DISPOSITION OF BUSINESS INTERESTS

*BY WILLIAM N. HADDAD**

THE MAIN PROBLEM in disposing of a business is finding a successor—someone willing and able to carry on the business after the owner's death. This is equally true whether the business is a farm, a grocery store, or a manufacturing plant. If the successor can be found or selected during the owner's life, and an arrangement can be made for him to buy the business upon the owner's death, two additional problems that confront many estates might be solved—namely, the problem of raising cash and the question of valuation.

The task of finding a successor is, of course, a practical or business problem. Legal forms and machinery alone cannot be counted on for a solution. A farmer knows that incorporating the farm will not serve as a substitute for an able-bodied son to carry on after he is gone. A businessman should likewise be aware that forming a corporation or a partnership does not automatically assure continuation of the business after his death, much less a realization by his estate of the value of the business as a going concern. There is little practical difference between the problems confronting the estate when the decedent's business was individually owned and when it was held by a wholly-owned corporation or by a family partnership in which the decedent was the sole manager. In all three cases the executor or the surviving partner may find himself under the necessity of liquidating the business unless a purchaser has been found before the decedent's death or can be found promptly thereafter.

It is true, however, that the existence of a partnership or a corporation may facilitate the transfer of the business to a successor or likely successor. Moreover, it may provide the machinery for attracting a successor and tying him into the business by giving him an immediate interest in it. In that sense the form of ownership may be important.

Many factors, of course, are to be considered in determining whether an enterprise should be conducted as an individually-owned business, as a partnership, or as a corporation. Most of these factors are associated with life rather than the situation produced by the owner's death. Not

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the least important consideration is the amount of income taxes payable under each alternative. In the years immediately preceding 1946, thousands of partnerships were formed as a refuge, or imagined refuge, from the high surtax rates applicable to individuals in the upper brackets on the one hand and the excess profits taxes applicable to corporations on the other. Since the repeal of the excess profits tax in 1945, the trend has been the other way, and many unincorporated businesses have been incorporated or reincorporated. Nevertheless, under present tax rates and though we disregard the possibility of a new excess profits tax, it will rarely be advisable to incorporate a business merely for the sake of obtaining the formal "continuity" that attaches to corporate existence. On the other hand, the convenience and flexibility of the corporate structure and the means that it affords of attracting or retaining likely successors through immediate ownership of a part of the stock are factors that might well be taken into account.

Although the ultimate problem is the same regardless of the type of ownership, some of the details and incidental problems vary with the form of organization. The three usual types of ownership will therefore be discussed separately.

INDIVIDUAL PROPRIETORSHIPS

The problem of succession is most acute in the case of an individually-owned business, not because of the form of the ownership but because of its exclusiveness. Any lifetime purchase agreement in such case must necessarily be with an outsider as distinguished from a part owner, and few outsiders are likely to be willing to commit themselves to buy the business for a fair price at an indefinite time in the future fixed by the owner's death. Occasionally, a satisfactory agreement can be made for the transfer of the business to one or more employees. But in such cases, it may be necessary to provide for payment of the purchase price in comparatively small installments over a long period of time. This might defeat the purpose of the sale by postponing the receipt of cash (while death taxes must still be paid immediately) and leaving a large part of the investment subject to the hazards of the business.

The use of life insurance might be considered in such cases, although if it is necessary to increase the employees' salaries beyond what they would otherwise be or to give them extra bonuses in order to pay for the life insurance, the owner should realize that the purchase price is being provided at his own expense, except to the extent that an income tax saving results from the payment. Such saving, however, may be a material factor. If, for example, the owner's top tax rate is 70% and the employee's is 40%, $1,000 of income retained by the employer means $300 after taxes, while the same amount paid to the employee leaves him $600 after taxes. With the same $1,000 (before taxes), the employee, in such an

example, could buy twice as much insurance as the employer, one-half of what he buys being at the employer's expense and the other half being attributable to a tax saving—obviously, a very desirable arrangement from the employee's standpoint. This all assumes, of course, that the extra compensation would not have been paid except for the purchase contract—something that it may be difficult to be sure of—and also that the total compensation paid meets the test of reasonableness so as to be deductible under Section 23 (a) of the Internal Revenue Code. It is probably safe to assume that most agreements to sell to employees are motivated more by a desire to benefit the employees or to retain their services than to solve the conventional problem in the employer's estate.

Some writers have suggested the possibility of selling an interest in the business, either incorporated or unincorporated, to an employees' pension or profit-sharing trust which is exempt from income tax under Section 165 (a) of the Internal Revenue Code. But the Commissioner of Internal Revenue, who, since 1942 has exercised strict supervision over such trusts, must be satisfied that the sale is not intended to serve any purpose except the "exclusive benefit of employees"; otherwise, the trust may be denied an exempt status on the ground that its purpose is to benefit the employer.[1] Such a program, if otherwise practicable, should be adopted only with the Commissioner's approval. And regardless of feasibility, the wisdom of investing in the employer's business any large portion of the funds set aside for employees might also be open to question. This is particularly true in the case of a pension trust, one of the principal objects of which is to provide the employees with a measure of security that will not be dependent on the continued success of the business.

If no satisfactory sale arrangement can be made during the owner's life, the best course for the owner to follow is perhaps to reduce the size of the problem by keeping the investment in the business as low as possible. This can be done by diverting some of the assets into other investments or, what is essentially the same thing, by taking out life insurance. In addition, the owner should make careful provision respecting the business in his will, as is hereinafter suggested.

PARTNERSHIPS

In the case of a partnership, the most logical successor is the surviving partner or partners. Every partnership should face the contingency of the death of a partner and make specific provision for it. That should be done in the interest of both the decedent and the survivors. Under the Uniform Partnership Act, the death of a partner dissolves the partnership, and unless the parties have agreed otherwise, it becomes the duty of the surviving partner or partners to liquidate the business immediately

[1] U.S. Treas. Reg. 111, § 29.165-1 (a) (1943); P.S. No. 49, P-H PENS. & PROFIT SHAR. SERV. ¶ 9547 (1945).

and to pay to the decedent's representative his share of the proceeds. The survivors thus occupy a position similar to that of an executor with no power to run the business. Of course, there is nothing to keep the survivors from buying the decedent's interest at that point. But such a purchase may have to be negotiated under unfavorable conditions. From the standpoint of the estate, the newly appointed executor may be in a poor position to determine a fair price, or he may have difficulty in obtaining the necessary authorizations or consents to make the sale; and from the standpoint of the survivors, they are under the urgent necessity of making a quick purchase because of their lack of authority to run the business, as distinguished from winding it up, and the risk they take if losses are incurred on the one hand and the necessity of preserving its value as a going business on the other.

It would be better, therefore, if the partnership agreement made provision for continuation of the business and a purchase of the decedent's interest by the survivors. Or if the parties are unwilling to make a commitment for such purchase, the survivors might be given an option for a limited time to buy the decedent's interest at a fair price plus the right to continue the business until the expiration of the option period, treating the estate as a partner or a limited partner during such period.

In any purchase arrangement, the primary purpose is to compensate the decedent's estate for the value of his interest in the partnership. Where, as in the case of a professional partnership, the firm has little capital, the fairest arrangement might be to give the estate a share of the income for one or more years after the decedent's death. In such a case, however, a serious question may arise as to the correct income tax treatment of the payments. If what the estate receives is regarded as payment for the decedent's share of the capital or good will of the business, the amounts received are not taxable as income to the recipients; nor are they deductible by the survivors. They are treated as payments of purchase price for a capital asset. If, on the other hand, the amounts are considered to be in payment of the decedent's interest in the income of the firm or to represent the estate's share of the income, they are taxable to the recipients and are subtracted from the income that would otherwise be taxable to the survivors. The decided cases on this subject are confused and reach varying results, the outcome frequently turning on the exact language used to describe the payments.[2] Careful draftsmanship is therefore im-

[2] *Compare*, for example, Coates v. Commissioner, 7 TC 125 (1946), Miller v. Commissioner, 38 B.T.A. 487 (1938), and Wilkins v. Commissioner, 7 TC 519 (1946), *aff'd*, 161 F.2d 830 (C.C.A. 1st 1947). The *Wilkins* case introduced a new complication. The surviving member of a law partnership had agreed to pay the estate of his deceased partner a percentage of the partnership income for a stated period prior to death, in payment for decedent's interest in fees accrued but not collected. This payment was held to be in purchase of accounts receivable and not deductible from the survivor's income. (The receivables, however, would thereby acquire a cost basis, and collections on them would be taxable only to the extent of the excess over the cost).

portant to show not only the amount to be paid but the theory of the payment.

By way of suggestion, the partnership agreement might make the following provisions:

1. That the partnership—where there are more than two partners—shall not terminate upon the death of a partner but shall continue as a partnership between the survivors for its unexpired term or any other desired period.[3]

2. That upon the death of a partner, the survivor or survivors shall buy his interest as of the date of his death (or any other specified date) at an agreed price or a price determined in accordance with a formula. In order to obtain fairly predictable income tax results, the payments to be made by the survivors might be divided into:

   (a) Any indebtedness owed by the firm to the decedent, including undrawn income from previous years.

   (b) The decedent's share of the income to the date of death or the date of the sale, including income subsequently received from unfinished business.

   (c) The price for his share of the capital and good will.[4]

3. The time of payment should, of course, be specified, and appropriate provisions should be made for security, remedies in case of default, etc.

As far as estate tax is concerned, the value of the decedent's interest is includible in his taxable estate, whether it represents principal or income [5]

[3] The death of a partner automatically dissolves a partnership but need not terminate it. *See* Heiner v. Mellon, 304 U.S. 271, 58 Sup. Ct. 926 (1938).

[4] If it is desired to substitute for some portion of item (c) payments which would be taxable to the estate (and not to the surviving partners), it may be possible to accomplish this result by giving the estate a share of partnership earnings for one or more years subsequent to the decedent's death, thereby making the estate, for this purpose, a partner. Such a formula is often used in professional partnership agreements as a convenient means of approximating the decedent's interest in unfinished business.

[5] This is probably true despite Bull v. United States, 295 U.S. 247, 55 Sup. Ct. 695 (1935), if it be assumed that the payments which the decedent is entitled to receive have an ascertainable value on the date of his death. The *Bull* case, which reached a contrary result, seems to be limited in application to a situation where the deceased partner had no interest in capital and where his estate is merely given the right to continue in the position of a partner for a period subsequent to his death. McClennen v. Commissioner, 131 F.2d 165 (C.C.A. 1st 1942); Lincoln Estate v. Commissioner, 1 TCM 326, (1942). See Rabkin and Johnson, *The Partnership Under the Federal Tax Laws*, 55 HARV. L. REV. 909 (1942).

and even though the amount representing income may later be taxable as such to the recipient under Section 126.[6]

The use of life insurance to provide for the payments to be made to the decedent's estate is discussed later.

CORPORATIONS

In the case of an incorporated business, the planning should commence, if possible, at the time the corporation is formed. An investment of $500,000 in a wholly-owned corporation is easier to deal with if it is made up of, say, $100,000 of bonds, $200,000 of preferred stock, and $200,000 of common stock. The $100,000 represented by the bonds can be withdrawn from the business, either during life or after death, usually without income tax consequences; whereas a retirement of preferred or common stock by the corporation might easily result in a tax to the stockholder. With two classes of stock, the preferred shares could be sold to outsiders, either before or after death, without giving up control of the company. And after death, the estate could more readily sell the common, retaining the preferred, since it would take less to finance the purchase.

This desirable flexibility can usually, within limits, easily be obtained on the incorporation of the business.[7] But with an existing corporation, an attempt to reach the same result by means of a recapitalization runs into serious income tax dangers. The issuance of bonds in the reorganization of a closely-held corporation is definitely hazardous under the *Adams* and *Bazely* cases.[8] The bonds may be taxable as dividends. And the Commissioner has recently been considering the possibility of according similar treatment to preferred stock.[9] In consequence, an estate sometimes finds it difficult to draw money out of a wholly-owned cor-

[6] Any amount taxable under § 126 of the Internal Revenue Code as income "in respect of a decedent" would be subject to the deduction allowed in § 126(c) for the estate tax paid on such amount. Section 126 may not apply to future income which is not attributable to services performed during the decedent's life. In such case if the value of the right to receive the payments is included in the decedent's estate for estate tax purposes, logically, a deduction should be allowed from taxable income for the amortization or exhaustion of such right. And whether or not such deduction is allowable, the fact that the payments are subject to income tax might well be taken into account in determining their value for estate tax purposes. Unfortunately, the decisions to date furnish no clear answers to these questions.

[7] See Schlesinger, *"Thin" Incorporations*, 61 HARV. L. REV. 50 (1947).

[8] Bazely v. Commissioner, 331 U.S. 737, 67 Sup. Ct. 1489 (1947).

[9] See Special Ruling, December 29, 1947, published in 5 CCH 1948 FED. TAX REP. ¶ 6059.

poration to pay estate taxes or other liabilities without incurring a substantial income tax.[10]

Many problems can be solved by inter vivos stock purchase agreements. Such agreements overcome the two principal drawbacks of stock in closely-held corporations, viz., lack of liquidity and uncertainty about valuation for estate tax purposes. The purchase agreement can be with the corporation, with other stockholders, or with third persons, typically employees. An agreement on the part of the corporation to buy its own stock is always subject to the rights of its creditors. Furthermore, it is more appropriate to the situation where the stock to be bought is a minority interest. If such an agreement is made by the principal stockholders, equity may require that a similar privilege be extended to the minority, unless their consent to the arrangement is obtained. Provision might be made that if the corporation fails or is unable to perform, the stock will be bought by the surviving stockholders who are parties to the agreement.

The agreement can be for a fixed price, for a formula amount which takes into account book value or earnings, or the value can be left to appraisement. The price so agreed upon, if negotiated in good faith and at arm's length, should be controlling for estate tax purposes.[11]

The effect of an option exercisable upon the owner's death on the estate tax value depends upon the circumstances under which it is given. If an irrevocable option is given in a business transaction for adequate consideration (which might consist of a cross-option), the option price should control, even though the date-of-death value is considerably higher.[12] In that case, the owner will have parted with a portion of the value during his life, receiving, by hypothesis, an adequate consideration in return. If, on the other hand, an option exercisable on death is granted without consideration, there is a gift of a portion of the value which takes effect at death and which must be added to the price named on the option.[13]

No reliance can therefore be placed on any option arrangement the primary purpose of which is to influence the valuation question. The valuation question might, however, be solved as an incident or by-product

[10] A retirement of a part of the stock where the corporation has a substantial earned surplus would probably be taxable as a dividend under Code § 115(g); and a liquidation of the corporation followed by an immediate transfer of the business (other than the cash, say) to a new corporation might conceivably have the same tax result. If the money is lent by the corporation to the estate and there is no prospect of repayment, *quaere* whether the loan would be recognized as a loan rather than a distribution.

[11] *See* Wilson v. Bowers, 57 F.2d 682 (C.C.A. 2nd 1932).

[12] See note 11 *supra; Bensel v. Commissioner*, 36 B.T.A. 246 (1937), *aff'd.*, 100 F.2d 639 (C.C.A. 3rd 1938).

[13] *See* Armstrong's Estate v. Commissioner, 3 TCM 77, *aff'd.*, 146 F.2d 457 (C.C.A. 7th 1944).

of a sale of the stock at a genuinely negotiated price; so the attention and emphasis should be directed to the sale.

USE OF LIFE INSURANCE

Life insurance is often used as the means of "funding" agreements to purchase business interests, particularly reciprocal agreements to buy or sell depending on survivorship. In many cases insurance may be the only practicable means of financing the purchase. Oftentimes, however, the arrangement involves a gamble between the parties which may not be fully realized or intended.

Take the simplest case: *A* agrees to buy certain property from *B* upon *B's* death for, say, $50,000. *A* doesn't have $50,000, but he is able to save out of his earnings $2,000 a year. If *B* lives out his expectancy, *A* can accumulate the $50,000 and make good his contract. But there is no assurance that *B* will live that long. So *A* takes out $50,000 of insurance on *B's* life and covers the obligation in that way. Insurance, in that case, is the perfect solution. The only gamble involved is between *A* and the insurance company.

Now, take another case: Two partners of the same age own, in equal shares, a business worth $100,000. The partnership agreement provides that upon the death of either partner, the survivor shall buy his interest for $50,000. It further provides that the firm shall take out $50,000 of insurance on each partner's life and pay the premiums out of its earnings; and that upon the death of either partner, his estate shall receive the $50,000 of insurance proceeds in payment for his interest. This is manifestly unfair to the partner who dies first, because his estate will end up with $50,000 while the survivor will have $100,000. The partners could have reached the same result more simply by taking out their own insurance for the benefit of their own families and having a survivor-take-all agreement with respect to the partnership—if that is what they really intended. And from the standpoint of the decedent's estate, it would have been much better if the decedent had taken out his own insurance and let the executor sell the interest in the business for whatever it would bring. That, however, would have left the survivor with an unsolved financing problem if he was to be the purchaser. One sensible way of solving the problem in a manner fair to both parties would be to consider the proceeds of any insurance paid for by the partnership as partnership assets and to pay a pro rata share to the decedent's estate or reflect such share in the purchase price. In the example given, the decedent's estate would, on that basis, receive a purchase price of $75,000 for his interest in the partnership or a purchase price of $50,000 plus $25,000 of the insurance proceeds.

In the same example, if the interests of the partners are unequal and one partner bears, say, 60% of the cost of the insurance, his estate should receive 60% of the insurance proceeds. This equalization can be brought about directly by a proper division of the proceeds or, indirectly, by treating the proceeds as partnership assets and reflecting them in the purchase price. The cash value of the policies on the survivor's life should likewise be treated as partnership assets if the premiums were paid out of partnership funds.

Suppose we vary the example and assume partners of different ages so that it costs more to carry the same amount of insurance on one partner than on the other. Here again, if the premiums are paid by the partnership and the proceeds are treated as partnership assets, no unfairness as between partners will result.[14]

It might be objected that the suggested treatment of the insurance proceeds as part of the partnership assets serves to increase the purchase price, thereby requiring more insurance to finance the purchase which, in turn, increases the price still further, and so on. That is true. A partnership with $100,000 of assets, in addition to $50,000 of insurance, could not pay a 50% partner with the insurance alone. It would take $100,000 of insurance to give him an equal division of the total assets.

If the above result is to be avoided equitably, the insurance should be bought and owned by the individual partners outside the partnership, each partner taking out insurance on the other's life. In that case, when one partner dies, the other will collect insurance which belongs to him personally and which he can use to buy out the decedent's interest in the partnership; while the decedent's estate will receive the agreed price for the partnership interest plus whatever value there might be in the outstanding policy on the surviving partner's life. The only trouble is that where there are several partners, instead of just two, each partner must take out insurance on each of the others, which may require the issuance of a large number of separate policies; or an arrangement must be made whereby the insurance on each partner's life is taken out for the joint benefit of all the other partners and the premiums are paid by them pro rata—that is, in proportion to each partner's interest in the proceeds. Where for purposes of convenience the policies are taken out and paid for through the partnership, both the agreement and the accounting records should show that no partner has any interest in the policies on his own life or is charged with any portion of the premiums on such policies. This is advisable not only in the interest of correct accounting between the

[14] There might be an unfairness if the interests of the partners are different as between capital and income unless (a) the premiums are charged to the partners in proportion to their interests in the capital, in which case the proceeds can simply be treated as partnership assets, or (b) special provision is made for a division of the proceeds in the same proportion as the premiums are paid.

partners, but also to prevent the proceeds from being subject to estate tax as part of the insured's estate.[15]

What has been said about the gamble involved in insurance arrangements between partners is equally true with respect to such arrangements between stockholders of a corporation. Unless a survivor-take-all agreement is actually intended, all such arrangements should be carefully analyzed to make sure that the decedent's interest is not to be paid for out of insurance which was bought, in whole or in part, at his own expense.

The same element of gamble can also be present where the purchase agreement is made with the corporation rather than another stockholder. If a 50% owner of a corporation having a net worth of $100,000 agrees to sell his stock to the corporation for $50,000, and the corporation pays for the stock out of insurance on his life which was taken out for the purpose, obviously a windfall would result to the remaining stockholders. In such case, fairness to the decedent's estate requires that the proceeds of the insurance be reflected in some way or taken into account in determining the price to be paid for the stock.

It will often be found necessary or convenient to set up a trust or escrow to secure the performance of a purchase agreement, particularly a stock purchase agreement and, more particularly, one to be financed by life insurance. A reciprocal stock purchase arrangement between two stockholders could be set up along the following lines:

1. The stockholders would agree that upon the death of either of them the survivor would buy his stock.
2. The price or the method for determining the price would be specified. The price could be a fixed amount, which might be revised from time to time by mutual agreement [16] or could be determined by a formula (based on book value, earnings, or anything else that is relevant) or could be left to appraisement.
3. Each of the parties would agree to carry a stated amount of insurance on the other's life and in the event of the death of the insured, to apply the proceeds on the purchase price of the decedent's stock.
4. A trust would be created to hold the stock and the insurance policies. The stock certificates would be properly endorsed for transfer, and the insurance policies would either be assigned or made payable to the trustee. The parties would

[15] Under § 811(g) of the Estate Tax Law as amended in 1942, the proceeds are includible in the insured's taxable estate if he either paid the premiums or had any of the incidents of ownership, *e.g.*, the right to change the beneficiaries. The question of whether the proceeds would be included in lieu of or in addition to the interest in the business is discussed later.

[16] A common arrangement is to agree on an initial price with the intention of revising it periodically. The danger in such arrangements is that the parties will neglect to make or be unable to agree on the revisions.

agree to pay the premiums on the policies or in the case of a "funded" trust, would provide the trustee with assets out of which payments could be made.

5. The trustee would be authorized upon the death of either party to collect the insurance on his life and to apply the proceeds on the purchase price of his stock. If the proceeds are less than the price, the stock would be delivered to the survivor upon payment of the balance. If the insurance proceeds exceed the purchase price, the surplus can be made payable either to the surviving stockholder (since, by hypothesis, he bought the insurance) or to the estate of the decedent, as might be agreed. If the latter result is desired, it would be preferable to set a minimum price on the stock equal to the insurance. In either case, the proceeds of the stock would be turned over to the decedent's estate or beneficiaries; or, conceivably, they could be retained by the trustee under provisions similar to those in a conventional type of trust. The policies on the survivor's life would be returned to the decedent's estate, or they could be sold to the survivor for their cash value.

The arrangement is, of course, subject to innumerable variations, depending on the facts and the results to be accomplished. The principal objects of an insurance trust of this type are (1) to secure the seller's obligation to deliver the stock (and to prevent its sale or disposition to anyone else) and (2) to secure, in whole or in part, the buyer's obligation to pay the purchase price. If the agreement is drafted on that theory, no estate tax complications should result. Though it may not always be clear whether the amount includible in the seller's estate is (a) the value of the stock (measured by the selling price) or (b) the insurance proceeds plus the additional amount, if any, to be paid by the purchaser,[17] the resulting estate tax, under present law, would be the same in either case.[18] However, if the insurance is paid directly to the decedent's bene-

[17] The Tax Court has followed first one theory and then the other. *See* Boston Safe Deposit & Trust Co. v. Commissioner, 30 B.T.A. 679 (1934); Dobrzensky v. Commissioner, 34 B.T.A. 305 (1936); Mitchell Estate v. Commissioner, 37 B.T.A. 1 (1938); Riecker Estate v. Commissioner, 3 TCM 1293 (1944). Unless a gift element is involved, there would be no basis for taxing both the insurance and the full value of the property. See Note, 48 COL. L. REV. 450; See note 18 *infra*.

[18] Conceivably, the state inheritance tax might be different in a state which does not tax insurance payable to beneficiaries other than the estate. But it may be doubted whether the proceeds received in exchange for the decedent's stock should be classed as "insurance" for this purpose. The discussion in the text assumes a purchase price negotiated at arm's length. In a case where that is not true—that is, where a gift is involved—the taxable amount may exceed the purchase price, whether insurance is used or not. *Quaere*, whether it should be considered that a gift is involved, though perhaps an unintentional one, where the decedent pays for some portion of the insurance which is used to buy his interest.

ficiary and the purchaser is required to pay only the excess of the agreed price over such proceeds, an income tax problem may be created for the purchaser. In *Legallet v. Commissioner*,[19] the Board of Tax Appeals held that the purchaser's cost of the property acquired in that manner does not include the insurance that was applied on the purchase price. In order to avoid this illogical result, it would be advisable to make the insurance payable to the trustee and to have the agreement indicate that the application of the proceeds on the purchase price is made on behalf of the purchaser.

The premiums on the life insurance are not deductible, and the proceeds are exempt from income tax, except that in the case of a policy transferred for a valuable consideration, the exempt amount is limited to the amount of the consideration plus the premiums paid subsequent to the transfer.[20]

There has been considerable speculation as to whether a corporation carrying life insurance to finance the purchase of its own stock is particularly vulnerable under Section 102 which imposes a penalty tax on unreasonable accumulations of surplus. The decisions shed very little light on this question; but to the extent that the insurance has a reserve value, it is a form of investment which it may or may not be possible to justify as serving a business need of the corporation, and it might well be taken into account in determining the company's position under Section 102.[21]

DISPOSITION BY WILL

In the absence of statute or clear authorization in a will, an executor has no authority to continue his testator's business.[22] His function is to close out the business as quickly as possible, and if he does not do so, he is personally liable for any losses that may be incurred. Section 213a of

[19] 41 B.T.A. 294 (1940). A similar result has been reached where stock is bought at less than value pursuant to an option granted in a will. Mack v. Commissioner, 148 F.2d 62 (C.C.A. 3rd 1945)); Merrell v. Evans, 8 F.2d 431 (D.C. Idaho 1925).

[20] INT. REV. CODE § 22(b)(1) and (2). The limitation on the exemption does not apply where the policy is assigned to the insured himself, U.S. Treas. Reg. 111, § 29.22(b)(2)-3 (1943); I.T. 3212, 1938-2 CUM. BULL. 65, nor in the case of certain tax-free exchanges. *See* the last sentence of the Code § 22(b)(2)(A).

[21] The question might also be asked as to whether payment of the premiums by the corporation constitutes an indirect payment by the insured stockholders within the meaning of § 811(g); also whether the amount of the premiums might be taxable as dividends or salary to the stockholders. It is believed that such questions will not cause serious trouble if (1) the insurance is taken out merely as a means of financing the purchase of the stock, (2) the stock is to be bought at a reasonable price, and (3) the company retains ownership of the policies (subject to the terms of the purchase agreement or trust).

[22] Smith v. Preston, 170 Ill. 179, 48 N.E. 688 (1879); Nonnast v. Northern Trust Co., 374 Ill. 248, 29 N.E. 2d 251 (1940).

the Probate Act of Illinois [23] gives an executor or administrator a limited authority, "for the preservation and settlement of the estate," to continue the business for one month following the date of his appointment and for such further time as the probate court may authorize on petition. Obligations incurred in the operation cannot, without prior approval of the court, involve the estate beyond the "assets of the business." In other words, in the absence of such prior court approval, if the "assets of the business" are insufficient to meet the obligations incurred, the executor is personally liable without any right of reimbursement out of the other assets.[24]

Anyone disposing of a business by will should therefore remember that it is extraordinary for the executor to operate a business, and that it is even more extraordinary to subject the outside assets of the estate to the debts incurred in such operation, and that it would take clear and unambiguous language to bring about such a result.

Some of the questions that should be considered in drafting a will disposing of an interest in a business are as follows:

1. If the interest is represented by securities of a corporation, is the executor (or trustee) authorized to retain the securities and distribute them in kind? Is that true, regardless of productivity, losses incurred, or other circumstances? Is he authorized to exchange the securities for other securities, and is he authorized to sell the securities or is he required to retain them? In the event of a sale, may he determine the price and terms of sale? Is he authorized to continue the corporation or to reorganize or liquidate it? Is he to select the directors and officers, and may he serve in such capacity, with or without compensation? May he enter into new or different lines of business? May he lend money to the corporation out of other assets in the estate? May he subscribe for other securities in the corporation? May he appoint proxies and give them discretionary powers? If the corporation is merged or reorganized, does he have the same powers with respect to the successor corporation? May he liquidate or dissolve the corporation, and, if so, may he accept the assets in kind and continue the business and on what terms?
2. In the case of an interest in a partnership, is the executor (or trustee) authorized to make a settlement with the remaining partners and, if so, on what terms? May he sell

[23] ILL. REV. STAT., c. 3, § 366a (1947), added by Act approved July 24, 1945, Ill. Laws 1945 2.

[24] The executor might contract himself out of personal liability by special agreement with prospective creditors, but that will seldom be practicable in day-to-day operations.

the interest or retain it? May he enter into a new agreement with the survivors of the business? May he subject the estate or the other assets in the estate to liability for debts or losses (this is probably not good against creditors)? May he sell the interest? May he make a compromise settlement?

3. In the case of an individually-owned business, it is of first importance to define what is included in the business. If the business is a farm, how much of the land is included? Does the farm include the home, the equipment, the livestock, the harvested crops, etc.? If the business is a store or a plant, does it include the real estate, the accounts receivable, the securities acquired in the business; does it include such things as patents? How much cash is included where the business has a separate bank account or where it doesn't? And what liabilities go with the business—payrolls, trade accounts, mortgages, property taxes, income taxes, etc.? After the "business" is identified, what is the executor or trustee to do with it? Is he authorized to sell it, operate, or liquidate it? For how long may he operate it? Is he authorized to hire and fire managers and other employees and fix their compensation; may he run the business himself and receive extra compensation for so doing? May he make long-term contracts; may he incur obligations to be paid out of the other assets in the estate? May he incorporate the business and, if so, in what state and on what terms as to capitalization, assets to be included, composition of directors and officers, compensation, etc.?

The will should also specify whether any or all the powers are intended to pass to a successor executor or trustee.

Since it is impossible to foresee every question that might come up and to make express provision for each, some reliance must be placed on broad powers given in general language. In determining how broad these powers should be, a word of caution might be in order: There is some hazard in every business, and after the death of the founder, there is probably an extra hazard. For the founder of a business to incur losses which wipe out not only the assets in the business but his other assets as well is serious enough. But it is much more serious for an executor or trustee to incur such losses. The results to the beneficiaries might be disastrous. One should be extremely cautious therefore in directing or authorizing an executor to take risks which might wipe out the estate. The policy of the law which narrowly circumscribes the function of an executor is not without wisdom.