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Using Trusts as Buyers in Shareholders' Agreements

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Summary: While irrevocable life insurance trusts have become commonplace in estate planning, such trusts are not often used in shareholder planning. Even though there are important technical difficulties attending use of trusts in buy-sell agreements, substantial benefits can also be achieved. This article explores the advantages and difficulties involved.

SETTING THE CONTEXT

General Shareholder Succession Concerns

An owner of a closely held business interest needs to plan for the transmission of that business interest at the owner's death. The owner may want the interest to pass to the next generation so that they can continue to participate in the equity and equity growth of the business, and perhaps so that the next generation can participate in the management of the business, as well, either on a day-to-day basis or on a policy-making basis.

On the other hand, a business owner may conclude that the requirements of the business are more than the next generation can be expected to handle, that the family and the business would both be best served by providing a market for the owner's interest at his or her death and by liquidating his or her interest. Some of the benefits of such an approach would be the provision of an income free of the risks of the business for the surviving spouse as well as for the next generation to the extent that is desired. Of course, interests free of the business' risks will also be free of the appreciation of those interests after the business owner's death. If there is more than one branch of the family participating in the business at the outset, that appreciation after the death of one of the business owners may well create significant differences in the wealth of the different branches of the family, perhaps creating dissension among them. [3]

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[3] *See generally True Est. v. Comr.,* T.C. Memo 2001-167, regarding Tamma Hattan's withdrawal from family businesses at Findings of Fact, ¶ II(D); H. Zaritsky, *Structuring Buy-Sell Agreements: Analysis with Forms* at ¶ 1.02, fn. 2 (2d ed., 2001) (hereinafter, “*SBSA*”).

Such a business owner also needs to restrict transfers of interests by those holding other interests in the business so that he or she is not forced to conduct the business enterprise with persons not to his or her liking. [4] For decades, courts have recognized that such concerns involve legitimate elements of personal choice. [5]

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[4] *See, e.g.,* M. Zuckerman & J. Grall, “Corporate Buy-Sell Agreements as Estate and Business Planning Tools,” 28 *Est. Plan.* 599, 600 (No. 12, Dec. 2001).

[5] *See SBSA*, above, fn. 3 at *id.* and H. Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms,* at ¶ 8.02 (RIA 2d ed., 1997) (hereinafter “*SEF*”).

These are profound decisions requiring keen insight and careful planning and are well beyond the scope

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of this article. [6] Nonetheless, these parameters set the context in which these decisions arise. Generally speaking, many of the foregoing objectives are achieved by a shareholders' agreement, sometimes referred to as a "buy-sell agreement."

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[6] A highly selective review of the excellent literature on this subject would include *SBSA*, fn. 3, above, as well as J. August, "Drafting Shareholders' Agreements for S Corporation Shareholders: Buy-Sell Procedures and Liquidated Damages," 5 *J. Partnership Tax'n* 67 (1988); E. Bradley, "Stock Transfer Restrictions and the Closed Corporation," 37 *Va. L. Rev.* 229 (1951); Coates, "Share Transfer and Transmission Restrictions in the Close Corporation," 3 *UBC L. Rev.* 96 (1968); S. Leimberg & M. Rosenbloom, *The Wait and See Buy Sell* (2000); S. Leimberg, M. Rosenbloom & J. Yohlin, *The Corporate Buy Sell Handbook* (2000); 2 F. O'Neal & R. Thompson, *O'Neal's Close Corporations,* ch. 7 (3d ed. 1987); Rand, "Closely Held Corporations: Restrictions on Stock Transfers," 84 *Com. L.J.* 461 (1979); F. Tannenbaum, "What Every Business Lawyer and Business Owner Should Know About Buy-Sell Agreements," Part I, 45 *Prac. Law.* 55-74 (Oct. 1999); and H. Zaritsky, "Forgotten Provisions of Buy-Sell Agreements," 19 *U. Miami Est. Plan. Inst.*, Ch. 6 (1985).

At the same time, the use of irrevocable life insurance trusts to avoid estate taxation of life insurance proceeds in the estates of survivors has become established practice. [7] This article addresses integrating these two techniques. Generally, the advantages of using life insurance trusts in shareholder agreement planning have been underutilized and are virtually unmentioned in the literature. [8] However, while there can be substantial benefits, there are also technical hurdles to implementing the use of trusts in shareholder planning.

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[7] *See generally* H. Zaritsky & S. Leimberg, *Tax Planning With Life Insurance,* ¶ 5.03 (2d ed., 1998) (hereinafter, "*TPLI*").

[8] The general benefits of using irrevocable life insurance trusts in buy-sell planning have been pointed out in S. Rothschild, "Uses of the BILIT—Business Irrevocable Life Insurance Trust And Solving Inequities In Business Continuation Agreements," *Trusts and Estates* at 22 (7/18/01). *See also* J. Budihas, "Strategies for Business Succession Planning: More Art Than Science," 106 *National Underwriter*, No. 25 at 18, 21 (6/24/02) (and see discussion below at fn. 53).

Form of Shareholders' Agreement — Redemption or Cross-Purchase?

There are three basic varieties of corporate buy-sell agreements: entity buyouts (including corporate redemption agreements), cross-purchase agreements among the owners of the business and agreements combining elements of each. [9] The income tax advantages of cross-purchase arrangements (including greater basis for surviving shareholders) have been discussed elsewhere. [10] Those advantages are significant (especially in the C corporation context). [11] However, a cross-purchase agreement will permit the plan to direct the business interests of the deceased owner in a non-pro-rata fashion among the business' other owners whereas a redemption requires that the interest of the deceased owner be shared on a pro-rata basis among the surviving shareholders. [12]

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[9] *See generally* Leimberg & Rosenbloom, above, fn. 6.

[10] *E.g.,* H. Zaritsky, *Tax Planning For Family Wealth Transfers* (3d ed., 1997) ("*TPFWT*") at ¶ 9.05[4][a] (regarding regular C corporations) and at ¶ 9.09[7][b] (regarding S corporations) and *SBSA*, chapters 2

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(income tax treatment of C corporation redemption agreements), 3 (income tax treatment of C corporation cross purchase agreements) and 4 (S corporation buy-sell agreements).

[11] In the context of C corporations, a redemption agreement forgoes the basis increase provided by a cross-purchase agreement as discussed in the authorities collected in fn. 10. However, there are substantial differences in the S corporation context. First, if the funds to be used for the buyout will come entirely from the business—one way or another—then those funds will increase the survivor's basis as the funds are distributed to the survivor. *See* R. Robinson & A. Weiss, *Tax Planning For S Corporations* (2000) (hereinafter, "*TPSC*") at § 12.05[2][c], pp. 12-49, *et seq.* That analysis is highly dependent on the source of the funds, however, and would not be applicable to an insured redemption agreement. However, another S corporation difference would then be applicable. In particular, an S corporation's receipt of insurance proceeds under § 1367(a)(1)(A) constitutes an additional and independent increase in basis for the surviving shareholders. *TPLI*, above, fn. 7, at ¶ 7.05[9][b], esp. at text accompanying fn. 164. *See also TPSC*, above, fn. 11, at § 12.05[3][d], at p. 12-56 (noting the waste of basis increase if the estate remains a shareholder at the time the insurance proceeds are received and suggesting that the redemption agreement provide for a sale immediately on the deceased shareholder's death to avoid allocating the basis increase from the receipt of the insurance proceeds to the already-stepped-up basis in the deceased shareholder's shares).

[12] J. Peterson & W. White, "Using a General Partnership to Structure and Fund Buy-Sell Agreements," 54 *Journal of Financial Service Professionals* 35 (No. 2, Jan. 2000).

This ability to funnel the business interest of the deceased owner away from the surviving owners can be quite useful. In particular, if the insurance policies funding the buy-sell agreement are owned by irrevocable trusts, the proceeds will be paid to those trusts, rather than being payable to one of the owners and those trusts will never be subject to an estate tax if properly crafted. Since the existing owners will not receive the proceeds, their assets will not be increased by those death benefits when paid and will therefore not be subject to estate tax in their estates, either. Those results by themselves may well accomplish very significant estate tax savings. [13] Thus, while some of the planning techniques examined in this article could be undertaken using a redemption agreement, [14] we assume throughout the remainder of this article that a cross-purchase arrangement is being used.

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[13] Current law reduces the estate tax by a combination of tax rate decreases and tax credit increases over the next eight years (2002-2009) and eliminates that tax in the year 2010. See generally Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16 (hereinafter, "the 2001 Act") at § § 501 and 511. However, the sunset provision in that law nullifies those provisions in the years 2011 and thereafter. 2001 Act at § 901. Overall, at this writing, it seems likely that the estate tax will be continued in some form, even after the phase-in period ending in 2009.

[14] Since the effect of a redemption is to increase the interests of all remaining shareholders in proportion to their interests in the corporation prior to the redemption, using a redemption format to accomplish the results discussed in this article would require having trusts as shareholders of very significant equity interests prior to the decedent's death. This could be accomplished by outright lifetime gifts or by sales of shares. Those sales could be sales to grantor trusts or installment sales. For a general discussion of those techniques see *TPFWT* at ¶ 2.02 (outright gifts) and ¶ 3.08 (installment sales).

Avoidance of Repetitive Taxation

In the context of multiple business owners, the avoidance of repetitive estate taxation especially from sibling to sibling can be an enormous benefit. Let's look at a hypothetical and fictional family consisting of

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Manny, Mo and Jack, three brothers each owning one-third of a $100 million enterprise. Under the current plan, assume each brother is to buy half of the interest of the first brother who dies, using life insurance, a very common arrangement. At the second death, assume the last survivor is to buy the interest of the next-to-last decedent. Assuming further that all three brothers outlive their spouses, [15] there will be an immediate estate tax on the death of each brother as indicated in the spreadsheet entitled "Repetitive Taxation Example at 50%."

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[15] For simplicity, we assumed no intervening growth. In the event that the brothers are not predeceased by their spouses, the tax would be postponed until the death of the surviving spouses by use of the marital deduction. Note, however, that the amount of the tax would not be changed very much since the benefits of the applicable credit amounts would be phased out at the level of wealth being considered. Even if those credits and exclusions are not phased out, the amount of the benefit is about $345,000 (2002), reducing the tax by three times that amount or about $1 million. Even assuming the phase-ins enacted under the 2001 Act, and further assuming that the $3.5 million exemption and 45% rate scheduled thereunder for 2009 were to apply to all three estates, the total savings from predeceasing rather than surviving the spouses would be $4,725,000 ($3.5 million times 45% times 3).

Moreover, the spreadsheet assumes no growth in between the siblings' deaths. Interim growth would, of course, exaggerate the effects. The results however need no exaggeration—*having a trust make the buyouts saves a full 40% of the aggregate estate tax* imposed on all three brothers. Here's how: At the first death, the surviving two brothers received insurance proceeds equal to the cost for the shares of the first brother who dies. The result is to increase the survivors' estates by the full amount of those proceeds. At the second death, insurance provided only the same one-third of the aggregate initial value, the same amount that had been provided at the first death. Therefore, the last survivor had to actually deplete his estate by one-sixth of the cost in order to pay the second decedent's estate. At the third death, the last survivor owns the entire enterprise and has paid from uninsured funds only one-sixth of the value. The result is that the survivor's estate has increased by $83,333,333.33 ($100,000,000-$16,666,666.67). The total estate tax (at a flat 50% rate) under that scenario is $83,333,333 ($16,666,667 at the first death, $25,000,000 at the second death and $41,666,667 at the last death). By using trusts, that tax is reduced to $50,000,000 (50% of $33,333,333 times 3), thus saving 40% of the estate tax or about $33,333,333. [16]

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[16] This comparison does not take into account valuation adjustments due to ownership of a minority interest, but this is not taken into account in making either of the comparisons. For a comparison illustrating the effect of minority and marketability discounts, see text accompanying fn. 37, below.

Comparative Creditor Protections

Significant creditor protections would also be achieved by a plan using trusts as buyers. Property that is owned outright can be taken away from the owner by that owner's creditors. Property that is held in a trust is at least much more protected from creditors by long-standing doctrines relating to discretionary trusts and spendthrift provisions. [17] If the trusts are properly structured, such trusts can provide the beneficiaries with substantial creditor protections. [18]

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[17] *See generally* A Scott, W. Fratcher & M. Ascher, 1 *Scott on Trusts* § 1 (4th ed., 1987).

[18] *E.g.,* P. Spero, *Asset Protection: Legal Protection and Strategies* ¶ 6.03 (2000).

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Complexity of Buy-Sell Planning and Negotiations

Perhaps the most significant non-legal issue is the complexity of a trust-oriented buy-sell agreement, as introduced into the already difficult and delicate business planning and negotiations. Whether children, grandchildren or other relatives will or will not be coming into the business—and the level of their various abilities and participation—are matters that are difficult to determine at all, no less in advance. The fact that large sums of money are involved only makes the desire for simplicity more pressing than ever. And, as shown below, none of the structures involved contributes to simplicity at all. However, in those family situations where appropriate, these techniques can save very substantial amounts of tax money, as illustrated above.

CHOOSING A TRUST ORIENTED BUY-SELL STRUCTURE

The remainder of this article discusses the significant tax issues confronted in attempting to achieve such a program and tries to point out methods by which those difficulties can be addressed, using Manny, Mo and Jack as a case study. To illuminate and hopefully resolve the difficulties, we consider six possible structures for implementing the plan, the first [19] and fourth of which have significant tax difficulties. In particular, we examine the tax consequences attendant to each brother creating a trust for the other brothers' families, a structure that looks and feels very much like the cross purchase arrangement presently in place between the brothers ("Structure 1"). Since that structure fails, we then examine the consequences of each brother creating a trust for his own family ("Structure 2") as well as various variations on that theme ("Structures 3-5"). Finally, we consider adding a partnership to the overall program ("Structure 6"). Selection of Trustees and powers to consider are also examined, principally in Structures 2-5. Transfer for value issues in setting up the trusts are considered as presented.

[19] The first structure could be utilized in one-way buy-out situations wherein only one of the current shareholders is going to succeed to the business interest as well as in situations wherein significant differences in the trust provisions are desirable.

Structure 1. Each Brother Creates Trusts Naming the Other Brother as Trustee for the Benefit of that Other Brother's Family

Assume that at the outset Manny, Mo and Jack, are parties to an already insured cross-purchase arrangement with respect to their interests in their business enterprise under which each owns substantial insurance on the life of the other. Assume, for example, that Manny transfers the policy he owns covering Mo to a trust for the benefit of Mo's family, naming Mo as trustee, and transfers the policy he owns covering Jack to another trust for the benefit of Jack's family, naming Jack as trustee. Assume Mo and Jack each create similar trusts with respect to each of the policies they own on Manny and each other.

This option most resembles the cross-purchase structure between the shareholders. It is, of course, that facial resemblance to the current circumstances, coupled with the transfers of the current life insurance policies covering each brother and the transfers of shares down the line that creates the significant problems with this approach that we examine.

The Reciprocal Trust Doctrine

The reciprocal trust doctrine presents a substantial hurdle to this sort of planning. In *U.S. v. Grace Est.*, [20]

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the Supreme Court was confronted with a situation in which the decedent had first created a trust under which he was a co-trustee for his wife's benefit and two weeks later the decedent's wife had created a trust under which she was the trustee for the decedent's benefit. The Court held that the trust created by the decedent should be treated as if it had been created by the wife and *vice versa.* The doctrine is applied to protect the application of § 2036 when (1) "the trusts [are] interrelated," and (2) "the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as lifetime beneficiaries." [21]

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[20] 395 U.S. 316 (1969). With respect to the reciprocal trust doctrine generally, see *Sather v. Comr.,* 251 F.3d 1168 (8th Cir. 2001); *Schuler Est. v. Comr.*, T.C. Memo 2000-392; *Bies Est. v. Comr.*, T.C. Memo 2000-338; *TPLI*, ¶ 5.03[12]; C. Hader, "Planning To Avoid the Reciprocal Trust Doctrine," 26 *Estate Planning J.* No. 8 (Oct. 1999).

[21] *Grace*, above, fn. 20, 395 U.S. at 324.

Furthermore, in *Bischoff v. Comr.,* [22] the Internal Revenue Service [23] successfully argued that the reciprocal trust doctrine should be applied not just to beneficial interests, like those involved in *Grace*, but also to fiduciary powers as well. The Court of Appeals in *Green Est. v. U.S.* [24] disagreed with that holding and stated that "*Bischoff* has been rejected by every circuit which [sic] has considered the application of the reciprocal trust doctrine." [25] However, further examination reveals that *Bischoff* is not such a tarnished authority after all. For example, in *Exchange Bank and Trust Company of Florida v. U.S.,* 694 F.2d 1261 (Fed. Cir. 1982), the Court of Appeals for the Federal Circuit, in holding that the reciprocal trust doctrine applied to transfers to custodianships under the Uniform Gift to Minors Act, stated:

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[22] 69 T.C. 32 (1977).

[23] Sometimes referred to herein as "IRS" or "Service."

[24] 68 F.3d 151 (6th Cir. 1995).

[25] *Id.*

We agree with the majority in *Bischoff* and the appellee in this action that the reciprocal trust doctrine merely identifies the true transferor, but the actual basis for taxation is founded upon specific statutory authority. The estate tax provisions applicable here, sections 2036 and 2038, reach out to tax both retained interests *and* powers. Thus, there may be a literal distinction, but this distinction does not impact on whether an arrangement is subject to taxation. (Emphasis in original.)

This hardly seems like the sort of universal rejection referred to in *Green*, above. [26] Indeed, not a single case fitting the *Green* court's description could be located. Thus, while the Sixth Circuit has held that the reciprocal trust doctrine does not apply to reciprocally held powers without any reciprocal beneficial interests, the Federal Circuit—and the Tax Court—seem to hold a contrary view.

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[26] *See also Sather*, above, fn. 20, after fn. 5, citing *Bischoff* with seeming approval.

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The validity of the fiduciary powers holding of *Bischoff* is crucial to consideration of the reciprocal trust doctrine as applied to Manny, Mo and Jack. [27] Overall, the scope of *Grace* seems somewhat uncertain in the context of bare reciprocal powers, given the conflicting opinions of the courts reviewed above. It seems clear, however, that IRS would claim the reciprocal trust doctrine should be applied to the above arrangement and it seems that such trusts would be considered “interrelated” since there is no significant reason for Manny to benefit Mo's or Jack's family and no reason for Mo or Jack to benefit Manny's family, etc.—no reason except that each expects the other to do likewise for his own family. [28]

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[27] After all, we can assume that none of the transferors are interested in retaining any beneficial interest in the trust, especially if they can be any sort of trustee so as to be eligible for commission compensation, if need be, and so that they can vote any interests entitled to vote.

[28] *See Levy Est. v. Comr.*, T.C. Memo 1983-453: “Since *Estate of Grace*, a number of factors have been examined in an attempt to determine whether trusts are interrelated. In *Estate of Bischoff v. Commissioner,* 69 T.C. 32, 37-38 (1977), this Court focused on the creation of trusts at approximately the same time and with identical terms. *See also Estate of Grace v. United States*, supra; *Krause v. Commissioner,* supra at 900. In addition, in *Krause* we noted that the trusts had the same trustees, and that the primary beneficiaries ‘were the natural objects of the grantor's bounty.' Similarly, in *Exchange Bank & Trust Company of Florida v. United States*, 694 F.2d 1261 [49 AFTR 2d 82-1446] (Fed. Cir. 1982), the appellate court concluded that trusts were interrelated which were created on the same date, involved an identical number of shares, and were apparently made pursuant to a prearranged plan. Thus, to determine whether the Herbert Levy Trust and Ilse Levy Trust are interrelated, we will consider their terms, corpus, trustees, and beneficiaries, as well as their date of creation and their relation, if any, to a prearranged plan.”

Indeed, *Green* seems to stand alone for the taxpayer on this issue, and we would at very least have to advise clients within the District of Columbia that only the Supreme Court could hold that they would not be taxable under the reciprocal trust doctrine if they used this arrangement. Only in the Sixth Circuit could we conclude that taxpayers are safe, so to speak, except from a Supreme Court decision. The result is that this approach seems to entail a significant risk of failing under the reciprocal trust doctrine, *Green* to the contrary notwithstanding.

Making This Structure Work — “One Way” Buy-Outs

In circumstances where only one branch of the family is being bought out, use of this structure will not run afoul of the reciprocal trust doctrine since there will not be reciprocal trusts. In such a circumstance, a single life insurance trust can be used to remove the assets purchased by the trust from repetitive taxation as well as removing the growth of those assets from all further transfer taxation with the possible exception of tax under the generation-skipping transfer tax.

Making This Structure Work — Differentiating the Trusts

Another approach to implementing this structure is to make the trusts different from each other. In some family circumstances, that may be both feasible and desirable. For example, one trust might allow a named beneficiary a general power of appointment with respect to some voting stock, perhaps on condition that the donee of that power serve on the board of directors or in an officer position for a stipulated period of time. Another trust might not allow any beneficiary any power of appointment, except to his or her own descendants, perhaps also on business-related conditions, e.g., perhaps only with respect to nonvoting shares. At least according to the Tax Court Memorandum Opinion in *Levy*, [29] such

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differences between the trusts can defeat reciprocal trust treatment. With respect to one branch of the family, succession to active participation may be foreclosed as far as the parties are concerned, and such differences may be implemented by differences in the trusts. Those trust differences may be substantial enough to overcome reciprocal trust treatment. Other than *Levy*, however, there are no bright lines in this area, either.

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[29] Above, fn. 28.

Conclusions with Respect to This Structure

If there is not a one-way buyout situation and differences between the trusts cannot be fashioned to satisfactorily overcome the reciprocal trust exposure, clients are not likely to be interested in becoming — and indeed are likely to be unwilling to become — heroes in their circuits, assuming a favorable result is even achieved. In short, clients would likely prefer an arrangement under which we can give greater assurances that the original estate planning and tax objectives will be accomplished.

Structure 2. Each Brother Creates a Trust for His Own Family's Benefit

In this arrangement, Manny transfers the policies on Mo and Jack to a trust for the benefit of Manny's *own* family, and Mo and Jack do likewise. [30] If the trust that Manny creates for his family names Mo and Jack jointly as his trustee, and Mo names Manny and Jack jointly as his trustee and Jack names Mo and Manny jointly as his trustee, we are in roughly the same predicament we encountered in Structure 1—since none of the brothers has any beneficial interest under any of the trusts, the reciprocal trust doctrine may apply under *Bischoff*, *Exchange Bank & Trust* and *Green* to the contrary notwithstanding. [31]

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[30] Fundamentally, this is the structure considered in Budihas, fn. 8, above.

[31] Does the fact that Manny transfers to Mo and Jack while Mo transfers to Manny and Jack and Jack transfers to Manny and Mo make any difference in the application of the reciprocal trust doctrine? We don't think so. The essence of the reciprocal trust doctrine is the fact than one transfer takes place in consideration of the other, rather than donatively. *See, e.g., Schuler Est.*, T.C. Memo 2000-392.

Indirect Reciprocal Trusts

While not expressly addressed by any case to date, it seems that the reciprocal trust doctrine would also reach the circumstance wherein Manny transfers his policies to a trust for Manny's family but naming Jack alone as the trustee, while Mo names Manny alone as trustee and Jack names Mo as trustee. In this circumstance, there is no direct reciprocity—that is, Jack didn't give to Mo and get from Mo—directly. But both § 2036 and the gift tax apply "directly or indirectly." [32] And the IRS would likely argue that each brother is acting in part as an agent for the other brother, that is, in making the transfer to the third brother. Admittedly, this becomes somewhat tenuous, but "substance over form" doctrines are pervasive in this area. [33]

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[32] *Dickman v. Comr.,* 465 U.S. 330 (1984); Regs. § 25.2511-1(a).

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[33] *E.g., Sather v. Comr.*, 251 F.3d 1168 (8th Cir. 2001).

Using Non-Shareholder Trustees — Reciprocal Trust Doctrine Inapplicable

But what if each brother initially makes his non-shareholder spouse the trustee—or uses an independent third party as trustee? In those circumstances, the reciprocal trust doctrine would not seem to apply. The trusts are likely not even "interrelated" as that term is used in *Grace*. After all, all that we have is each brother creating a trust for the benefit of his own family, an undertaking not related to the acts or omissions of the other brothers. Moreover, none of the brothers ends up "in approximately the same economic position as they would have been in had they created the trusts and named themselves as life beneficiaries...." [34] Rather, they each end up as settlors of a trust for their own respective families.

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[34] *Grace*, fn. 21, above, at 324.

In some circumstances, using an independent, non-shareholder trustee may be an acceptable solution. In those circumstances, the selection and succession of the trustee will likely be of pivotal importance and the use of a trust protector seems appropriate as well. [35]

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[35] By trust protector, we refer to an independent non-trustee third party given the right to remove and replace the trustee in his or her discretion. A trust protector can also be given other powers.

In many circumstances, however, using solely independent trustees will not be acceptable. After all, the surviving brothers might not end up having control of the business as they would in a cross-purchase arrangement between the individuals. That control of the business enterprise after the death of each of the current owners is usually a very important and delicate factor in creating a business succession plan in the first place.

Making This Structure Work — Using Non-Shareholder Trustees and Non-Managing Interests

An option making the use of non-shareholder trustees more palatable in light of control concerns is to create managing and non-managing interests [36] and apply this plan only to the non-managing interests. If the managing interests are confined to a very small percentage of the company's ownership, this structure will allow passage of the bulk of the equity without causing inclusion of that equity in the gross estate of any of the shareholders. Moreover, such non-managing interests will be entitled to the largest valuation discounts, allowing for the most efficient use of gifting to the trusts holding the life insurance death benefits necessary to buy significant non-managing equity interests.

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[36] E.g., voting and nonvoting stock in a corporation, general and limited partnership interests in a partnership and managing and non-managing LLC interests in that sort of entity.

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For example, assume that Manny, Mo and Jack's enterprise is recapitalized to become 97% nonvoting and only 3% (1% each) voting stock. The results are indicated in the spreadsheet entitled “Voting-Nonvoting Recap” and show savings of about $37.5 million or approximately 52% of the tax due without using trusts. [37]

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[37] The estimated estate tax due without using trusts but after the recap is $72 million, about $11.3 million less than the tax without using either the recap or the trusts. The spreadsheet entitled “Voting-Nonvoting Recap” does not take into account differences between the discounts applicable to minority voting shares and those applicable to nonvoting shares. Generally, the discounts applicable to nonvoting shares would be slightly greater than the discounts applicable to minority voting shares since nonvoting shares, by definition, can *never* vote while voting shares can vote and could therefore be acquired by someone interested in acquiring voting control. *See* TAM 9436005 and compare *Simplot Est. v. Comr.*, 249 F.3d 1191 (9th Cir. 2001), *rev'g* 112 T.C. 130 (1999). It should be noted than under a plan not using trusts to acquire shares at the deaths of the first two shareholders to die, those minority discounts will entirely evaporate in the estate of the last surviving shareholder. At that point, the whole enterprise will be owned by the sole surviving shareholder and no minority discount will apply.

This sort of planning might have appeared to be somewhat undercut the Tax Court decision in *Simplot,* [38] holding that a minimum 10% value had to be allocated to the vote, but that decision has now been reversed by the Ninth Circuit Court of Appeals. [39]

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[38] 112 T.C. 130 (1999), *rev'd*, 249 F.3d 1191 (9th Cir., 2001). *See generally* D. Belcher, et al. “Fair Market Value of Voting Interests After *Simplot v. Commissioner*,” 11 *Prob. Pract. Rptr.* 1 (July 1999).

[39] In *Simplot,* the retained voting interests were valued by reference to a premium calculated as a percentage of the entire corporation's value. That makes the voting premium large. Thus, transferring only the non-managing (nonvoting) interests might have had somewhat more limited utility than was previously thought. This was a limited problem in that the vote was thought to have a 10% minimum value. Thus, if the voting stock constituted 10% of the equity, the Tax Court decision in *Simplot* had very limited significance. But the Tax Court's thinking on this has now been reversed by the Court of Appeals. The result is that using trusts to own non-managing interests should have all of the desired effects under this structure. Nonetheless, substantiation of the taxpayer's factual position with respect to valuation of the nonvoting stock is a substantial task and must be supported by a competent appraisal. Even then, such transactions are subjected to significant scrutiny and must overcome the presumption of correctness attending any contrary determination by the Commissioner. This can be a very heavy burden. *See, e.g., Wall v. Comr.*, T.C. Memo 2001-75 (Beghe, J.)

Conclusions Regarding This Structure

The result is that using nonvoting shares and a trust created by each shareholder for his own family naming a non-shareholder trustee is one way to accomplish a significant amount of benefit without the additional complications considered in the structures below.

Structure 3. Can the Voting Stock Be Converted to Nonvoting Stock on Death?

That leaves us with the voting stock. Can we devise a program that would be applicable to the voting stock? Consider converting the voting stock to nonvoting stock at death. If the voting stock is converted at death into nonvoting stock under the Shareholders’ Agreement, then the surviving shareholders will share control of the enterprise in the percentages that existed between them prior to the deceased

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shareholder's death. [40] In the case of Manny, Mo and Jack, for example, Mo and Jack would become equal 50% shareholders on Manny's death.

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[40] Such a conversion would not be given effect for purposes of gift tax value under § § 2701, 2703. Sections 2703 and 2704 also apply for estate tax purposes. The estate tax result would be to tax the estate of the deceased shareholder in an amount equal to the value of all interests held by the decedent in the entity prior to the lapse and the value of such interests immediately after the lapse of the voting right. *See* § 2704(a)(1)(B). In other words, estate tax is applied as if no lapse had taken place. *See* Regs. § 25.2704-1(f), *Ex.* 1.

The cost of such an arrangement, in terms of the additional transfer tax to be imposed at Manny's death under § 2704 is likely to be minimal assuming that the voting-nonvoting recapitalization discussed above has been implemented. That is because the measure of the tax on lapse is the difference between the value of the decedent's interests before the lapse and afterwards. [41] Referring back to our example in the “Voting-Nonvoting Recap” spreadsheet, the value of the voting stock was only $1 million for 1% of the equity, while the value of the nonvoting stock received in exchange for the voting stock on the lapse of the voting rights was $650,000. [42] Thus, the increase in tax under § 2704 could not exceed $350,000 in our example, the value of the nonvoting discount. Assuming savings from the recapitalization and trust plan of $37.49 million (as demonstrated above), that savings would be reduced by the additional tax imposed on $350,000, or by about $175,000, to a mere $37,316,667! Even if we applied a full voting premium, contrary to the Court of Appeals decision in *Simplot*, [43] the total estate taxes saved after subtracting the tax imposed by reason of the lapse would only be $36,816,667. [44]

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[41] Regs. § 25.2704-1(f), *Ex.* 5.

[42] The value of all of Manny's interests in the entity before death (and before the lapse) would have been $22,016,667 and the value immediately after the lapse would be $21,666,667, calculated by applying the discount for nonvoting stock to the value before discount of the pre-lapse voting stock, $1 million and then adding that the to value of the nonvoting stock. The difference is the value of Manny's converted shares. The value added back to Manny's estate would be $350,000 ($22,016,667-$21,666,667).

[43] See fns. 37-39, above.

[44] $2 million (voting value after premium applied) less $650,000 (value of equivalent non-voting shares) = $1,350,000 times 50% (highest marginal estate tax rate) = $675,000, reducing gross savings from plan of $37,491,667 to $36,816,667.

Conclusions Regarding This Structure

At least after segregating managing and non-managing interests, this arrangement may well be useful, especially in light of the Court of Appeals decision in *Simplot.*

Structure 4. Can the Survivors Be Contingent Special Business Trustees?

Another approach is to use Structure 2, as described above, and provide in the trust that any business interest is to be controlled by a “special business trustee.” Unfortunately, this approach doesn't seem to achieve the tax objectives because of the application of § 2036(b). At the outset, each trust would only own life insurance covering the lives of the other shareholders and will not own any interest in the

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business. The special business trustee could be appointed only in the event that the trust acquires an interest in a closely held business so that the appointment will not even be effective until that occurs. Indeed, none of the trusts will acquire a closely held business interest until the death of one of the other owners, a possibility that is not within anyone's control and definitely will not occur in the trust created by the first of the shareholders to die during his life. [45]

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[45] Appointment of the special business trustee contingent on acquisition of a closely held business interest would occur after the death of the first insured to die only under the terms of the other two trusts since only those two trusts would own insurance on that insured's life.

During the Life of All Owners Until the First Death

The powers of the "special business trustee" would be contingent on the acquisition of an interest in a closely held business. That possibility is contingent on events not within the control of the taxpayer. However, while such contingencies are relevant under § 2038, [46] such contingencies are generally not relevant under § 2036. [47] The result is that we would not generally be free to ignore the appointment of a special business trustee under § 2036(a) and the reciprocal trust doctrine might seem applicable.

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[46] Regs. § 20.2038-1(b) ("However, section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's life).").

[47] Regs. § 20.2036-1(b)(3) ("With respect to such a power, it is immaterial ... (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime).").

Under § 2036(b), the proposed regulations seem to exclude application of § 2036(b) during the life of all of the owners or at the death of the first owner. Prop. Regs. § 20.2036-2(a)(3), in flush language, provides:

The rule of this section does not does not require inclusion of stock in the gross estate if the transferred stock has no voting rights or if the donor has not retained voting rights in the stock transferred. Thus, for example, if a person owning 100 percent of the voting and nonvoting stock of a corporation transfers the nonvoting stock, that person shall not be treated as having retained the enjoyment of the property transferred merely because of voting rights in the stock retained. Stock carrying voting rights that will vest only when conditions occur, such as preferred stock which gains voting rights only if no dividends are paid, is subject to this section. *However, if the decedent's right to vote stock is only in a fiduciary capacity (e.g., because decedent is trustee of a trust to which the stock has been transferred), such stock is subject to this section only if, after the transfer by the decedent, the conditions occur that give the decedent the right to vote the stock.* (Emphasis supplied.)

It thus seems clear that there is no special exposure to § 2036(b) by use of reciprocal special business trustee appointments until the death of the first shareholder to die. While § 2036(a) still seems to apply under the reciprocal trust doctrine, it may be that the only right the special business trustee has is a right to vote the closely held stock. Under § 2036(a), such a right is not a retention of enjoyment under *U.S. v. Byrum*. [48] Thus, § 2036(a) would not apply — at least not during the life of all of the owners and not at the death of the first owner to die. Assume that Manny is the first shareholder to die. Insurance on Mo and

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Jack would still be owned by the decedent's (Manny's) trust and Manny would not have been a trustee of any trust contemplated by this planning. As such, there simply isn't anything to treat Manny as the transferor of for transfer tax purposes. His shares are purchased one-half by a trust created by Jack and one-half by a trust created by Mo under neither of which was Manny a transferor or a trustee at the time of his death.

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[48] 408 U.S. 125, *reh'g denied*, 409 U.S. 898 (1972).

Section 2036(a) would treat Manny, as a contingent special business trustee, as retaining enjoyment under the trust he is special trustee of except for the fact that the right to vote has been held not to be a retention of enjoyment by the Supreme Court.

After the First Death

After the first death, however, § 2036(b) seems to apply. The proposed regulations (quoted above) seem to exclude application of § 2036(b) *until the conditions giving rise to the right to vote occur.* [49] Of course, the trust of which Manny is actually a special business trustee should not give him other powers outside of the right to vote the closely held stock as special business trustee. [50]

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[49] Prop. Regs. § 20.2036-2(a)(3) (flush language).

[50] Manny can have a right to manage the business interests, and should have no beneficial interest in the trust. The right to manage property is not a taxable § 2036 power. *Reinecke v. Northern Trust Company,* 278 U.S. 339 (1929); *Old Colony Trust Company v. U.S.*, 423 F. 2d 601 (1st Cir. 1970), *overruling State Street Trust Company v. U.S.*, 263 F.2d 635 (1st Cir. 1959); *Ford Est. v. Comr.,* 53 T.C. 114 (1969), *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971), *nonacq.*, 1978-2 C.B. 3; Stephens, Maxfield & Lind, *Federal Estate and Gift Taxation* ¶ 4.08[6][a] (7th ed., 1997) (hereinafter "*FESG*").

Since Manny is treated as a special business trustee despite the contingency of his appointment, it seems that *the reciprocal trust doctrine would then treat him as the transferor of the trust under which he is an insured.* So long as the special business trustee has no economic rights in the insurance policies, it seems plain that no incident of ownership will be treated as held by Manny. [51]

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[51] Compare Rev. Rul. 82-145, 1982-2 C.B. 213 with Rev. Rul. 76-274, 1976-2 C.B. 278, especially regarding Situation 3 and see PLRs 9848011, 9651030, 9651017and 9348009 and FSAs 1998-252 and 1998-328. Neither private letter rulings nor field service advices are authority and may not be cited as precedent under § 6110. They are referred to only for their rationale.

Indirect Retention of the Right to Vote

With respect to the retained right to vote shares, however, *the combined application of the reciprocal trust doctrine and § 2036(b) produce an estate tax exposure for all shareholders other than Manny, the first to die.* Section 2036(b) is clear that the section was intended to reach both "direct and indirect" retention of

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the right to vote. [52] In 1983, the Treasury proposed regulations under § 2036(b) and those proposals reflect that concern. The proposals describe many circumstances in which an "indirect" retention of the right to vote will be found. In particular, *the proposed regulations treat any property provided to a trust by the decedent which property is used to acquire stock that is a controlled corporation as to the decedent as an indirect retention of voting rights with respect to the stock acquired* in the exchange. [53] The treatment of life insurance death benefits (as either property provided by the decedent or not) is not discussed in the proposed regulations, nor are there any rulings on this subject.

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[52] § 2036(b)(1).

[53] Prop. Regs. § 20.2036-2(e)(2) and -2(e)(4), *Exs.* 1-4; and see S. Rep No. 745, 95th Cong, 2d Sess. 89, 90-91 (1978). It is this exposure that infects the proposed split dollar trust plan described in Budihas, fn. 8, above. The suggestion is that John and Mary, two 50-50 shareholders, each create trusts of which each would be the settlor and trustee for the respective benefit of his or her own family. The trusts hold insurance on the other shareholder. When either shareholder dies, the survivor collects the proceeds and buys his or her stock. Thus, the transferor-trustee has provided the funds to buy the voting stock in a controlled corporation and thereafter the trustee has the right to vote the stock. Thus, the result seems to be that the voting stock of the controlled corporation will be included in the transferor-trustee's taxable estate under the proposed regulations. *See especially Exs.* 1 and 4, above. But see analysis of the "after each addition" rule at fn. 54, below, and following.

The indirect transfer rules in the proposed regulations operate to make certainty on this subject difficult to attain. Transfers by decedents are treated as indirect retentions of the right to vote when the property transferred to the trust is used to purchase voting stock in a corporation that is a controlled corporation as to the transferor. The proposed regulations then state:

For this purpose, the portion of the funds treated as provided by the decedent shall be determined *after each addition* to the trust, and is equal to a fraction. Prop. Regs. § 20.2036-2(e)(2) (Emphasis supplied). [54]

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[54] In the next sentence the proposed regulations describes the fraction as one in which the numerator is the total value of the trust immediately prior to the latest addition multiplied by the fraction of such value treated as provided by the decedent and the amount of the latest addition to the extent provided by the decedent. None of this will be applicable until the contingent appointments of special business trustees take effect, i.e., until after the first death occurs.

But *after each addition*, it seems unlikely that the decedent will have been treated as providing any of the funds, especially during the lifetime of all three shareholders. Then, the trusts will not be reciprocal trusts and each shareholder will be treated as providing funds only to that trust to which he has in fact provided funds by direct transfer. That is to say, Manny will be treated as having provided the portion of funds he actually contributed to the trust for his own family and will not be treated as having provided any portion of the funds contributed to any of the trusts created by his brothers, Jack and Mo. As such, the indirect transfer rule by itself should not be applied to include voting stock if the trusts are not treated as reciprocal trusts during the joint lifetime of all three brothers.

The result is that the estate of the first decedent to die (assumed to be Manny) does not seem to have exposure to estate taxation by being a special business trustee of the trusts created by Jack and Mo since the conditions giving the decedent the right to vote the stock did not occur at any time during his

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lifetime.

As to Mo and Jack, however, estate tax exposure seems clearer. Mo's trust acquired one-half of Manny's shares after Manny's death and Jack's trust acquired the other half *at the same time.* Mo is a special business trustee of Jack's trust and Jack is a special business trustee of Mo's trust. Unless you are comfortable with the notion that the trusts are not "interrelated" under *Grace* in the first place, at Mo's death (assuming Mo dies second), Mo may be treated under the reciprocal trust doctrine as applied to the powers of the special business trustee as "retaining" the right to vote the stock in Jack's trust (even though Mo is actually only the special business trustee of Jack's trust). And the conditions giving Mo the right to vote the stock in Jack's trust would have actually occurred during Mo's lifetime after Manny's death. As such, the stock in Jack's trust would be treated as stock of a controlled corporation as to Mo. If Mo is treated as if he were Jack, it seems that Mo may be treated as providing the consideration actually provided by Jack under § 2036(b) as applied under the reciprocal trust doctrine. The result is to treat Mo as having retained the right to vote the shares under § 2036(b) as applied to Jack's trust under which Mo is special business trustee. Similarly, Jack might be treated as having retained voting rights under Mo's trust. These conclusions would defeat the objectives of this planning as to the surviving shareholders but not as to the first shareholder to die.

Would the reciprocal trust doctrine be applicable? Obviously, none of the adverse estate tax consequences apply unless the reciprocal trust doctrine is applicable in the first place. It seems that the criteria set forth by the various courts considered by the Tax Court in *Levy* are met by the transfers at the death of the first shareholder to die: they are contemporaneous, they are in equal amounts, and may well be considered to have occurred pursuant to a prearranged plan. [55] Only different trust terms and arguments about whether the trusts are "interrelated" or not seem to stand in the way of applying the reciprocal trust doctrine to these circumstances. Moreover, it should be understood that Congress seems to have intended the application of the reciprocal trust doctrine in tandem with the application of the retained voting rights provisions of § 2036(b). In enacting § 2036(b), the Senate Finance Committee explains the intended scope of § 2036(b) as follows:

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[55] See authorities collected in fn. 28.

In addition, the indirect retention of voting rights in the case of *reciprocal transfers* of stock in trust *would result in the inclusion of the stock with respect to which the decedent had voting rights as trustee.* However, voting rights in stock transferred in trust by *the decedent will not be considered to have been retained by the decedent merely because a relative was the trustee who voted the stock.* In these cases, the *voting rights would be considered to have been indirectly retained by the decedent if in substance the decedent had retained such voting rights, e.g., there had been an arrangement or agreement for the trustee to vote the stock in accordance with directions from the decedent.* [56] (Emphasis supplied.)

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[56] S. Rep. No. 95-745, 95th Cong., 2d Sess. 91 (1978) at pages 90-91.

This excerpt from the legislative history is both favorable (in that taxpayers can probably show that the surviving shareholders have not had any agreement on voting the shares since they were equal shareholders before and now remain equal shareholders). In any case in which the IRS has the burden of proof under § 7491, the Service probably would not be able to carry that burden. [57] But this is unfavorable news in general since it indicates that Congress intended for the reciprocal trust doctrine and § 2036(b) to

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be applied in tandem, albeit subject to the limitations noted.

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[57] Of course, what constitutes "credible evidence" that there was no such agreement is uncertain.

Can we overcome these problems by structuring the trust so that the powers retained are not powers that will cause inclusion even if retained by the transferor? This seems doubtful. While the surviving brothers may certainly retain—either under their own trusts or under the trusts created by the other brothers or both, general powers to manage investments, [58] it seems they may not have the right to vote the stock of a controlled corporation under § 2036(b) unless the trusts are not considered "interrelated" so that the reciprocal trust doctrine cannot apply.

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[58] See authorities collected in fn. 50.

Conclusions Regarding This Structure

We conclude that while the "special business trustee" provision may be permissible in the estate of the first decedent to die, this strategy presents significant risks in the estates of the surviving shareholders unless the reciprocal trust doctrine is not applicable, and that seems somewhat unlikely.

Structure 5. Each Brother Creates a Trust for His Own Family, Is Not a Trustee or Special Business Trustee of Any of the Trusts, But Has a Limited Power to Remove And Replace the Independent Trustee Under the Trusts He Has Created

Under this arrangement, Manny creates a trust for his own family, funding the trust with insurance on Jack and Mo, and retains the right to remove and replace the trustee of that trustee. Assume further that Manny himself may not ever become a trustee or a special business trustee and may only appoint a person qualifying under Rev. Rul. 95-58. [59] Thus, Manny would have the power to remove and replace the trustee holding life insurance on Jack's and Mo's lives. After all, after Mo's death, assuming Manny survives, Manny's trust would purchase half of Mo's shares.

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[59] 1995-2 C.B. 191, *revoking* Rev. Rul. 79-353, 1979-2 C.B. 325. Rev. Rul. 95-58 permits appointment only to those persons not described in § 672(c). That would permit the grantor to remove a trustee and replace that trustee with any "individual or corporate successor trustee that was *not*" (emphasis added) either (1) the grantor's spouse, (2) the grantor's father, (3) the grantor's mother, (4) the grantor's issue, (5) the grantor's brother or sister, (6) an employee of the grantor, (7) any corporation in which the grantor's holdings or the trust's holding are significant from the viewpoint of control, or (8) a subordinate employee of any corporation in which the grantor is an executive.

To a large degree, the same sorts of analyses as have been undertaken above will be pertinent, subject to a few modifications. First, the power to remove and replace the trustee will *not* result in the attribution of the trustee's powers to the holder of the removal and replacement power so long as that power does not permit those holders to appoint themselves or a related or subordinate party. [60] Second, the power to remove and replace will not be treated as retention of the trustee's powers under § 2041. [61] Moreover,

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since each trust will have been created by each shareholder for his own family and since the grantor will have retained the power to remove and replace the trustee at all times and from time to time with respect only to the trust he created, this provision will not increase exposure to application of the reciprocal trust doctrine. [62]

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[60] Rev. Rul. 95-58, above, fn. 59. *See also Wall Est. v. Comr.*, 101 T.C. 300 (1993) (declaring Rev. Rul. 79-353 invalid) and *Vak Est. v. Comr.*, 973 F.2d 1409 (8th Cir. 1992), *rev'g* T.C. Memo 1991-503. *But see* PLR 8936032 ("The fact that A or B could be appointed as successor trustee does not change this result because they did not retain the power to remove or discharge a trustee and appoint themselves as trustee.") (Note that this ruling occurs prior to the revocation of Rev. Rul. 79-353).

[61] PLRs 9607008 and 9741009.

[62] See discussion above at text accompanying fn. 28 and see fn. 28.

And that brings us to the application of § 2036(b) as applied to such a structure. Does the power to remove and replace the trustee nonetheless implicate § 2036(b) as an indirect retention of the right to vote? The proposed regulations under § 2036(b) state that if the decedent had a power "to obtain the right to vote, *such as where he may appoint himself as a trustee* of a trust holding the stock, the decedent has retained the power to vote for purposes of section 2036." [63] But under the trust provision we have in mind, none of the brothers could be appointed as a replacement trustee because each of them is a person described in § 672(c) as to the other. [64] And the proposed regulation certainly seems a reasonable implementation of the conflicting legislative history quoted above. [65] Each shareholder would only have the power to remove one trustee and replace that trustee with another qualifying as *not* a related or subordinate party under § 672(c) and Rev. Rul. 95-58. And most of the arguments set forth in criticism of Rev. Rul. 79-353 would seem to apply as well to the notion that a successor trustee would abandon its fiduciary duties with respect to the voting of controlled corporation shares any more than it would abandon any other fiduciary obligations. [66] The result should be that the rightto remove and replace the trustee is as permissible under § 2036(b) as it would be under § 2036(a). Whether the power to remove and replace the trustee will be a sufficiently satisfactory approach as far as the client is concerned will, of course, vary from situation to situation.

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[63] Prop. Regs. § 20.2036-2(c) (emphasis supplied).

[64] See fn. 59, above.

[65] See text accompanying fn. 56, above.

[66] *See generally Wall*, above, fn. 60.

Grantor Trust Status

Retaining the right to remove and replace the trustee would also have income tax consequences in that the trust will be treated as a grantor trust if the power is retained by the person creating the trust. [67] If Manny retains the power to remove and replace the trustee, that will have the effect of treating him as the owner of the trust for income tax purposes and therefore will make the trust an eligible S corporation shareholder [68] — until Manny's death, when grantor trust treatment will stop. Of course, Manny's trust

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will not actually become a shareholder until Jack's or Mo's death, which may be before or after Manny's death.

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[67] *See* PLR 200030018. A general discussion of the income taxation of grantor trusts is beyond the scope of this article. *See generally* J. Blattmachr & A. Michaelson, *Income Taxation of Estates and Trusts* ch. 3 (14th ed., July 1996) and FSA 200207007 (holding that a grantor trust and the grantor are identical for statute of limitations purposes and that the statute runs from the filing of the grantor's return, not from the filing of the trust's return.)

[68] § 1361(c)(2)(A)(i).

Conclusions Regarding This Structure

Retaining the sort of limited power to remove and replace the trustee on the terms and conditions described above appears permissible under the reciprocal trust doctrine as well as under § § 2036(b), 2038 [69] and 2041. As such, this structure may be useful in some cases.

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[69] See generally authorities collected in fn. 60, above.

Structure 6. Using a Partnership of Trusts

The use of a partnership in buy-sell planning has been the subject of significant recent commentary. [70] That article considered the use of a general partnership avoiding various transfer for value difficulties inherent in other schemes using a single policy on each insured as well as providing the ability to transfer life insurance to a departing insured during lifetime without creating taxable income on receipt of the policy, creating flexibility in allocating premiums among the partners, avoiding exposure of the assets to corporate and beneficiary creditors and facilitating use of the policies for retirement should that be desirable under the circumstances.

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[70] J. Peterson & W. White, "Using a General Partnership to Structure and Fund Buy-Sell Agreements," 54 *Journal of Financial Service Professionals* 35 (No. 2, Jan. 2000).

None of the favorable results achieved by the concepts discussed in that article would be undermined by using a limited partnership or limited liability company [71] instead of a general partnership. Consider using a limited partnership or limited liability company (hereinafter collectively referred to as an "LLE") to hold the insurance policies contributed to LLE capital by the individual partners, which LLE consists of the trusts and the insureds. The individual partners could then transfer those LLE interests to the trusts each of them had created for his or her family. [72] The LLE could specially allocate the receipt of the death benefits to the specified trusts and those trusts could use those death benefits to buy the shares of the deceased shareholder, as the occasion arose, or the LLE could simply use the death benefits received to buy the shares of the decedent's stock. The result would be to funnel the interests of the deceased shareholders away from their own estates and to the trusts, saving substantial amounts of estate tax.

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[71] *See generally* A. Mittelman & R. Balter, "Limited Liability Company Buy-Sell Agreements And Life Insurance," 29 *Est. Plan.* 460 (No. 9, Sept. 2002).

[72] Such a structure would take advantage of the minority and lack of marketability discounts created by transferring partnership interests as opposed to transferring insurance policies at interpolated terminal reserve values. Compare *Jones Est. v. Comr.,* 116 T.C. No. 11 (2001) (valuation of partnership interests) with *TPLI*, above, fn. 7, at ¶ 3.02[2].

An LLE among the trusts, including the individual shareholders as partners as well, would add significant flexibility to the overall situation and help to insulate some of the desirable permutations from transfer for value exposure under § 101. [73] Moreover, an LLE among the trusts and the shareholders will be permissible in the S corporation context so long as the trusts are eligible S shareholders of one sort or another. [74] Strategically, the partnership could facilitate control, by admitting some subsequent partners as general partners and some as only limited partners or even only as assignees.

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[73] *Id.*

[74] The trusts can be structured as grantor trusts using the power to remove and replace trustees during the life of each shareholder. But there are significant uncertainties attending grantor trust status when *Crummey* withdrawal powers are used for gift tax purposes. *See* R. Balter, "Drafting Suggestions for Irrevocable Life Insurance Trusts," 55 *Journal of Financial Service Professionals* 76, 80-86 (No.3, May 2001). To avoid those difficulties when using *Crummey* powers, consider having the trustee make the electing small business trust election under § 1361(e)(1). And compare Prop. Regs. § 1.1361-1(m)(9), *Ex.* 3, permitting a trust that is partly treated as owned by the grantor as eligible to be treated as an electing small business trust. And see Prop. Regs. § 1.641(c)-1(c), to similar effect. Of course, if grantor trust treatment is decided upon, such a trust could become a Qualifying Sub S Trust or "QSST" under § 1361(d) or an Electing Small Business Trust or "ESBT" under § 1361(e) after the grantor's death. A partnership among otherwise eligible S shareholders is permitted. *See TPSC* at ¶ 13.07.

With respect to voting stock, the result of making the trusts created under Structure 2 partners in an LLE which then acquires the stock may be that there would not be an indirect retention of the right to vote under § 2036(b), even after the first shareholder's death. Prop. Regs. § 20.2036-2(e)(2) provides:

...[I]f the decedent makes a transfer by gift to a trust, and the trust subsequently acquires stock in which the decedent has voting rights, then for purposes of section 2036(a), the transaction will be treated as an indirect transfer of stock by the decedent (irrespective of whether the acquisition of the stock can be traced to the gift).

This aspect of the indirect transfer rule would not seem to apply in the case where the trusts are limited partners in an LLE and that partnership acquires the stock. First, if the stock is *not allocated amongst the partners,* the trusts will not acquire "stock in which the decedent has voting rights." Second, if the trusts are limited partners and only the partnership acquires the stock, the trusts would not have acquired voting rights in the stock of a controlled corporation.

Another aspect of the indirect transfer rule provides:

If a third party makes a transfer to the trust and the consideration for the transfer was furnished by the decedent, the transfer by the third party to the trust will be treated as a transfer by the decedent to the

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trust. [75]

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[75] Prop. Regs. § 20.2036-2(e)(2).

Would the general partners have acquired voting rights in stock in a controlled corporation so as to have that voting stock treated as included in their estates? Assume that the three brothers each owned a 1% general partner interest. Assume further that the trusts contributed the various policies each brother owned prior to placing the policies into the trusts to the partnership. And assume that each brother has retained a right to remove and replace the trustee he appointed in his own trust, but is not a special business trustee under any of the trusts. Since there is no predicate for applying the reciprocal trust doctrine, no one is treated as having transferred anything to any trust other than the trust each shareholder has created. The result may be that no surviving brother is treated as having provided consideration for the stock purchased from the trust he created. [76]

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[76] This is the same result as would obtain without the use of partnership.

But what if the brothers were special business trustees under the trusts of each other brother, the situation we condemned in considering Structure 4, above. [77] Under this aspect of the indirect transfer rule, a third party must have provided the consideration for the purchase of the shares. The consideration for the purchase in this scenario would have been provided by life insurance death benefits and those policies producing the death benefits would, in turn, have been provided to the partnership by each of the trusts. In turn, the trusts would have received those policies from the grantor of each respective trust, at least prior to the death of the first brother. *Since this rule is applied after each addition,* [78] *however, the rule will not treat any of the surviving brothers as transferors to any trust other than his own as long as there have not been any transfers to the trusts after the death of the first shareholder to die.* This is because until that time, none of the trusts will be reciprocal trusts. [79]

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[77] See text accompanying fns. 45-58.

[78] See text accompanying fn. 54, and the paragraph thereafter.

[79] See text following fn. 53, above.

This result has significant implicatiaons for the structure of the plan, particularly: (1) *Do not count on funding from all shareholders throughout their lifetimes. Instead, try to get the policies "paid up" during a limited time period.* If the policies can be fully funded during the joint lifetime of the three shareholders, there will not be "an addition" after which to apply § 2036(b) and Prop. Regs. § 20.2036-2(e)(2). (2) *Consider having the partnership allocate sufficient amounts of the death benefit from the policy covering the first shareholder to die to completely pay up the policies covering the surviving shareholders.* This payment paying up the policies would not be "an addition" to any trust so long as the partnership is used, whereas without a partnership there might be "an addition" to the trust under analogous circumstances. Instead, the partnership will be making payments on its own assets, not making additions to trusts. If there is no "addition," there will not be any occasion to change the transferor from the original grantor by

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reason of the application of the reciprocal trust doctrine. Moreover, though the trusts would then be considered reciprocal trusts, that should not result in a determination that one of the surviving brothers provided consideration to a trust he did not create (but for the application of the reciprocal trust doctrine) since no transfer to those trusts took place while they were “reciprocal trusts.” [80]

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[80] TAM 199938005 is not to the contrary. In that ruling, the decedent transferred stock to a partnership of which he was a general partner. Thus, the statutory conditions were satisfied by a transfer for less than adequate consideration with a retention of the voting right in shares of a corporation which is a controlled corporation as to the person retaining the voting rights.

Conclusions Regarding This Structure

Despite the arguments set forth above, which may well carry the day, there seems to be significant tax uncertainty in any scenario where the shareholders surviving the first death actually acquire the right to vote the shares of a corporation that is a controlled corporation as to them. When all is said and done, that may be what we have: a decedent (one of the shareholders surviving the first shareholder who dies) who is a general partner and who has the right to vote stock in a corporation that is a controlled corporation as to him. That may be adequate to fulfill the conditions of the statute despite the fact that the only transfer he ever made without full and adequate consideration was a transfer of the original policies to the trust for his family. Even if the voting stock is brought into the estate of the survivors on a 50-50 basis, those costs are minimal compared to the overall benefits of this planning, as discussed above. [81] The safer course seems to be to have the voting stock converted to nonvoting stock on the death of any shareholder. Then, those voting rights are not acquired by anyone.

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[81] See text accompanying fn. 44.

BUY-SELL AGREEMENT MODIFICATIONS AND ISSUES WHEN A TRUST FOR BENEFIT OF NON-SHAREHOLDERS WILL BE THE PURCHASER

For situations in which a trust under which the beneficiaries are not current shareholders will be the purchaser of a deceased owner's stock, there are a number of special issues which must be addressed by counsel to the owners and the drafter of the buy-sell agreement.

Is the Obligation Enforceable?

Ordinarily, only the owners of the company and sometimes their spouses will sign and agree to be bound by the buy-sell agreement. With the trust arrangement, the trustee must sign the agreement, too, and agree to be bound by the purchase obligation created under the agreement. In a traditional “trusteed” buy-sell, the trustee acts like an escrow agent, and the only real obligations are to receive the death benefit, transfer title to the ownership interest being sold, and pay out the proceeds of the insurance. If there is a note payment, then the trustee may have some continuing responsibility. However, with the trustee acquiring stock for the benefit of trust beneficiaries, the trustee is actually acquiring the stock to be held as an asset of the trust.

What if the Trustee Defaults?

Can the trustee be sued or forced to complete the purchase by a court? What is the consideration for

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entering into this contract? Clearly, the trustee should be permitted to enter into an option agreement to purchase an interest in a business. But, can the trustee be forced to consummate a purchase if the business is failing when the buy-sell is triggered? Would it be a breach of fiduciary duty by the trustee to make such an investment? Perhaps, the beneficiaries of the trust should sign the buy-sell agreement, too, or provide releases and indemnifications to protect the trustee for entering into such a transaction clearly intended to benefit the beneficiaries.

While the answers to these questions are by no means clear, one possible solution is for the business owners to transfer a small number of shares in the company to the trust concurrent with execution of the buy-sell. Doing so connects the trust to the business, and should make it much easier to convince a court that the buy-sell contract should be enforced against the trust.

Is the Trust a Permissible Owner of S Corporation Stock?

If the company whose stock is being purchased is an S corporation, then it is imperative that the trust be a permitted owner of S corporation stock. [82] The only kinds of trusts which can owns stock in an S corporation are grantor trusts, QSSTs and ESBTs. Loss of the S election can have devastating impact on the shareholders, and S corporation shareholder agreements commonly have provisions which can trigger offers to sell one's interest in the company for doing anything that jeopardizes the S election.

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[82] Section 1361 limits the kinds of trusts that can be owners of S corporation stock to a Sub-Part E Trust (more commonly known as a grantor trust — *see* § 1361(c)(2) and § § 671-679), a Qualified Subchapter S Trust (*see* § 1361(d)), or an Electing Small Business Trust (*see* § 1361(e)).

The firm's counsel needs to be assured that the trust always will qualify to own stock in the S corporation. If it will initially qualify as a grantor trust, then there has to be a back-up method of qualifying if it loses its grantor trust status (e.g., the grantor dies). The trustee should have the power to create a QSST if the trust provisions do not already qualify (e.g., a discretionary trust will not qualify), or, the trustee should have the power to file an ESBT election, or either one. The shareholder/settlor of the trust should be required to represent to the other owners that the trust always will be able to qualify as an S corporation, and the trustee should sign the buy-sell agreement promising to make any election necessary to accomplish this purpose. In fact, the owners may even want a provision in the buy-sell agreement permitting them to direct the beneficiary or trustee to make a QSST election or an ESBT election.

Don't Forget About Income Taxes

If the grantor trust technique will be used to qualify the trust as an S corporation shareholder, the settlor should be prepared to pay the income taxes of the trust once it becomes an owner of the S corporation. If the settlor is not prepared to pay these income taxes, then the trust should have provisions permitting the trustee to reimburse the settlor for payment of the income taxes. This is not a drafting issue as much as a tax trap of which the owners should be wary.

What Happens if a Trustee Resigns?

Often in the course of a trust's existence, a trustee will resign and be replaced by a successor. Not only must the trust continue to obligate all successor trustees to be bound by the buy-sell commitment of their predecessors, but the successor trustees also should be required to consent to be bound by the terms of the agreement before their appointments becomes effective as trustees. Including a provision in the trust giving shareholders a veto power over future trustee appointments could be construed as an ownership right with the resulting negative estate tax implications for the trust settlor, and probably should be

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avoided both in the trust and the buy-sell.

Transfer for Value Issues

As is often the case with buy-sell agreements funded with life insurance, transfer for value considerations are present. Transfer for value always must be avoided. Otherwise, the life insurance death benefit may become taxable income. [83] The transfer for value question arises in a different context when a trust is being used to own the life insurance for non-owner beneficiaries. With this kind of trust arrangement, none of the policies already owned by the trust will be transferred to anyone when an owner dies. Instead, the trust will retain all of the insurance it already owns without any change in the beneficial interest owned in the policies by any beneficiary.

[83] § 101(a).

However, there is one situation in which a transfer for value problem is present. Let's consider an example. The facts are as follows. Manny and Mo each own 50% of their company. Manny creates Trust A to buy Mo's interest in the company. Trust A buys life insurance on Mo's life to fund its buy-sell obligation. Mo may or may not be using the trust arrangement for his buy-sell obligation. Assume he does not use a trust, and Mo purchases a life insurance policy on Manny's life for his share of the buy-sell. If Mo dies before Manny, either Manny or Trust A may want to acquire from Mo's estate the life insurance he owned on Manny's life. It will be okay for Manny to purchase the insurance from Mo's estate, but it may not be okay for Trust A to purchase the insurance from Mo's estate. The trust making the purchase would be a transfer for value unless an exception to § 101(a) applies. The exceptions that might be relied upon are the sale to the insured exception or the sale to a partner of the insured exception. The latter could be achieved if Trust A is a partner of Manny's in another venture. The first exception may be achieved if the trust is a grantor trust. A purchase by a grantor trust of a policy on the life of the grantor should be treated as a sale to the grantor himself if the IRS is consistent in its treatment of grantor trusts. However, the IRS has stated that it will not rule on this question.

It would seem preferable for the trust to purchase the insurance on Manny's life from Mo's estate to keep the death benefit out of Manny's estate when he dies. A wait-and-see provision in the shareholders' agreement to determine who can purchase the insurance and when from a deceased shareholder's estate is appropriate in this situation.

Transfer for Value With Three of More Owners

In the same situation as described above, if Mo owned a policy on a third owner, Jack, then Trust A may need to acquire the policy on Jack's life to fund its obligation to purchase Jack's stock when he later dies. If Trust A acquires the policy insuring Jack from Mo's estate, there surely will be a transfer for value There may not be any exceptions to rely upon unless the partner of the insured exception can somehow be structured.

Transfer for Value When a Beneficiary Cashes Out

Another transfer for value problem could arise if there is more than one beneficiary of the trust that owns the insurance. If one of the beneficiaries no longer wants to participate in the plan and is bought out of the trust, there may be a transfer for value between two or more beneficiaries, neither of whom is the insured. This is not a drafting problem as much as it is a problem to be considered by the owner/settlor when choosing trust beneficiaries.

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Does the Trust Obligation Create a Second Class of Stock?

S Corporations only are permitted to have one class of stock. If there is more than one class of stock, then the S election is terminated. [84] Ordinarily, IRS regulations provide that the options created under a buy-sell agreement do not create a second class of stock. [85] However, an exception is when the price is significantly higher or lower than the fair market value of the stock subject to the agreement.

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[84] § 1361(b)(1)(D). Voting and nonvoting shares of common are considered one class of stock by the IRS.

[85] Regs. § 1.1361-1(l)(2)(iii)(A).

This pricing issue could become a problem with life insurance funded plans. Sometimes, to avoid valuation issues and/or future insurability problems, the owners of a company will purchase more insurance than is currently needed to fund the buy-sell. Often, the buy-sell drafter will include a provision that provides that the price at death will be the higher of the fair market value as determined under the agreement or the life insurance death benefit. If the insurance policy death benefit is substantially higher than the current fair market value, one wonders if this provision could inadvertently create a second class of stock owned by the trust. Caution may dictate not buying too much extra insurance when a trust is being used for this purpose with an S corporation.

CONCLUSIONS

The use of life insurance trusts to funnel significant value from the estates of business people under buy-sell agreements offers very significant benefits, although the complications and technicalities are also substantial. This approach seems most viable with respect to non-managing interests e.g., nonvoting stock in a corporation. When nonvoting stock or other non-managing interests represent the bulk of the business' equity, very substantial benefits can be achieved. With respect to voting stock, the most viable approach using trusts as buyers seems to be to have that stock convert into nonvoting stock at death despite the fact that that conversion will not be recognized for estate and gift tax purposes under Chapter 14.

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ENTERPRISE FAIR MARKET VALUE AFTER DISCOUNTS	$ 100,000,000
MANNY'S % INTEREST	33.33%
MO'S % INTEREST	33.33%
JACK'S %INTEREST	33.33%
THERE IS NO GROWTH BETWEEN THE BROTHERS' DEATHS	
BUY-SELL OBLIGATES EACH BROTHER TO BUY HALF AT OTHER'S DEATH	
ALL EXEMPTIONS ARE USED AT DEATH	
ALL BROTHERS SURVIVE ALL SPOUSES	

TYPICAL CROSS PURCHASE ARRANGEMENT	
1ST DEATH	
MANNY'S PERCENTAGE INTEREST AT DEATH	33.33%
MANNY'S INTEREST AT DEATH	$ 33,333,333
INSURANCE PAID TO MO AND JACK- NO DEPLETION BY PAYMENT FOR SHARES	$ 33,333,333
ESTATE TAX AT MANNY'S DEATH AT 50%	$ 16,666,667
2ND DEATH	
MO'S PERCENTAGE INTEREST AT DEATH	50%
MO'S INTEREST AT DEATH	$ 50,000,000
INSURANCE PAID TO JACK	$ 33,333,333
ESTATE TAX AT MO'S DEATH AT 50%	$ 25,000,000
3RD DEATH	
JACK'S PERCENTAGE INTEREST AT DEATH	100%
JACK'S INTEREST AT DEATH	$ 100,000,000
DEPLETION OF JACK'S ESTATE PAYING FOR MO'S INTEREST	$ (16,666,667)
ESTATE TAX AT JACK'S DEATH AT 50%	$ 41,666,667
TOTAL TAX AFTER ALL THREE HAVE DIED	***$ 83,333,333***
USING TRUSTS AS BUYERS	
1ST DEATH	
MANNY'S PERCENTAGE INTEREST AT DEATH	33.33%
MANNY'S INTEREST AT DEATH	$ 33,333,333
ESTATE TAX AT MANNY'S DEATH AT 50%	$ 16,666,667
2ND DEATH	
MO'S PERCENTAGE INTEREST AT DEATH	33%
MO'S INTEREST AT DEATH	$ 33,333,333
ESTATE TAX AT MO'S DEATH AT 50%	$ 16,666,667
3RD DEATH	
JACK'S PERCENTAGE INTEREST AT DEATH	33%

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JACK'S INTEREST AT DEATH	$ 33,333,333
ESTATE TAX AT JACK'S DEATH AT 50%	$ 16,666,667
TOTAL TAX AFTER ALL THREE HAVE DIED	***$ 50,000,000***
ESTATE TAXES SAVED — 40%	***$ 33,333,333***

Voting-Nonvoting Recap

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