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The Effect of Estate, Inheritance and Gift Taxes on the Concentration of Business Enterprise

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THE EFFECT OF ESTATE, INHERITANCE AND GIFT TAXES ON THE CONCENTRATION OF BUSINESS ENTERPRISE

By

EDWARD N. POLISHER*

The Declaration of Independence introduced in America a new concept of government founded upon the dignity of the individual. It proclaimed the inalienable rights of every citizen to life, liberty and the pursuit of happiness. These rights were vouchsafed to the people of the United States under the Bill of Rights which forms part of our Constitution. Among these inalienable rights was and is freedom of individual enterprise. Its protection and development became one of the compelling philosophies of our national economy, while the existence of monopolies has been and is deemed inimical to the best interests of the Nation's economy.[1]

This freedom of individual enterprise has expressed itself in the creation and growth of business ventures. The advent of industrialization in the United States about a century ago gave tremendous impetus in this direction. While many businesses are widely owned, by far the majority of them are held by individuals and small groups of business associates. These latter may be conducted either as a partnership or as a corporation whose shares are closely held. There are 4,000,000 business enterprises in America, of which 3,000,000 could be classified as small business. Small business has been defined as any business with 100 or fewer employees or with sales of $1,000,000.00 or less; however, a business beyond that amount in sales or number of employees might still be called a small business, if it had owner-management or closeness of ownership to the operation, or if it operated in an industry where the particular business was the smallest that could possibly exist.[2] The writer, however, adopts as the definition of small business for the purposes of this discussion only those businesses in which there is owner-management or ownership closely held. Thus, throughout this paper, the terms "small business" and "closely held business interest" will be used interchangeably.

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1 Mr. A. D. H. Kaplan, of the Brookings Institution, testifying before the Joint Committee on the Economic Report, 81st Congress (Part 1, P. 51), said in part:

"A successful effort to preserve our system of private enterprise must provide expanding opportunities for the development of small, independent business enterprises. Big-business executives, as well as those directly engaged in small business, recognize the importance of the small independent enterprise as an essential leaven in the total business structure. Indeed, small business is much more than a leaven; in its own right, it accounts for more than one-third of the total output of goods and services that make possible the American standard of living. It is in the public interest that small business should not lack for adequate facilities to maximize its contributions."

2 Ibid, P. 69.

Experience indicates that, in many estates, the business interest of the decedent constitutes a substantial asset. This must be valued, together with other assets in the estate, to determine the amount of the net estate subject to Federal estate and local death taxes. Since these taxes, and the debts and costs of administration of the estate, must be paid in cash within a limited time after death, it may become necessary to liquidate or dispose of the business interest to provide the necessary cash; this, because the financial structure of the average business, in which capital is an income-producing factor, is such that large sums of cash and liquid resouces are not present normally beyond its reasonable needs for working capital. The remainder of its resources is usually invested in buildings, machinery, equipment, raw materials, accounts receivable, inventory and other assets necessary to the successful operation of the business. Thus the problem is two-fold: First, to ascertain the valuation which will be placed upon the business interest by the estate tax authorities, which in turn determines in part the amount of such taxes to become payable; and second, to take the necessary steps to assure the conversion into cash of estate assets, which may include the business interest, at a fair and reasonable price without drastic sacrifice in values. It is the combination of these two factors which creates the threat to the survival of small or closely held business interests. To these problems we shall devote ourselves.

In a sense, the inquiry undertaken for discussion in this paper, as limited by the title of the subject, compels consideration of the problem in a kind of vacuum. If we were to analyze it comprehensively, we would be obliged to consider the effect of many other factors normally present in our economy which are potent influences upon the continuance, destruction and concentration of business interests. To mention but a few, they include inefficient management, lack of business vision, loss of effective management by death and other causes, inadequate financing and competition among businesses.

Moreover, this presentation is made from the viewpoint of the tax expert with emphasis upon the threat to and fate of individual enterprises. The effect upon the general economy is not considered. The latter would be the approach of the economist.

Motivation for Federal Estate and Gift Taxes

The imposition of estate tax by the Federal government in 1916[8] and the current gift tax in 1932 was motivated in part by a desire to prevent the transmission from generation to generation of vast fortunes by wills, inheritances or gifts. Such succession of wealth was deemed not to be consistent with the ideals and sentiments of the American people. Security for oneself and one's family could be provided adequately by a reasonable inheritance; but accumulations which result-

8 There are two Federal Estate Taxes levied. One, the basic tax, based upon the 1926 Revenue Act; the other, the additional estate tax, enacted by the 1932 Revenue Act and since amended.

ed in the perpetuation of great concentration of control in relatively few individuals over the employment and welfare of many was regarded as undesirable.[4]

This philosophy was not original with President Franklin D. Roosevelt. A similar sentiment was expressed by President Theodore Roosevelt in his message to the Congress in 1907.

The theory that taxation is intended to provide revenue only is not supported by experience or by history. Current social attitudes of the American people have had a marked influence upon the purposes and objectives of taxation.[5] The very pattern by which the tax is imposed—progressive, graduated rates which increase as the amount of the estate becomes larger—evidences the intention of the Congress to accomplish a redistribution of the greater accumulations of wealth at death.

The Federal estate and gift taxes have not been significant sources of revenue in relation to the total revenues of the Government. For the fiscal year ended June 30, 1949, they constituted approximately 2% of the revenue.[6] The effect of the marital deduction introduced by the 1948 Revenue Act is estimated to reduce this to approximately 1.4% of the total Federal revenue.

The statistics of the creation and growth of individual business enterprises would seem to belie the fact that such taxes have had any adverse influence upon individual enterprises, except in limited areas where the type and size of the industry makes bigness a necessary concomitant of successful operation in our modern economy. There has been a steady growth in the number of business ventures. There is no dependable statistical information which would support the assertion that such taxes have resulted in a definite trend towards disintegration of small

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[4] See message to Congress of President Franklin D. Roosevelt dated June 19, 1935.

[5] Frankfurter, *Mr. Justice Cardozo and Public Law*, 52 HARV. L. REV. 440, 448 (1939); Paul, *Federal Estate and Gift Taxation*, Section 1.07, Note 24 (1942).

[6] The Annual Report of the Commissioner of Internal Revenue, U. S. Treasury Department, for the fiscal year ended June 30, 1949, supplies the following statistics:

	Total Income and Profit Taxes	Estate and Gift Taxes	Total Internal Revenue Collections
1932	$ 1,056,756,697	$ 47,422,313	$ 1,557,729,042.64
1933	746,791,404	34,309,724	1,619,839,224.30
1934	819,655,955	113,138,364	2,672,239,194.52
1935	1,105,790,865	212,111,959	3,299,435,572.18
1936	1,427,447,594	378,839,515	3,520,208,381.09
1937	2,179,841,835	305,547,766	4,653,195,315.28
1938	2,629,029,732	416,874,065	5,658,765,314.33
1939	2,185,114,305	360,715,210	5,181,573,952.58
1940	2,129,609,307	360,071,167	5,340,452,346.78
1941	3,471,123,930	407,057,747	7,370,108,377.66
1942	8,006,883,544	432,540,288	13,047,868,517.72
1943	16,298,888,092	447,495,678	22,371,386,496.55
1944	33,027,801,888	511,210,337	40,121,760,232.77
1945	35,061,526,200	643,055,077	43,800,387,575.90
1946	31,258,138,152	676,832,302	40,672,096,997.88
1947	29,019,755,956	779,291,074	39,108,385,741.63
1948	31,172,190,533	899,345,444	41,864,542,295.40
1949	29,605,491,151	796,537,914	40,463,125,018.61

business enterprises or in their disposition to monopolistic interests. There have been statements from various quarters that the relation of the amount of the estate and gift taxes collected by the Federal government to the total revenues in recent years has been so slight as to indicate no serious economic problem. All admit, however, that within the broad field, these figures cannot accurately reflect the effect of such taxation in individual cases. As to the latter, there must certainly be incidents of hardship which have resulted in the destruction or transfer of small business to monopolistic enterprises. Reliable statistics in support of this conclusion are not available.

Federal Gift Tax

The Federal gift tax was originally adopted as one means of preventing the tax-free transmission of property from one generation to the next. It has had little or no effect on the concentration of business interests. This has resulted from the application of (1) the annual exclusions and exemptions allowed to taxpayers under the gift tax law; (2) the initial low and graduated gift tax rates which every donor may take advantage of, after the annual exclusions and specific exemption have been consumed; (3) the creation of the marital deduction and the split-gift provisions under the 1948 Revenue Act. The "marital deduction" reduces the amount of the gift from one spouse to the other by one-half; while the "split-gift provision" permits each consenting, married donor to be treated as the individual donor of half the amount of the gift and be taxed thereon as his own gift, even though the property which forms the subject matter of the gift may belong solely to the other.

The practical effect of the Federal gift tax has been to preserve closely held business interests for the benefit of the succeeding generation by making possible the transfer of such interests, in whole or in part, during the lifetime of the owner; by eliminating from his estate at death such portions which were gifts made by the donor during his lifetime; by reducing the burden of the Federal estate taxes; and by insuring the continuity of ownership in the hands of the intended beneficiaries.

State Inheritance Taxes

State inheritance taxes have had slight effect on the concentration of business enterprise. In the main, this is due to the fact that the rates of such taxation in most jurisdictions are low and do not create a serious burden upon the estate. In addition, most states grant liberal exemptions from inheritance taxation to certain types of assets held by the estate, such as life insurance and property held jointly by husband and wife. These have had the effect of materially diminishing the size of estates subject to tax and the amount of such taxes which the estate must pay.

Valuation of Business for Federal Estate Tax:

One of the serious difficulties encountered by representatives of estates arises from the method of determining the valuation of the closely held business interest for Federal estate tax purposes. Normally, there is no readily available market for such interest which would establish its value. With the larger business interest, whose securities are traded on an exchange, or in over-the-counter transactions, this problem is largely overcome.

The Internal Revenue Code itself provides merely that the property of the decedent shall be valued either as of the date of death or, at the election of the Executors or Administrators, as of one year after death.[7] The latter is intended to give the estate an opportunity to take advantage of declining values following the decedent's death. The Regulations, however, set forth in general terms the elements of valuation which must be considered in arriving at the valuation of a closely-held business interest. Where the business interest of the decedent was a sole proprietorship or a partnership, the assets must be appraised and their fair market value ascertained. Among the assets which must be taken into account is "goodwill" at the applicable date.[8] Where the business interest is conducted as a closely-held corporation, the value of the decedent's shares in the business must be determined upon the basis of the company's net worth, earning power, dividend paying capacity, and all other relevant factors having a bearing upon the value of the stock.[9] The emphasis placed upon "earning power," in the case of closely-held corporations, corresponds to the element of "goodwill" which must be taken into account in the case of a sole proprietorship or a partnership. The fair market value of the assets of the business does not mean the book value. It is, according to the Regulations, the price which a willing buyer will pay to a seller not forced to sell.[10] The difference between book value and fair market value becomes apparent in cases involving such assets as business real estate and equipment against which large reserves for depreciation have been set up based upon cost. Moreover, patterns, trademarks and secret processes are usually carried on the books at a nominal value, but often have a real and substantial value.

The operation of the methods for determining "goodwill" and "earning power" employed creates some unlooked for and astounding valuation results at the hands of the estate tax authorities. The method commonly used is the income tax method.[11] Under it, an allowance is made for an 8% return on tangibles in a normal business and 10% in businesses which are of speculative character. This sum is deducted from the average net income earned by the business during the preceding five years. The balance of the average income is then capitalized at 15% to 20%, the lower figure being applied to stable businesses, while the higher is employed where the business is speculative. The sum arrived at by the last mentioned multiplication represents the value of the intangibles or "goodwill." This "goodwill" figure is then added to the fair market value of the business

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7 Sec. 811(a) and (j).
8 Reg. 105, Sec. 81.10(d).
9 Reg. 105, Sec. 81.10(c).
10 Reg. 105, Sec. 81.10(a).
11 A.R.M. 34, 2 CB 31.

assets and the total represents the value of business for Federal estate tax purposes.

Example: The A Company (sole proprietorship or partnership) has total tangible assets, after liabilities, of which .... $500,000.00 has been its average invested capital for five years.

Its average annual earnings for the past five years were $75,000.00
In a sole proprietorship and a partnership, earnings are determined before any allowance for Federal in- taxes paid. In corporation, the earnings are computed after payment of corpate Federal income taxes.

From this we deduct 8% of $500,000.00 or $40,000.00

Earnings attributable to intangibles $35,000.00
Capitalizing the "intangible earnings" at 15%, we arrive at a figure for goodwill of $233,450.00

The goodwill figure is added to the value of the business assets and a total value for Federal estate tax purposes is computed $733,450.00

The justification for the use of this formula is based upon the theory that profits from a business operation, in which capital is an income-producing factor, are attributable to two elements: (1) The capital employed in the business; and (2) the earnings resulting from the intangibles connected with the business and which are considered as earnings attributable to good will. If the total arrived at under the formula exceeds the value of the net assets, after liabilities, the difference represents goodwill. The larger figure is then used as the valuation of the business interest for Federal estate tax purposes, instead of the net asset value. If the calculation does not indicate a total value in excess of the net assets, after liabilities, it is then concluded that no goodwill exists.

There are, however, several important limitations to the above formula. First, before goodwill can be considered as an element of valuation, it must be determined that the business is of a type in which goodwill actually exists. Thus, if the business depends wholly upon the personal services, contacts or special skill of the decedent, or is of an extremely hazardous nature, or is based upon government contracts or upon a cancellable franchise, no goodwill exists despite the amount of the earnings; similarly, where the business interest is to be liquidated at the owner's death. Moreover, in determining the average annual income, only those years of the business existence which are closest to the date of death and are truly representative of the normal operations should be used. The number of years' earnings has been extended to 12 years in one case where this period appeared to be more representative. Abnormally good or bad years have been disregarded. Thus, the swollen profits earned during the war years have recently been ignored as not being typical of the earning capacity of the business.[12]

The effect of the addition of goodwill to the net worth of the decedent's business interest is its inclusion as an asset in the estate at the higher value. The burden of Federal estate taxes is thus substantially increased without at the same time providing any marketable assets from which additional cash might be realized to discharge this augmented tax obligation.

It is the unpredictability of the valuation, resulting from the indefinite and variable application of this formula, which creates one of the principal threats in this area to the continuation of business enterprise at the death of the owner.

A review of the decisions of the Courts will indicate that of the small percentage of cases which ultimately reach the Courts for decision, the variance between the valuation placed upon the business interest by the estate and that contended for by the Commissioner is often so marked as to create cause for wonder as to whether both were operating under the same formula.[13] The results of the decisions seem to have placed the Courts in the position of an arbitrator, in those cases where the Court refused to adopt the position of one or the other of the litigants, resulting usually in a compromise figure between the two extremes as the valuation determined by the Court. By far the largest number of these situations is disposed of in Bureau of Internal Revenue channels and never come into the Courts. There are no statistics available for these.

There have been many complaints among practitioners, and in the literature dealing with the subject, and various remedies have been suggested.[14] Un-

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12 Polisher, *Estate Planning and Estate Tax Saving* (1948); Vol. I, P. 317; *Federal Taxation of Closely Held Interests*, by same author, 54 DICK. L. REV. 150 (1950).

13 See, Estate of Henry T. Sloane, deceased, 3 TCM 358 (1944), where the following valuations of closely held stock were in issue:

	Values returned by Executors in Estate Tax Return		Values determined by Respondent	
Description of Stock	Approx. Value per share	Total Value	Approx. Value per share	Total Value
362 shares Masland com.	$ 15.00	$ 5,404.66	$ 35.00	$ 12,670.00
750 shares Masland pfd.	37.50	28,057.50	65.00	48,750.00
3,175 shares W. & J. Sloane com...	1.30	4,019.53	51.00	161,861.50
1,900 shares W. & J. Sloane pfd. ..	5.00	9,367.00	100.00	190,000.00
8,228 shares W. & J. Sloane prior pfd.	15.25	124,901.04	100.00	822,800.00
120 shares Alexander Smith	2,015.00	241,784.40	6,232.00	747,895.45
3,020 shares Sloan Mfg.	10.00	29,988.60	60.00	180,587.12

14 One suggestion is the use of the net asset value, with goodwill or going concern value added only where the exceptional earnings demonstrate that the stock is worth substantially more to the holder than an aliquot percentage of the immediate and measurable assets. The earnings must be abnormal before goodwill is valued. Rice, *The Valuation of Close Held Stocks: a Lottery in Federal Taxation*, 98 U. OF PA. L. REV. 367, Pp. 388-389 (Feb. 1950). Another suggestion is that the maximum valuation be the mean of the book value and capitalization of earnings value and that the final valuation be the result of a compromise downward after negotiations. W. T. Hackett, testimony before the Joint Committee on the Economic Report, 81st Congress, Part 1, P. 503.

doubtedly, it would aid materially in anticipating and providing for the tax obligations arising at death, if a more definitive basis for valuation of closely held interests were announced and adhered to.

Cash to Pay Taxes

Once the valuation of the closely held business interest is determined and the amount of the death taxes ascertained, the next threat to its continuance stems from the need to provide the cash with which to pay them. This is no problem where it is not intended that the business be carried on after death and is to be liquidated. It is trite but true that such taxes must be discharged only by payment of cash and not by property within 15 months after death. The amount required may be dis-proportionately large in relation to the estate assets which are liquid or readily convertible into cash. Death may have occurred in an economic period when a forced sale of assets owned would result in drastic sacrifice of values. The withdrawal of substantial amounts of cash from the business itself may impair its necessary working capital and jeopardize its ability to carry on profitably. Financing facilities through normal channels may be unavailable.

Our personal experience and that of several of the leading banking institutions within our acquaintance which act as fiduciaries would indicate that, generally, the obligation to pay the estate taxes creates no mortal threat to the continuance of the business interest which cannot be parried. There are, of course, cases of individual hardship where a toll may be taken.

A comforting analysis of the liquidity of estates was recently published by Professor C. Lowell Harriss.[15] His findings are here reprinted with his express permission.

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15 Harriss, *Liquidity of Estates and Death Tax Liability*, 64 POL. SCI. Q. 533 (1949).

ESTATES SUBJECT TO FEDERAL ESTATE TAX, 1942-44; NUMBER, GROSS ESTATE, TAX, AND LIQUID ASSETS. AMOUNTS AND PERCENTAGES.[1]

Size of Net Estate[2]	Number	Amount of Gross Estate Plus Tax-Exempt Life Insurance	Total Tax[3]	Fully Liquid Assets[4] Amount	Fully Liquid Assets[4] % of Total Tax	Total Liquid Assets[5] Amount	Total Liquid Assets[5] % of Total Tax
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
(Thousands)		(Millions)	(Millions)	(Millions)		(Millions)	
Under $100	23,254	$1,971	$ 44	$ 645	$1,466[6]	$ 904	$2,055[6]
$100-$200	8,914	1,544	156	513	329	772	495
$200-$300	2,546	747	129	243	188	390	302
$300-$500	1,815	857	170	282	166	463	272
$500-$1,000	1,148	946	232	334	144	548	236
$1,000-$2,000	438	720	215	258	120	427	199
$2,000-$3,000	96	325	98	123	126	208	212
$3,000-$5,000	47	208	85	76	89	127	149
$5,000-$10,000	32	325	140	125	89	211	151
$10,000 and over	9	230	115	43	37	127	110
Total	$38,299	$7,875	$1,383	$2,639	191	$4,173	302

1. Source: U. S. Treasury Department, Bureau of Internal Revenue, Statistics of Income (Washington, 1944-45); photostats of data for 1944. Data are from returns filed in these years. Returns of non-resident aliens are not included.
2. Before deduction of specific exemption.
3. Total federal tax (plus estimated addition due to audit of returns) before deduction of credit for state death taxes. Does not include state death taxes not deductible from federal tax; for many small estates the state tax not accounted for here is much larger than the federal tax.
4. Includes cash, U. S. government bonds (and other debts), state and municipal bonds, one half of all "other bonds", and life insurance.
5. Includes "fully liquid assets", see note 4, plus one-half of corporation stock.
6. Relates to federal tax only. Figure would be much smaller if state taxes were included.

Because of rounding, detail will not necessarily add to totals.

(NOTE: Mr. Harriss admits that estate assets composed of corporation stocks, which would include stocks in closely held corporations, were arbitrarily treated as one-half liquid. He states that any error in this respect would probably be in the direction of an understatement of business liquidity. At the same time, his computations assume that all individual and partnership business interests were included as illiquid assets. Since we are examining specifically the effect of Federal estate taxes on the concentration of business, this unsupported assumption of liquidity of corporate stocks to the extent of one-half must impair a complete reliance on his findings. Perhaps a further study now being made by him will supply the corroborating data.)

Mr. Harriss' conclusions indicate that, in general, estates of the size that would include a closely held business interest enjoyed a satisfactory degree of liquidity which would not make them vulnerable to the payment of estate taxes.

The fact that the impact of Federal estate taxes at current rates on such business interests does not reach a destructive level should not be construed by the Treasury as an invitation to increase the burden. The philosophy of equitable taxation will never justify the imposition of a levy which decimates vital elements of our economy.

Planning for Death is Imperative

The existence of this threat to the integrity and preservation of small business carries with it a reciprocal salutary effect. The awareness of this problem has served as an encouraging stimulus to the owners of small business enterprises to plan properly in order to avert the rigours of such taxes at death. There are many recognized, ethical procedures which may be adopted during the lifetime of the owner of a business enterprise which would lessen considerably the impact of such taxes. Some of these are designed to reduce the burden of taxation when death occurs; others are intended to insure the continuity of the business enterprise by making available experienced successor management; and still others seek to provide the liquidity which would be necessary to preserve the business unit as an effective and profitable continuing entity. Moreover, there are measures which may be taken after the death of the owner which can aid substantially in reducing the effect of the Federal estate taxes on the preservation of the business interest.

In the final analysis, the situation may be summed up thus: The burden of Federal estate taxation upon small business is a threat to its existence and contunity when the death of its principal owner or owners occur. If not properly planned for, death may visit havoc upon such ventures and destroy them. On the other hand, its impact may be softened materially and the burden lightened by proper planning in advance of death, or the adoption of legitimate procedures available after death, which would assure the continuance of the business venture.[16]

Even though we may conclude that Federal estate and gift taxes constitute no overall threat to the general economy, the fact that it is capable of striking down a small business enterprise in a particular situation is sufficient to justify our serious concern. These are vital to our concept of a desirable economy. In medical science, many diseases are considered mortal and invite the expenditure of vast amounts of time, money and services in an effort to control them, even

[16] W. T. Hackett in his testimony before the Joint Committee on the Economic Report, 81st Cong., 1st See. (P. 520) states that estate and inheritance taxes are slowly destroying small business; while C. L. Harriss comes to substantially the same conclusions as the author. See, Harriss, *Estate Taxes and the Family-owned Business*, 38 CALIF. L. REV. 117 (1950).

though they attack only a small percentage of the total population. For the stricken business enterprise, it is small comfort that it is one of only a small number which may be adversely affected by the operation of the estate tax.

The burden of Federal estate taxes has been increased constantly since it was first enacted by the Congress. This resulted from the:

(a) Reduction of exemptions;

(b) Increase of rates of taxation;

(c) Expanded concept of property includible in the estate which is made subject to taxation;

(d) Broadened principles of valuation especially insofar as they apply to the valuation of closely held business interests.

One notable exception to this trend was the introduction by the 1948 Revenue Act of the marital deduction for estates of married decedents.

Procedures in Aid of Business Preservation

1. Gifts: The transfer by gift during life, of all or a portion of the business interest, is often a sound plan for its continuation under the control of the management intended to succeed the owner when he retires or upon his death. Aside from tax considerations, it affords the owner an opportunity to guide with his experience and to train the more active and ambitious younger management. In most instances, the donees would be members of the donor's family active in the business with him, or business associates in whom the owner has developed confidence. Thus, a stronger and more effective successor management could be provided which would reduce the risk of the disintegration of the business at the owner's death because of untrained management.

From the standpoint of taxes, such gifts, if based upon motives associated with life, such as a desire to give future management an opportunity for assuming responsibility and developing experience, or because the owner desires to be relieved of responsibility, would run slight risk of being deemed transfers in contemplation of death. The tax results of such effective gifts are significant. The amount of the gift is withdrawn from the estate of the donor in its highest bracket and thus the estate tax is reduced substantially. The gift may be free of gift tax if its amount is within the applicable annual exclusions and the specific exemption allowed; but if it should exceed these, it would be subject to the much lower rates of the gift tax. Any gift tax paid by the donor would further reduce which the business was conducted, or the introduction of the donees as constituent owners, or a recapitalization before they can be made conveniently. It is surprising that the statistics reveal a rather restrained use of the gift, despite its many advantages.

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the donor's estate.[17] Such gifts may involve a change in the legal entity under

[17] POLISHER, *Estate Planning and Estate Tax Saving* (1948), Vol. 2, Pages 486-7.

2. Agreement among business associates fixing the valuation at death:

It is possible to eliminate the uncertainties of valuation of the business interest and to neutralize the harrowing element of the valuation of goodwill by proper provision in advance of death. Where the decedent's business interest is subject at the decedent's death to an agreement of sale, or to a legally binding option exercisable by his business associates, partners or co-shareholders, at a fixed price, the fair market value for Federal estate tax purposes is limited to such price, provided it was fair and reasonable at the time it was established. For this purpose, the book value at death would seem to represent a price fairly established if it does not differ too greatly from the fair value of the assets. The partners instead may agree that the value is to be determined by successive, periodic valuations to be established by mutual statements in writing, signed by the parties from time to time, with the last such statement before death to govern. Similarly, in such cases, if the price is fair in relation to the value of the business, it will control. A further condition for such price fixing arrangements to be recognized for Federal estate tax is that the estate owner must be precluded by the agreement from disposing of his business interest during his lifetime, except with the consent of the other parties to the agreement or only upon the same terms which are to prevail at death.[18]

3. Business Life Insurance:

Where the business is conducted as a sole proprietorship, there are usually one or more business associates of proven ability and experience, in whom the estate owner has confidence and under whose management the business could be continued profitably after his death for the benefit of his family and the associates. Under such circumstances, an application for insurance on the life of the owner of the business should be made by the associates who would pay the premiums themselves. The funds for premiums could be made available through profit sharing arrangements or increased salaries. The total must not exceed reasonable compensation.

Where the business is a partnership, the application for insurance should be made by each partner on the life of the other and the premiums thereon paid by the partner who is not the insured. The insurance may also be purchased by the partnership itself as owner, which would pay the premiums and would be named as beneficiary. The proceeds of the life insurance should by agreement be committed to the purchase of the decedent's business interest at his death at a fixed price in accordance with the prior discussion. Where the partnership owns the policy, the agreement should eliminate the proceeds of the life insurance received at death as an element in valuation. In the above circumstances, the proceeds when received are not income subject to Federal income tax. Nor are they taxable as assets in the insured's estate .

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18 Ibid, Vol. 1, Pp. 310-318; Vol. 2, Pp. 506-508.

Where the business is conducted as a corporation whose stock is closely held, the purchase of life insurance on the life of the shareholders who own the business may take one of two forms:

(a) By the shareholders applying for the insurance upon the lives of each other;

(b) If such shareholder is a "key man" of the corporation, through the application by the corporation for insurance upon his life.

There should be an accompanying agreement among the shareholders or with company, as the case may be, under which the decedent's shares would be purchased at his death at a fixed price, reasonable and fair when fixed.

From a practical standpoint, the effect of retiring the decedent's shares of stock through repurchase by the corporation is to transfer automatically to the surviving shareholders, pro rata, the decedent's interest in the corporation. This follows from the fact that there will be fewer shares outstanding and the value of the remaining shares held by the surviving stockholders will increase correspondingly.[19]

For the purpose of this discussion, the resulting transfer of the decedent's interest in the business at his death to his business associates would not effect a concentration of business enterprise. It would merely continue the venture under the ownerhip of the purchasers.

4. Personal Life Insurance:

Where the owner of an individual business is insurable, but there are no business associates in a position to implement the plan set forth in 3. above, the use of personal life insurance assures the availability of cash for estate needs. Preferably, this should be applied for and the premiums thereon paid by some member of the family other than the insured, without contribution thereto, directly or indirectly, by the insured. Under such conditions, the proceeds when received by the applicant, on the insured's death, would be free of income and estate taxes. If the insured, himself, must apply for the insurance or pay the premiums, the cash position of his estate in most cases will be improved by the net amount available to his estate after payment of estate taxes.[20]

5. Marital Deduction:

The 1948 Revenue Act created an additional deduction applicable to the estates of all married decedents who died after December 31, 1947. Under it, a decedent's estate is allowed a marital deduction from the gross estate in an amount equal to the value of all interests in property passing from the decedent to the surviving spouse, under certain conditions. The deduction is limited to an

[19] Ibid, Vol. 1, Pp. 209-214; Vol. 2, Pp. 523-536.
[20] Ibid, Vol. 2, Pp. 519-523.

amount not in excess of fifty percent of the "adjusted gross estate" for interests in property passing to the surviving spouse, but only to the extent that such interest is included in determining the value of decedent's estate for Federal estate tax.

The result is to permit one-half the estate of a married decedent to escape Federal estate taxation at his death, if he complies with the requirements of the 1948 Revenue Act; otherwise, this advantage will be lost. The savings in estate taxes are always in excess of 50% of those which would be payable normally, since the marital deduction in effect reduces the estate from the highest brackets subject to tax and the remainder is taxed in the initial lower rates.[21]

The following table reflects the estate tax savings at the death of the first spouse to die, where the maximum marital deduction is availed of:

Before 1948 Act Estate After Deductions* but Before Exemptions	Estate Tax Thereon Before 1948 Act	After 1948 Act Same Estate as in Column 1 After Marital Deduction Reflected	Estate Tax Thereon After 1948 Act
120,000	9,340	60,000	None
200,000	31,500	100,000	4,800
500,000	116,500	250,000	45,300
1,000,000	270,300	500,000	116,500
5,000,000	2,038,000	2,500,000	830,000
10,000,000	4,975,000	5,000,000	2,038,000

However, the surviving spouse will incur at her death an estate tax based upon the value of her own estate at that time. In determining the value of such estate, the property received from the deceased spouse will be included to the extent that it forms part of the surviving spouse's estate.

The operation of the marital deduction has brought about a definite reversal in the trend of the continuation or discontinuance of small business enterprises due to the estate tax burden. Prior to the 1948 Revenue Act, the tendency was to arrange for the sale of the business during life or at the death of the owner. With the substantial reduction in the estate taxes by the proper use of the marital deduction, the pressure for the sale or other disposition of the business interest to strangers is very much lessened. In this respect, the marital deduction operates to resist concentration of business enterprise.[22]

*Deductions under Section 812 (b) of the Code only, for funeral expenses, administration costs, fees, debts, support for dependents and losses during estate administration.

21 Ibid, Chapters XXVII and XXVIII in text and in 1950 supplement.
22 Ibid, Vol. 2, Pp. 681-682.

6. The Charitable Foundation:

Under the Internal Revenue Code, bequests to charity are fully deductible from the gross estate for Federal estate tax. The proper utilization of this mechanism can substantially lighten the burden of estate taxes. Thus, where one-half the estate passes to the surviving spouse under the marital deduction and the balance to a charity or a charitable foundation, there is no estate tax payable; or the bequest to the charity may be in the form of a remainder interest after a life estate for the natural beneficiaries of the owner. In the latter case, the value of the remainder to charity is deductible and the value of the life estate only is subject to tax. There are a number of variations of this procedure that can prove beneficial tax-wise.[23]

7. Optional Valuation:

The Federal estate tax law grants the executor the right to choose, for purposes of valuation but subject to certain limitations, the value of the decedent's property either at the date of death or one year thereafter. By careful attention to this opportunity to select the date of valuation, the burden of estate taxes may be lessened materially. Where death occurs in a period of rising prices, the choice of the date of death for valuing the estate assets will inure to the estate's benefit. Conversely, where the trend is downward, the selection of one year after death to value the estate's assets will produce a tax saving advantage.[24]

8. If none of the above procedures meets the circumstances of the business owner, then resort must be had to the development of a sale for the business during his lifetime. The endeavor to negotiate a sale by the executors after the owner's death and under the pressure of the need for cash to settle the estate and to pay the taxes is hardly a favorable climate to realize fair value for such an asset. Drastic sacrifice is the rule under such conditions. Anticipation of this problem by the business owner and an unhurried sale during his lifetime should produce a reasonable price.

9. Should all of the suggested appoaches be unattainable, there is always available an application to the Commissioner to extend the time for payment of the tax for a period not exceeding ten years with interest at 4%. This relief is granted where the Commissioner is satisfied that payment on the due date would impose undue hardship on the estate. The estate, one of whose substantial assets is a closely held business interest, would qualify most particularly for favorable consideration by the Commissioner.[25]

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23 Ibid, Chapter XXIV; Polisher, *Obtaining the Maximum for the Estate and the Charity in making Charitable Gifts,* 53 DICK. L. REV. 87 (1949). Since this paper was delivered, the 1950 Revenue Act was enacted on September 23, 1950. Its provisions curtail some of the tax advantages of Charitable Foundations which engage in certain prohibited transaction. See section 162(a) and 3813 added to the Code by the 1950 Revenue Act.

24 Ibid, Vol. 2, P. 506. See also Note 7 above.

25 Ibid, Vol. 1, P. 286. INTERNAL REVENUE CODE, § 822(a)(2).