argued that other family members with reason to purchase stock valued as in the *Rothgery* case, are not "willing buyers" and should be excluded from the hypothetical valuation market, just as sales to such family members are questionable comparative sales because of non-business motivation.[132]

The principles of valuation of close corporation stock were thoughtfully applied to stock in a ranch corporation in *Estate of Ethel C. Dooly.*[133] This case involved the valuation of two separate blocks of stock in a corporation—one owned by the shareholder and comprising 9.69 percent of the stock and the other block being owned by a holding company to the extent of 50.01 per cent of the stock. The Tax Court adopted the valuations proposed by the witness for the taxpayer. These valuations were approximately 37 per cent of the underlying asset value per share for the smaller block of stock and approximately 55 per cent of the underlying asset

129. Cravens v. Welch, 10 F. Supp. 94, 95 (S.D. Cal. 1935).
130. 260 F.2d 818 (5th Cir. 1958).
131. 127 F. Supp. 710 (D. Conn. 1954). *See also* Guelker v. United States, U.S. TAX CAS. (74-1, at 84,409) ¶ 12,992 (N.D.W. Va. 1973); Rushton v. Commissioner, 498 F.2d 88 (5th Cir. 1974) holding similar gifts to be treated for purposes of the blockage discount without consideration of companion donations.
132. *See* AMERICAN INSTITUTE OF REAL ESTATE APPRAISERS, THE APPRAISAL OF REAL ESTATE 286 (6th ed. 1973).
133. 31 CCH Tax Ct. Mem. 814 (1972).

value per share for the larger block. The court made the following statements:

> Under similar circumstances, this Court has refused to uphold the respondent's determination that the value of stock of an operating corporation should be determined solely on the basis of asset value . . . . Both blocks of stock were valued with the understanding that neither block represented power sufficient to liquidate the corporation, and the difference between the value of the majority and the minority block is due to the fact that the holder of the majority block could control the operation of the business while the holder of the minority block could not do so.[134]

The *Dooly* case also emphasizes that holding agricultural assets in corporate form allows the taxpayer to argue that earnings capitalization must constitute an appraisal factor as well as comparative sales. As the court stated: "in ascertaining the fair market value of stock of Island Ranching, both earnings and asset value should be considered."[135] Revenue Ruling 59-60[136] emphasizes "earning power" and "dividend paying capacity" as two significant factors to be considered in valuing a corporation as a going entity and discusses the elements of the income capitalization approach, *e.g.*, the income of the business involved and the rate of capitalization to be used in determining the underlying value.

In *Dooly* the Service attempted to negate the influence of the income capitalization approach on value by arguing that the capitalization rate should be the same as the average rate of return on a ranching operation in the area—in this case, approximately two per cent. The mathematical effect of increasing the land value, and causing it to approximate the comparative sales from which the rate of return is drawn, is obvious. The Tax Court replied:

> [T]he capitalization rate and the average rate of return on capital are not the same. The capitalization rate is the rate of return at which an investor is willing to invest his funds taking into consideration the risk factor involved in the investment being contemplated . . . . Thus, in determining the capitalization rate, an investor would take into account the rate of a "riskless" investment and add in an allowance for the risk involved in the particular investment being contemplated. In contrast, the average rate of return on capital as used by the respondent is simply the yearly income of an enterprise divided by the capital invested in the corporation.[137]

The importance of employing competent, firmly stated, professional appraisal testimony is reflected in the *Dooly* court's com-

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134. *Id.* at 818.
135. *Id.*
136. Rev. Rul. 59-60, 1959-1 INT. REV. BULL. 237, 243.
137. 31 CCH Tax Ct. Mem. at 820.

ment that "[b]ecause the petitioners' appraisers used a capitalization rate which is within the realm of reason, and because there is no evidence indicating that a lower rate should be used, we uphold the petitioners use of the 7% rate."[138] The tendency of courts is to defer to the appraiser making the most knowledgeable presentation in terms of standard and accepted appraisal theory and practice. The result is usually a substantial discounting of noncontrolling close corporation stock in spite of the Service's arguments that only comparative sales of the underlying corporate assets should be referred to. Such discounting is now quite commonly accepted by courts and even by the Service itself. For example, the witness for the Commissioner in *Estate of Gregg Maxcy*[139] agreed that a stock holding constituting 82 out of 174 issued shares of a family held citrus fruit and cattle raising corporation would be worth only 75 per cent of the value of a majority interest because of its undesirability to prospective purchasers.

Revenue Ruling 59-60[140] expressly recognizes the distinctive nature of closely held corporations. It defines them as follows:

> Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire issue is held by one family. The result of this situation is that little, if any, trading of the shares takes place. There is therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all the elements of a representative transaction as defined by the term "fair market value."[141]

The Ruling also suggests the application of earnings to market value ratios of publicly held stocks in similar industries having a market for their trading. This valuation aspect has little application in farm and ranch corporations because there are few publicly held ranching and farming enterprises, and those that exist have generally been publicly held corporations with ranching or farming assets forming a minor portion of the corporate assets.[142]

Another consideration affecting the valuation of close corporation stock which may depress its value is the presence of first re-

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138. *Id.*
139. 28 CCH Tax Ct. Mem. 783 (1969).
140. Rev. Rul. 59-60, 1959-1 INT. REV. BULL. 237.
141. *Id.* at § 2.03.
142. *See* Hopkin, *supra* note 3, at Exhibit B, reporting the divesting of agricultural holdings by two large publicly held corporations as a result of operating inefficiencies and lack of return. *Compare* the tragic history of a publicly held wheat farming corporation in Kansas, detailed in State *ex rel.* Boynton v. Wheat Farming Co., 137 Kan. 697, 22 P.2d 1093 (1933).

fusal restrictions not constituting binding sale agreements.[143] In *Estate of Lucretia Eddy Cotchett*[144] by-law restrictions provided that there would be no sale or transfer to a non-shareholder (other than family members) unless the stock was first offered to the corporation at the price offered by any third party, and after a waiting period of 90 days. The Tax Court discounted the value of the shares 34 per cent below the pro-rata value of the underlying assets. The court referred to the restrictive agreement as one of the factors involved and reasoned that a prospective purchaser of stock would hedge against the possibility of volatile declines in the value of underlying assets during the waiting period. Such a consideration could very well apply to a corporation having substantial livestock assets.

These considerations suggest some specific planning possibilities. Gifts of small percentages of stock will allow values to be carried out of the donor's estate substantially in excess of the values required to be reported for gift tax purposes because of the stock's discounted value. Thus, gifts of minority shares have a "leverage" effect not present to the same degree in any other subject matter suitable for gifts.[145] The same reasoning should to some extent, apply to general partnership and limited partnership interests, but there is no established line of cases in this area.[146]

The value of stock retained in the estates of parents may be significantly impaired where the retained ownership requires adjustment in value. Thus if gifts of stock reduce the donor-parent's holding so that liquidating or operating control is lost, the value of the remaining stock is reduced in relation to the underlying assets. This obtains at least to the extent that its value is discounted for lack of marketability and lack of management control and liquidation.[147]

143. 1971-2 CUM. BULL. 3, *acquiescing in* Estate of Pearl Gibbons Reynolds v. Commissioner, 55 T.C. 172 (1970).
144. 33 CCH Tax Ct. Mem. 138 (1974).
145. *E.g.*, Tishman v. United States, 207 F. Supp. 830 (E.D. Va. 1959). The same considerations apply to gifts of undivided interests in land, but the discount factor is substantially smaller.
146. *See* Rev. Rul. 68-154, 1968-1 CUM. BULL. 395, discussing the valuation of interests in a general partnership marketing farm products. Based on cases therein cited, it was concluded that the value must be based on an asset by asset valuation of the partnership properties. A general partner, as opposed to a minority shareholder, may compel liquidation and cash payment of his share, UNIFORM PARTNERSHIP ACT § 38. *See* UNIFORM LIMITED PARTNERSHIP ACT § 16 establishing the right of limited partners to compel dissolution if there is no agreement to the contrary.
147. *See* Kelley, *supra* note 119, at 339, 346.

If the family assets are held so that the issuance of corporate stock may be approximately equal between the parents, a very modest gift program may reduce stock owned by both parents to less than 50 per cent of the outstanding and issued stock. Assuming no agreement to retain dividends or agreements by any donees or legatees of the stock to purchase stock from the parents or their estates, the retained stock should be valued for estate tax purposes as minority stock.

A further variation of this gift plan can result in generation skipping to relieve the estate tax in the second generation combined with outright ownership of substantial values by the second generation. Stock constituting less than 50 per cent of the issued and outstanding shares of the family corporation may be left to the successor operators, and the balance left to the successor operator or operators for life with special power of appointment among the descendants of the first generation. Thus the second generation shareholder may, if necessary, vote to liquidate the corporation wholly or partially[148] and receive up to 50 per cent of the entire estate of the first generation parent as investment assets. If, however, the stock remains in the estate of the second generation shareholder, it will be subject to the minority stock valuation factors.

Finally, marital deduction wills should provide a means of obtaining similar tax treatment. If corporate shares are distributed so that the marital portion remaining taxable to the surviving spouse does not constitute a controlling corporate interest, the valuation principles discussed above should be equally applicable to the stock comprising the marital share.

## VI. PLANNING FOR STABILIZATION OF ESTATE VALUES

In view of the inflationary potential of agricultural capital assets and the value increases resulting from increased capital investment, efforts toward the control of estate values and enhancement of estate liquidity,[149] may still prove insufficient adequately to control intergeneration transfer costs. The best considered estate plan may be substantially thrown awry by increased values in the estates of parents.[150] Some method of assuring that there will be no

148. The primary attack of the Revenue Service under Code § 2036(a) in *United States v. Byrum*, 408 U.S. 125 (1972), does not apply here since there is no transfer by the second generation person resulting in the retained voting control.

149. *See* notes 2-27 and accompanying text *supra*.

150. O'Connell, *Estate Planning Devices with Special Usefulness in Com-*

substantial increase in the values upon which the estate plan is based may become necessary.

A common method of "freezing" projected estate values is to sell the assets to the next generation. The family assets, or stock in the family corporation may be sold upon a fixed price contract payable in installments or in exchange for a private annuity.[151] Dual benefit may be obtained in estates where such an arrangement is within the financial capability of the parties. Estate tax values may be concretely established, and at the same time an adequate flow of retirement income for the parents is assured.[152]

Binding options for the purchase of the parents' stock in the family corporation by a child or children will similarly fix the estate tax value if the option is given for a bona fide business purpose and is exercisable during the deceased's lifetime, as well as at death.[153] If the parent has set a specific option price at which the successor operator is allowed to purchase an absentee shareholder's portions of the stock in the family corporation, consideration might be given to establishing this option during lifetime rather than only in the wills of the parents. Until exercise of the option the parents continue to vote the stock, increase in value is channeled to the party having the right to exercise the option, and the estate tax values are fixed without the necessity of a dispute with the Service. The option price may be tied to a formula or may be revised from time to time by mutual agreement. It should be based on realistic initial values, or a taxable gift of the excess value of the option price will result. When none of these approaches are considered suitable, more complex arrangements to achieve value stabilization through the issuance of multi-class corporate stock may be explored.[154]

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*bating Effects of Inflation*, ESTATE PLANNING 92 (Winter, 1974). *See also* Kanter, *Freezing Future Estate Growth*, TRUSTS AND ESTATES 132 (March 1974). For an extensive discussion of various estate planning arrangements involving private annuities, lease backs, intra-family loans and intra-family business purchases see *Estate Planning Through Family Bargaining*, 8 REAL PROPERTY PROBATE AND TRUST J. 223 (1973). 223 (1973).

151. *See Estate Planning Through Family Bargaining*, *supra* note 150; Reed, *The private annuity: Indications for Use, Rules to be Followed, Tax Advantages and Risks*, ESTATE PLANNING 19 (Autumn 1974).

152. *Estate Planning Through Family Bargaining*, *supra* note 150.

153. Estate of Albert L. Salt, 17 T.C. 92 (1951). *See* Treas. Reg. § 20.2031-2(h) (1954) and Rev. Rul. 54-76, 1954-1 CUM. BULL. 194. Such agreements are also binding as to the value of other assets such as partnership interests. Angela Fiorito, 33 T.C. 440 (1959).

154. Komma, *Preferred Stock and the Close Corporation*, TRUSTS AND ESTATES 180 (March 1973); Kanter, *supra* note 150. *See* O'Connell, *supra* note 150, at 93.

A common method of stabilizing value is to capitalize the family corporation with a class of preferred stock and a class of common stock.[155] The donor then makes gifts of the common stock and retains the preferred shares.[156] The preferred stock should include a dividend preference, a liquidation preference, and be subject to redemption at a fixed price.[157] This freezes the maximum value of the preferred stock at its redemption price and liquidation preference, and all corporate asset growth is channeled to the common stock.

Such stock classifications may assist the handling of absentee shareholders. The common stock can be passed to the successor operators and the preferred stock to the absentees either with or without an option for the successor operators to purchase the preferred. Control by the successor operators can be preserved by making the preferred non-voting and the common voting, so that the common will control regardless of the percentage of the corporate capitalization it represents. Such arrangement may be sufficient to achieve the parents' objective, without any intent to reconsolidate stock in the hands of the operators, if there is sufficient cash flow to provide satisfactory dividends to the absentee shareholders. For example, such a situation may obtain at the present time in corporations emphasizing cultivated crops rather than livestock.

Such multi-class stock arrangements disqualify the corporation for subchapter S election.[158] If preservation of the subchapter S election is desired, an alternative is to create debt to the extent of the corporate capitalization considered permissible.[159] This should be followed by gifts of the common stock. Recent developments concerning what constitutes two classes of stock for subchapter S purposes indicate that corporate capitalization, to the extent it is true debt, will not be considered a second class of stock. This is true even if such debt is issued pro rata to the shareholders.[160] Capitalization with either a substantial amount of debt or nonvoting preferred stock necessarily lowers the dollar value of common stock which must be given away in order to reduce the stock holding of the parents below two-thirds, or one-half of the voting stock, with the resulting valuation effects discussed above.

If the determination has been made to use multiple classes of

155. For purposes of illustration, voting control is ignored.
156. Komma, *supra* note 154.
157. *Id.* at 209.
158. CODE § 1371(a)(4).
159. BITTKER & EUSTICE, *supra* note 112, at ¶ 4.02 *et. seq.*
160. *Id.* 6.02, at 6-2, 6-8 (Supp. 1974).

stock in the estate plan, gifts and bequests may be made in trust to take advantage of the flexibility of distribution allowed by that medium of asset ownership.[161] Retention of corporate control through multiple classes of stock and trusts has been clarified somewhat by the *Byrum* case.[162] However, this may still represent an area of some risk. For example, Revenue Ruling 67-54[163] considered a situation where classes of nonvoting preferred stock and debentures were retained by the donor to the extent of the full current value of the corporate assets. A small class of voting common stock was also retained, and all nonvoting common stock was given in trust. The ruling states:

> Where a decedent transfers nonvoting stock in trust and holds for the remainder of his life voting stock giving him control over the dividend policy of the corporation, he has retained, for a period which did not in fact end before his death, the right to determine the income from the nonvoting stock.[164]

The decedent had also restricted the trust from disposing of the nonvoting stock without his consent, and the combination of his retained rights was held to render the transfer of the nonvoting stock taxable under section 2036.

While the valuation of preferred stock retained by the donor is the maximum of its liquidation preference and redemption price, these prices do not necessarily fix the minimum value. As stated by one author:

> One of the advantages of placing the voting control with the common shares is that this may cause a substantial-future potential discount in the valuation of the preferred shares at the time of death of the holder even though they represent a full fair market value at the date of the exchange, since the shares are in a closely held company and absent voting control there would be no way of forcing a redemption of those shares and no way of liquidating the company without the consent of the common shareholders.[165]

The case of *William H. Mauldin*[166] similarly suggests that the per share value of nonvoting preferred stock may be discounted to less

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161. This is subject to the caveat regarding the dangers of stock upon which no dividend is paid being treated as non-income producing property if used to fund a marital type trust. *See* note 66 *supra.*
162. 408 U.S. 125 (1972).
163. Rev. Rul. 67-54, 1967-1 INT. REV. BULL. 269.
164. *Id.* at 270.
165. Kanter, *supra* note 150, at 175. It should be noted that the liquidation preference price and the redemption price are always set at the same figure so that no dispute may arise as to which figure is the stock valuation limit.
166. 60 T.C. 749 (1973). *See also* Estate of Lewis G. Kaye v. Commissioner, 32 CCH Tax Ct. Mem. 1270 (1973).

than face value where corporate earnings are insufficient to justify that value.

Classes of voting and nonvoting common stock may also be used to facilitate the transfer of voting control.[167] A smaller valuation of sale or gift may thus be sufficient to place voting control in the hands of the successor and reduce the stock of the parents to a minority position.

Further, nonvoting stock may be subject to a valuation discount. Revenue Ruling 67-54 takes the position that the per share value of voting stock should be relatively larger than the per share value of nonvoting stock.[168] In *Seymour Silverman*[169] the Tax Court stated: "The only point on which the expert witnesses seemingly agreed was that the nonvoting stock should be treated the same as a minority interest in a closely-held corporation."[170] The Court in *Korslin v. United States* expressly discounted stock not having voting rights.[171]

The donor may desire to make substantial stock gifts, but if the gifts are made from one class of voting stock he would be reduced to a minority position. Giving nonvoting shares and retaining voting stock, however, could assure control. But even if restrictions of disposition or distribution are not retained, the applicability of Revenue Ruling 67-54 is uncertain.

Certain other possibilities for the use of multi-class stock suggest themselves. First, preferred stock may be used to fund the marital legacy with common stock passing to the nonmarital share. Consequently, any significant inflation in values during the surviving spouse's lifetime will not be taxed to the surviving spouse's estate.

Another alternative would be to authorize, but not issue, a class of preferred stock at the time of the initial incorporation. The unissued shares may be held in reserve for recapitalization if values of corporate assets decline. This technique might be used effectively, for example, in a situation where the value of livestock is declining.

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167. *See* Freeland & Phillips, *Planning for the Large Single-asset Estate*, 36 J. OF TAXATION 218, 221 (1972).
168. Oster, *A Comparison of the Alternatives for Planning the Estate of an Owner of a Close Corporation*, 2 TAXATION FOR LAWYERS 222, 229 (Jan.-Feb. 1974).
169. 33 CCH Tax Ct. Mem. 1321 (1974).
170. *Id.* at 1328 n.5.
171. U.S. TAX CAS. (73-1, at 81,224) ¶ 12,907 (E.D. Wis. 1973). *See also* Makoff v. Commissioner, 26 CCH Tax. Ct. Mem. 83 (1967).

Finally, multiple corporations may be used to achieve various degrees of asset control and income distribution in response to complex asset and family situations. For example, land and operating personal property might be placed in separate corporations with the land leased to the operating corporation. This would allow the operating corporation to maintain subchapter S status while multiple classes of stock in the land holding company are issued to achieve value stabilization.

If the use of multi-class stock is desired after the original incorporation, a recapitalization will be necessary. Tax free reorganization under Code section 368(a)(1)(E) could be attained in one of two ways. Multiple classes of common stock could be issued in exchange for the surrender of the initial class of common stock, or multiple classes of common and preferred stock could be issued in such an exchange.[172]

The classic "E" reorganization is the exchange of common stock for common and preferred. To qualify as an "E" recapitalization, and thereby avoid any possibly of shareholder taxation on retained income or capital gain on the exchanged shares, it is necessary that the recapitalization have a business purpose. A purpose which would meet the "business purpose" test would be assisting the retirement of a shareholder and transferring business control to another.[173] The *Silverman* case sets forth an example of a recapitalization for the purpose of making gifts of nonvoting common stock to the donor's children and sets forth the difference in valuation treatment between voting and nonvoting common stock.[174]

To the extent that the corporation has retained earnings at the time of the recapitalization, the preferred stock issued will be "tainted" section 306 stock.[175] Any redemption of such stock is then treated as an ordinary dividend to the extent prescribed by section 301. After the shareholder's death, however, such stock is no longer subject to section 306.[176]

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172. *See* Hanna, *A Recapitalization: The E Reorganization of the Internal Revenue Code*, 27 TAX LAWYER 447 (1974), discussing the mechanics of an E reorganization in detail, and indicating the freedom of such a reorganization from the impact of Code § 305 in the context of retirement of senior shareholders and transition of control to junior shareholders.
173. Treas. Reg. § 1.305-3(e) ex. 12 (1973); *see* Dean v. Commissioner, 10 T.C. 19 (1948).
174. 33 CCH Tax Ct. Mem. 1321 (1974).
175. *See* Hanna, *supra* note 172, at 454.
176. Treas. Reg. § 1.306-3(e) (1973). *See* Komma, *supra* note 154, at 183.

## VII. PRESERVATION OF THE OPERATING UNIT

Several factors make it highly desirable to retain the farm unit intact as it passes to each succeeding generation. These include the economic emphasis on capital rather than income, the necessary dedication of both the farm operator and his family to the work of the business, the degree of willingness of children of agricultural families to continue in the family enterprise, and the psychological satisfactions of agricultural life.[177]

Often, however, little parental planning for the intergeneration transition has been undertaken, and the successor operator has been left to purchase shares of absentee children on an arms length basis.[178] If a substantial portion of the family wealth passes to the operator or operators and the death taxes are manageable, such unplanned arrangements have operated satisfactorily in many instances. Increasingly, however, each generation faces a shortage of capital and at the same time must begin a repurchase and rebuilding effort to meet the capital needs of the operating unit.[179] The result is the so called "family farm cycle" which, because of the necessity of capital reinvestment, tends to impair the efficiency of the agricultural enterprise.[180] Often this phenomenon is accompanied by lack of retirement planning for the elder generation and undue delay in the passage of management to the succeeding generation. The effects of the cycle are exaggerated by the decreasing efficiency of the elderly operator and the lack of incentive on the part of those in the succeeding generation who have not developed capital participation during the parents' lifetime.[181]

The increasingly severe estate tax burden on the values required for even the minimum economic family farm or ranch enterprise further exaggerates the cycle and contributes to the capital crisis which typically occurs once a generation. Thus, the likelihood that successful rebuilding of adequate capital assets can be accomplished by each succeeding agricultural generation is further decreased.

Effective planning for the transfer from one generation to another must be undertaken, not only on a testamentary basis, but

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The effect of Code § 306 may be further avoided by the use of the holding or "container" corporation.

177. Hines, *supra* note 2, at 11-5, summarizing interviews made by the University of Iowa Agricultural Law Center.

178. Boehlje, *Intergeneration Transfers: Is Agriculture Unique?*, TRUSTS AND ESTATES 172, 173 (March 1973).

179. Hines, *supra* note 2, at 11-5.

180. *Id.*

181. Boehlje, *supra* note 178, at 172.

on a basis of managed lifetime transition.[182] If the typical family farm or ranch is to remain as an operating unit, the parents must prepare themselves to make the transfer of ownership and management control in a manner which will assure that the tax burden and buy-out costs of the succeeding operators are within reasonable limits.[183] This process is greatly facilitated by creating ownership forms designed to accomplish the devolution and conservation of family capital. The close corporation offers particular advantages in planning for the transition of the family agricultural enterprise.[184] As one study has stated:

> Thus when the dual criteria of preserving operational continuity and enhancing business opportunities are considered, the farm corporation is easily the best of the three alternative business forms. As farm size and income increase, these business planning attributes will make the farm corporation an increasingly attractive estate planning tool.[185]

Often, the parents who have invested their entire adult life in building an efficient enterprise are reluctant to suffer the loss of control resulting from gift transfers of specific assets or fractions of assets. The corporation dramatically eases this problem because of the legal attributes of the corporate entity.[186] If gifts of stock are coupled with testamentary planning and provisions have been made for dealing with absentee heirs, the successor operators may proceed with sure knowledge that their devotion to the family business will not be wasted following the death of their parents.[187]

## VIII. PLANNING FOR RECONSOLIDATION OF OWNERSHIP

The dilemma of how to maintain the farm or ranch as an operating entity from one generation to the next while still being fair to absentee children is the most difficult issue of farm and ranch estate planning.[188] The corporate solution provides several alternatives for approaching this problem.

The use of the corporate form allows stock ownership, and consequently income participation, to be distributed among operating

182. Fiore, *Analyzing and Planning the Finances and Estate of the Family Engaged in Agricultural Business*, 1 ESTATE PLANNING 96 (1974). The importance of lifetime estate management planning for the farm family is emphasized in Boehlje, *supra* note 178.
183. *See* Boehlje, *supra* note 178; Harl, *supra* note 18, at 367.
184. *See* Harl, *supra* note 18; *Large Farm Estates, supra* note 2, at 870.
185. *Large Farm Estates, supra* note 2, at 873.
186. *See* Section II *supra*.
187. *Id. See also* Boehlje, *supra* note 178, at 175.
188. Harl, *supra* note 18, at 378.

and absentee heirs. Through voting control devices, trusts or multiple classes of voting and nonvoting stock, control of the enterprise can be placed in the operating heirs even though they may own a minority of the stock.[189] Theoretically, at least, by employing this device capital of the absentee heirs could be retained in the business at no fixed cost to the business. However, a low rate of income and the typical desire in agriculture to retain as much operating income as possible for expansion or debt reduction may produce inequities and dissatisfied absentee shareholders.

Incorporation automatically eliminates the possibility of a real estate partition through which the donee or legatee of an undivided interest in real estate may compel sale.[190] When the assets (such as cultivated land operated by tenants) yield an adequate rate of return and when there is no debt which would impair the ability to pay dividends, the corporate form may fulfill a desire on a part of the parents to keep their holdings intact while still giving all the children equal participation. This approach may be coupled with a farm lease to the operating children, or a ranch lease to a separate entity owned by the operating children in which the operating livestock reposes.[191] Alternatively, the corporation may serve as a vehicle to give the successor operators control of management during the period of time when the legacies to absentee shareholders are being funded and to provide a medium for the purchase of the stock of said shareholders.

One approach is for the parents to establish specific cash amounts which provide fair legacies to the absentee shareholders, the funding of which is within the reasonable economic capabilities of the operating unit, or to create a formula based on date of death values which will arrive at such a sum. Those involved should recognize the economic fact that if the agricultural assets are to be held intact by the successor operators, their rate of return will be far lower than the return the absentee heirs are likely to obtain upon the investment of their cash legacies.[192] One method of arriving at the value of these legacies is to compute a sum which the absentee heirs' share of anticipated income from the family enterprise would produce when capitalized at the going rate of return for conservative financial investments.[193]

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189. *Id.* at 379.
190. *Id.*
191. Fiore, *supra* note 182, at 99.
192. Harl, *supra* note 18, at 379.
193. *See* Kelley, *Estate Planning for Farmers and Ranchers*, PRAC. LAW. (Oct. 1974), at 24.

If the successor operators are given the option to purchase shares of the absentee children at such sums, the successor may then decide after the death of the parents whether it is feasible to exercise the option. Alternatively, the absentee children may be given the option of cashing out their shares. The cash amount of such an option should be sufficiently low to give the absentee children incentive to leave their capital in the business. But it should be sufficiently high so that they can realize reasonable cash funds if they do not consider the dividend return from their stock adequate.

The parents may consider how far in the future (*i.e.*, how many generations) they wish to attempt preservation of the operating unit. It may be that only a single generation is feasible, which can be accomplished by lease arrangements in the manner suggested above. On the other hand, protection of the family enterprise from estate tax at the death of the second generation together with preservation of the operating unit during the lifetime of the second generation may be accomplished by generation-skipping transfers. Thus, stock may be given to the successor operators for life, with a limited power of appointment (perhaps confined to lineal descendants of the parents).[194] This can be done by creating legal life estates in corporate stock, without the intervention of a trust which would jeopardize the option for subchapter S election.[195] As a result, the family enterprise is held intact, but since it is owned by the corporation rather than by the individuals, all assets may be sold, operated or mortgaged without regard to the complexities of stock ownership. When stock is spread among the second generation in this manner, it is critical that carefully considered reconsolidation arrangements be included if ownership in the operators is necessary because of low income flow or otherwise.

In addition to option purchase arrangements, discussed above, if more than one person is to remain a shareholder during continued operation of the enterprise, an appropriate agreement restricting transfer of the stock is essential.[196] Such an agreement may create options for corporate redemption of the stock or purchase by other shareholders upon events typically covered in arms-length buy-sell agreements such as death of a shareholder, attempted sale or disposition of shares to non-family members, bankruptcy,

194. Casner, *supra* note 62.
195. CODE § 1371(a)(2); Treas. Reg. § 1.1371-1 (1959).
196. Comment, *Considerations When Incorporating the Family Farm*, 39 NEB. L. REV. 547, 555 (1960). Various types of stock transfer restrictions are comprehensively discussed at F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE § 7.01 (1958).

divorce, execution of judgment liens, foreclosure of stock pledges to secure loans, or other personal or financial calamities. The primary consideration in such arrangements is determining the option price.[197] A number of alternatives are available: the price may be related to federal estate tax or state inheritance tax appraisal values; the price may be at par or book value, although such amounts tend to be below market value and may lead to tontine-like arrangements whereby the shareholder to live the longest receives a windfall;[198] or the price may be arrived at by an annual revision method, with or without alternative appraisal backup, in the manner in which conventional buy-sell agreements are often arranged.

## IX. POST-MORTEM PLANNING

In addition to the lifetime planning appraoches for estate tax minimization, certain post-mortem planning options are available which can greatly contribute toward lessening the economic impact of intergeneration transfer.

A significant income tax benefit in the estate of agricultural operators (and unavailable to landlords) is that the step-up in basis of assets owned at death applies to zero basis raised properties (crops and livestock) which otherwise would produce ordinary income when sold.[199] In addition, if the alternate valuation date is elected, the gain (such as the gain in weight of calves) between date of death and the six month alternate valuation date is eliminated from income.[200] The advantage of the step-up in basis for property the sale of which would generate ordinary income is further enhanced because property which would ordinarily trigger the recapture of previous depreciation deductions or Excess Deductions Account expenses when sold does not result in recapture to the estate.[201]

197. *Considerations When Incorporating The Family Farm*, *supra* note 196, at 559.
198. Kelley, *supra* note 119, at 353.
199. Rev. Rul. 64-289, 1964-2 CUM. BULL. 173. *See also* Rev. Rul 58-436, 1958-2 CUM. BULL. 366. *See* Morrison and Vacovsky, *Estate and Income Tax Treatment of a Decedent's Farm Crops and Rents*, 4 CREIGHTON L. REV. 67 (1970-71). This includes raised and harvested grain, unharvested crops in place, raised calves, and older livestock.
200. Rev. Rul. 58-436, 1958-2 CUM. BULL. 366. The recapture provisions of Code § 1251 relating to farm losses used to off-set non-farm income, Code § 1252 relating to the gain upon the sale of farm land held for less than ten years, and the recapture provisions of Code § 1245 do not apply to farm property passing at the owners death, by reason of the increase in basis under Code § 1014.
201. Treas. Reg. § 1.1223-1(j) (1957).

Another tax advantage was added by the 1969 Tax Reform Act which added section 1223(11), providing that property having a basis determined under section 1014 is to be considered as property held for more than six months if disposed of within six months after death. Regulations under this section 191 specifically provide that property considered to be held for six months under section 1223(11) is considered that type of property for purposes of section 1231(b)(3) which extends long term capital gain treatment to cattle and horses held for more than twenty-four months and other livestock held for more than twelve months. It appears that such assets now qualify for capital gain treatment if sold within six months following death.

The farm landlord may treat in-kind rentals which are separated to him, but not sold, as income in respect of a decedent, and thereby achieve some income tax benefit.[202]

One of the disadvantages of incorporating agrictultural enterprises is that it sacrifices the income tax benefits otherwise available in the course of estate administration. The step-up in basis applies to the corporate stock only, not to the properties owned by the corporation.[203] Liquidation of the corporation shortly following death would be necessary to achieve any of these income tax benefits. If the formation of the corporation was motivated by a desire to hold the corporate property intact, this normally will not be a desirable alternative. Liquidation might be considered, however, where the corporation was formed only to facilitate gifts and the only legatees are the corporate operator or operators who do not feel the need of continuing business in the corporate form.[204]

The significant estate income tax advantages accruing from careful selection of the estate fiscal year may also be lost to the estate which holds substantial incorporated assets. Typically, the estate's income tax year is selected to trap income in the estate at income tax brackets lower than those of the estate distributees, and to defer income tax for an additional year with regard to income distributed to the legatees.[205]

If the corporation is conventional, dividends may be declared

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202. CODE § 691.
203. CODE § 1014.
204. *See* McQuiston & Ballard, *Current Status of the Liquidation-Reincorporation Problem*, 31 J. TAXATION 328 (1969). (Later reincorporation should be carefully evaluated in the light of the common liquidation-reincorporation principles which allow the later reincorporation to be disregarded for income tax reasons.)
205. *See* Desmond, *Taxation of Estate Income*, 113 TRUSTS & ESTATES 728 (1974).

any time during administration of the estate to gain the benefits of election of the estate fiscal year achieved, but it may be undesirable to declare dividends for other income tax reasons. Similarly the subchapter S corporation may declare and pay a dividend at any time and place specific cash distributions within the year taxable to the estate. Dividend timing from the subchapter S corporation and the election of the estate fiscal year must be carefully coordinated to avoid inappropriate diversions of income resulting from the constructive dividend of undistributed taxable income on the last day of the corporation's fiscal year.[206] An additional consideration where a subchapter S corpoation is involved is that the executor is a new shareholder and must file a consent to the subchapter S election within 30 days of appointment.[207] Although a trust holding shares disqualifies the subchapter S election, an estate does not.[208]

If the corporate stock exceeds 35 per cent of the gross estate, or 50 per cent of the taxable estate, it may be redeemed by the estate under section 303 to the extent of estate taxes and funeral and administrative expenses.[209] Technically, the result is capital gain to the estate with the redemption treated as a sale of the stock, resulting in the elimination of dividend treatment if the corporation has retained earnings. Since the stock basis was stepped up at the date of death, there is no taxable gain if the redemption is at the date of death value per share. Section 303 redemptions must occur within three years and ninety days after the filing of the estate tax return and be fully paid and completed within that time.[210] If the corporation cannot complete the redemption in that period, or if the redemption spread over a longer period is desired, (such as to fund payments resulting from a section 6166 election[211]) notes from the corporation payable in later installments may be distributed in redemption of the stock. Stock redemptions in excess of the allowable section 303 levels will be taxed as ordinary income to the extent of retained earnings unless qualifying for capital gains treament under section 302.[212]

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206. *See generally* McGaffey, *Estate Planning and the Subchapter S Corporation*, 112 TRUSTS & ESTATES 6 (1973) (discussion of handling subchapter S stock in the course of estate administration).
207. CODE § 1372(e)(1).
208. CODE § 1371(d)(2).
209. *See Estates, Gifts and Trusts* No. 242, TAX MANAGEMENT PORTFOLIO (BNA, 1970) (mechanics of § 303 redemption). *See also* Oster, *supra* note 168.
210. CODE § 303(b)(1).
211. *See* note 214 and accompanying text *infra*.
212. Silberberg, *Post Mortem Tax Planning for Estates with Substantial*

If the corporation has had subchapter S status since its inception, or if there are no retained earnings, the stock may be redeemed from the estate by the corporation without dividend consequence. Again, if such redemption is at the date of the death value per share, there is no taxable capital gain to the estate. Theoretically, in either conventional or subchapter S corporations, if the stock is redeemed at the value listed on the return, and the date of death value is substantially raised on audit, the possibility arises that the difference is a gift to the shareholders by the legatees of the estate. Under *Herringer v. Commissioner*[213] no annual exclusions would be allowed for such a gift. Perhaps such a situation could be avoided by deliberately structuring the redemption to trigger an increase in redemption price if stock value is incrased on audit of the estate tax return.

There may be an advantage to the estate of the agricultural operator in the election, made available in 1968 under section 6166, to pay that portion of the estate tax attributable pro rata to qualifying assets in ten equal installments.[214] Such assets must be those applied to the conduct of an active business, including an incorporated business, and the corporate stock, partnership interest, or propriatorship assets must exceed 35 per cent of the gross estate or 50 per cent of the taxable estate. Corporate stock to be eligible must exceed 20 per cent of the issued and outstanding stock or must be stock of a corporation having 10 or fewer shareholders.[215] In this respect, the qualifying number of shareholders is counted differently than under subchapter S. A husband and wife owning property as joint tenants count as two shareholders rather than one as is the case in qualification for the subchapter S election.[216]

The section 6166 election provides significant relief to the closely held active business at the present interest rate. Even with the interest rate increased, the automatic financing of the estate tax remains a valuable option. The installment payment of estate tax may be calculated to coincide with the installment payment of options for successor operators to purchase the interest of absentee

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*Holdings of Closely Held Stock*, 2 TAXATION FOR LAWYERS 342, 345 (1974). *See generally* Crumbley & Taylor, *Redeeming Stock of Subchapter S Shareholders*, 52 TAXES 74 (1974) (redemptions qualifying under § 302).

213. 235 F.2d 149 (9th Cir. 1956).

214. *See generally* Silberberg, *supra* note 212, at 345; Miller, *Several Routes are Available to Obtain an Extension of Time for Payment of Estate Taxes*, 3 TAXATION FOR LAWYERS 96 (1974) (application of the § 6166 election).

215. Treas. Reg. § 20.6166-2(a) (1960).

216. Treas. Reg. § 20.6166-2(b) (1960).

shareholders. In determining the option price to be paid, under stock reconsolidation arrangements and the terms for installment payment of such price, the effect of section 6166 option should be calculated, and the option price adjusted for estate taxes. There are other, but less valuable, alternatives under section 6161 for extending the time for payment of estate taxes for "reasonable cause" or "undue hardship."[217]

Where a legal life estate and remainders in corporate stock are used to avoid the subchapter S termination effect of trust interests, and such remainders are vested by the terms of the owner's will or through the exercise of a lifetime power of appointment by the life tenant, Code section 6163 comes into play. If a remainderman fails to survive the life tenant, his estate may elect to defer the payment of the estate tax pro-rated to the reversionary or remainder interest until six months after termination of the life estate. Further extension may be had for undue hardship.

If the estate includes stock of a currently electing subchapter S corporation, the history of the corporation should be reviewed to determine whether it has retained earnings generated from any period of activity as a conventional corporation, or otherwise. Farm or ranch corporations will generally have unwithdrawn, previously taxed income ("PTI") at the time of death. If any of these retained earnings were generated before the corporation elected subchapter S status, withdrawals, dividends or redemptions must be examined. Although the decedent could have withdrawn funds from the corporation before his death which would have been applied against the PTI and would not have been taxed in the hands of the shareholder, this is a personal privilege of the decedent and terminates at death. The PTI account is thus eliminated and not available to the executor.[218] If PTI is accumulated during the administration of the estate, the same situation obtains upon distribution of the subchapter S stock at the end of the estate administration. The executor's PTI account terminates and is not available to the distributee.[219] Any sums then withdrawn by the distributee in excess of current undistributed taxable income will be taxable dividends to the extent the corporation continues to have retained earnings.

A significant post-mortem factor is the effect of incorporation on the whole process of estate administration.[220] The complexities of accounting, obtaining court orders to authorize conduct of business

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217. *See* Miller, *supra* note 214.
218. *See* McGaffey, *supra* note 206.
219. *Id.*
220. Kelley, *supra* note 119, at 338.

or sales of business property, and the problems incident to the operation of business assets and their distribution at the end of the estate are eliminated by incorporating such assets. Only the corporate stock is subject to administration and only dividends paid or amounts received in redemption of stock need be included in the executor's accounts. The corporate business and business decisions continue uninterrupted by the probate process, privacy of the business accounts is obtainable (to the extent they are not required to be placed on public record in the process of inheritance tax determination), and the fiduciary handles only corporate stock and need not manage the business enterprise.

A further possibility is that the executor may be directed to incorporate the estate assets, or some of them, for the purpose of using the corporate vehicle to manage business assets and pass business ownership to succeeding legatees. Where the testamentary trust may be an inadequate vehicle for the operation of a continuing business enterprise, the creation of a testamentary corporation may serve a useful purpose.

## X. CONCLUSION

The use of artificial devices of asset ownership to create divisible property rights in assets otherwise impossible or awkward to divide is a useful estate planning device. The corporation may effectively serve as such a device. From the property standpoint alone, it provides a simple and efficient mechanism for creating future interests and the fractional division of absolute ownerships in properties involving any combination of short-lived assets or going business operations which might otherwise be extremely difficult to distribute.

Stock in a corporation holding the family agricultural assets provides a convenient medium for complex intergeneration successions, including divisions at various times and among various persons, and allows complex divisions of the rights to control the property, receive the income from the property, and own the economic substance of the property. Such divisions are often necessary to minimize federal estate tax, preserve and centralize management of family capital, and allow participation by family members not forming part of the operating management.

The corporation is, however, a paradoxical device. While greatly simplifying intergenerational devolution of property in many ways, it contains inherent income tax complexities which must be carefully evaluated and administered. It involves detailed record keeping and requires the former sole proprietor to develop habits nec-

essary to work within an organizational format. The choice of the corporate farm sacrifices some post-mortem income tax advantages, but may offer the possibility of income tax saving on earnings reinvested in the business.

As an artificial legal person, the family corporation requires professional care and feeding. The estate planner's job is not finished with the formation of the corporation and its use in the family lifetime and testamentary transfers. Its record keeping must be supervised and decisions which may effect taxability must be carefully monitored throughout its existence.

While use of the close corporation in farm and ranch estate planning must be evaluated to determine its benefits and disadvantages for a particular family, it offers great potential for controlling death tax burdens, as well as facilitating inheritance. As the inflation of farm and asset values insidiously works to sap the economic strength of family agricultural enterprises through ever increasing death taxes, many such enterprises will be confronted with the necessity of adopting carefully considered and highly sophisticated estate planning approaches if their integrity is to be defended.

The corporation provides, both through its basic form and the well traveled paths of law concerning its taxability and stock valuation, some unique opportunities. The loss of flexibility in dealing with the family assets is a relatively small price to pay for the family which seeks intergenerational stability of asset ownership. The facets of incorporation which would be severe handicaps to more volatile types of business are actually advantageous in preserving the family farm or ranch unit between generations.

Thoughtful consideration of the many aspects of incorporation as an estate planning device serves to illustrate to the estate planner that there are no panaceas for tax avoidance and efficient property devolution. Each situation must be analyzed on its own terms and treated by using legal tools adapted to the desires, personalities and asset mix of each family.