7 Family Businesses

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Family Business Planning Strategies

Following is a summary of planning strategies used in this Tab.

- A sole proprietor can deduct the cost of his or her health care directly on Schedule C or F by hiring his or her spouse to work in the family business. If the sole proprietor offers accident and health coverage through a self-insured medical expense reimbursement plan, deductible expenses include reimbursed medical expenses for health insurance premiums and other costs not reimbursed by insurance. A medical reimbursement plan converts expenses that would otherwise be Schedule A itemized deductions subject to the 10% AGI limitation into deductible business expenses. See *Hire Spouse to Work in a Family Business,* next column.
- If the spouse is hired as a bona fide employee of the sole proprietor, other fringe benefits besides health benefits that are deductible by the business and excluded from the employee-spouse's income could be provided, including group term life insurance, meals and lodging, and transportation benefits. These same benefits offered to the employee-spouse of an S corporation are not excludable from taxable wages. See *Hire Spouse to Work in a Family Business,* next column.
- Hiring a spouse to work in the family business helps to retain family income by not having to pay a non-family member to perform the work as an employee. See *Hire Spouse to Work in a Family Business,* next column.
- A parent who owns a family business can hire his or her child to work for the business and shift income from the parent over to the child at a lower tax rate. Earned income by a child is not subject to Kiddie Tax rules. If the child makes deductible IRA contributions with wages earned, the parent and child can convert contributions to a college savings plan into a current tax deduction. Future withdrawals from the IRA used for college avoid the 10% early withdrawal penalty and are generally subject to the child's lower tax rate. Tax on the child's IRA withdrawals may also be offset by an education tax credit or deduction. See *Hire Child to Work in a Family Business,* page 7-4.
- By transferring real estate to a Family Limited Partnership (FLP) prior to death, estate tax may be reduced on the value of the real estate at death. The taxpayer transfers the real

continued in next column

Family Business Planning Strategies continued

  estate to the FLP in exchange for general and limited partnership interest. Then the taxpayer can make gifts of the FLP's limited partnership interest to family members. These transfers would qualify for valuation discounts because they lack marketability and control. See *Real Estate Transfer to Family Limited Partnership,* page 7-6.
- Running a family business out of a qualified home office can turn nondeductible housing expenses into legitimate business deductions. A qualified home office can also turn nondeductible commuting expenses into deductible business mileage. See *Home Office Tax Benefits,* page 7-10.
- A succession plan for a family business might address the following issues: key person life insurance, sibling rivalry, qualifications and experience, outside managers, business secrets, technology, buy/sell agreements, estate planning, and sale of the business. See *Succession Planning,* page 7-13.

Hire Spouse to Work in a Family Business

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- Schedule F (Form 1040), *Profit or Loss From Farming*
- Reg. §1.105-11, *Self-insured medical reimbursement plan*

Tax Issue

A sole proprietor can deduct health care costs that are paid for an employee as a business expense. By deducting the expenses directly on Schedule C (or Schedule F for a self-employed farmer), the deduction reduces both income tax and self-employment tax. It also reduces the FICA tax of an employee because the employee gets health insurance on a pre-tax basis rather than receiving a higher wage and then paying for premiums on an after-tax basis.

Since the sole proprietor is not considered an employee of the business, his or her own health care expenses (and health care for members of his or her family) are not deductible on Schedule C or F. Rather, the self-employed individual can claim an above-the-line deduction on the front of Form 1040 for health insurance paid. The self-employed health insurance deduction reduces income tax, but not self-employment tax.

Health care expenses not covered by insurance that are paid on behalf of the sole proprietor (and his or her family) are deductible on Schedule A, subject to the 10% AGI limitation (7.5% for taxpayers age 65 or older).

Applicable Tax Law

- Medical expenses are generally deductible on Schedule A as an itemized deduction, subject to the 10% AGI limitation.
- The self-employed health insurance deduction allows a sole proprietor to deduct his or her health insurance premiums as an above-the-line deduction on the front of Form 1040, rather than as an itemized deduction on Schedule A. The deduction does not reduce the sole proprietor's self-employment tax. The deduction is limited to health insurance and does not include out-of-pocket medical expenses that are not covered by insurance.

- Employer-provided health insurance and health reimbursement arrangements offered to employees are excluded from employee wages and deductible by the employer. If a sole proprietor is an employer and hires his or her spouse as a bona fide employee, health benefits provided to the employee-spouse are excluded from the spouse's wages and deductible by the sole proprietor on Schedule C (or Schedule F). The deduction reduces both income and self-employment tax.
- An accident and health insurance policy should be purchased in the name of the employee-spouse to exclude the benefit from gross income. If the insurance is purchased in the name of the self-employed person, then a deduction for the cost of insurance claimed on Schedule C (or Schedule F) may be disallowed.
- In order for a spouse of a sole proprietor to be treated as a bona fide employee, close scrutiny is required to determine whether a bona fide employer-employee relationship exists and whether payments are made on account of the employer-employee relationship or on account of the family relationship. The employee-spouse must perform actual services for the business and be paid an actual wage as an employee.
- An employer-employee relationship cannot exist unless the employer has the right to control the activities of the employee.
- Other factors that support the employer-employee characterization include consistent work by the employee for the employer, the payment of employee benefits, services provided by the employee that are integral to the business operations, employee training provided by the employer, and the existence of an employment contract.
- If the employer establishes a medical reimbursement plan, the plan must be in writing [Reg. §1.105-11(b)(1)(i)], the employer must inform all employees of the plan, and the employees must meet the participation requirements of the plan.

Tax Planning Strategies

Deduct health insurance directly on Schedule C or F. A sole proprietor can deduct the cost of his or her health care directly on Schedule C or F by hiring his or her spouse to work in the family business. A deduction for 100% of the cost of providing health coverage for the sole proprietor (and his or her family) may be claimed by doing the following:

- The sole proprietor hires his or her spouse as a bona fide employee of the business.
- The employee-spouse performs services for the business as an employee.
- The sole proprietor provides family accident and health coverage for all employees of the business, including the employee-spouse.
- Accident and health coverage for employees (including the employee-spouse) may be provided either through a self-insured medical expense reimbursement plan under IRC section 105(b) or by purchasing an accident and health insurance policy under IRC section 106(a).
- The cost of health coverage and medical expense reimbursements are excluded from the employee-spouse's gross income and are deductible as a business expense by the sole proprietor. (Rev. Rul. 71-588)
- The sole proprietor is then covered by the plan as a member of the employee-spouse's family.
- If the sole proprietor offers accident and health coverage through a self-insured medical expense reimbursement plan, deductible expenses include reimbursed medical expenses for health insurance premiums and other costs not reimbursed by insurance. A medical reimbursement plan converts expenses that would otherwise be Schedule A itemized deductions subject to the 10% AGI limitation into deductible business expenses.

Other fringe benefits. If the spouse is hired as a bona fide employee of the sole proprietor, other fringe benefits deductible by the business and excluded from the employee-spouse's income could be provided.

These include:

- Qualified retirement plan contributions,
- Group term life insurance,
- Transportation benefits, and
- Travel expenses attributable to the spouse if he or she accompanies the sole proprietor on a business trip as an employee for a valid business reason.

Not subject to FUTA. If the spouse is hired as a bona fide employee of the sole proprietor, taxable wages paid to the employee-spouse are not subject to federal unemployment taxes (FUTA).

Retain family income. If the spouse is hired as a bona fide employee of the sole proprietor, money used to pay the wages of the employee-spouse remain within the

family of the sole proprietor, in contrast to wages paid to a non-family employee to perform the same job.

Examples

Example #1: Jeff is an independent insurance agent doing business as a sole proprietor. He has one employee named Jill who does bookkeeping and general office work. Jeff pays Jill $30,000 per year. After deducting her wages, payroll taxes, and other business expenses, Jeff's net self-employment income equals $75,000. Jeff has a wife named Shawn. She earns $30,000 per year as an employee doing office work for another company. Shawn's employer does not offer any health care benefits. Jeff purchases health insurance for his family, but does not offer any benefits to his employee. The cost of his family health insurance is $8,400 per year. Assume Jeff and Shawn have no children and have $20,000 in itemized deductions. They also pay $2,000 per year out-of-pocket in medical expenses not reimbursed by insurance, such as co-pays, dental, and vision care. Since these expenses do not exceed the 10% AGI limitation for medical expenses on Schedule A, they are not deductible. For 2015, their tax return is calculated as follows:

Jeff's Schedule C net profit	$75,000
Shawn's W-2 wages	30,000
Minus one-half SE tax deduction	(5,299)
Minus self-employed health insurance deduction	(8,400)
AGI	$91,301
Minus itemized deductions	(20,000)
Minus personal exemptions	(7,900)
Taxable income	$63,301
Federal income tax	8,576
SE tax (15.3%)	10,597
Shawn's share of FICA (7.65%)	2,295
Total 2015 federal tax liability	$21,468

After taxes and the cost of health care, funds available equal $73,132 ($75,000 + $30,000 – $21,468 – $8,400 – $2,000).

Example #2: Assume same facts as Example #1, except that instead of hiring a non-relative (Jill) to work as an employee, Jeff hires his wife, Shawn, to work as his only employee (Shawn works for Jeff instead of the other company). Assume Jeff saves $500 in FUTA taxes, state unemployment taxes, and workers compensation insurance for hiring his spouse to work for him rather than a non-relative. Jeff offers an employer-provided health reimbursement plan for his employees and their spouses, which reimburses the cost of health insurance and up to $2,000 of other medical expenses not covered by insurance. As the spouse of his employee, the $10,400 ($8,400 + $2,000) cost of health care for Shawn and her husband (Jeff) is deductible by Jeff on Schedule C and excluded from Shawn's W-2 wages. For 2015, their tax return is calculated as follows:

Jeff's Schedule C net profit ($75,000 + $500 – $10,400)	$65,100
Shawn's W-2 wages	30,000
Minus one-half SE tax deduction	(4,599)
AGI	$90,501
Minus itemized deductions	(20,000)
Minus personal exemptions	(8,000)
Taxable income	$62,501
Federal income tax	8,456
SE Tax (15.3%)	9,198
Shawn's share of FICA (7.65%)	2,295
Total 2015 federal tax liability	$19,949

After taxes and the cost of health care, funds available equal $75,151 ($65,100 + $30,000 – $19,949). Thus, Jeff saves $2,019 ($75,151 – $73,132) by hiring his wife to work for him rather than a non-relative.

Possible Risks

- The IRS is very aggressive in trying to claim the employee-spouse is not a bona fide employee of the business. The payments made under the accident and health plan must be on account of the employer-employee relationship and not on account of the family relationship. There are many facts and circumstances that could go against the taxpayer if the employer-employee relationship is not firmly established.
- The accident and health policy generally must be purchased in the name of the employee-spouse to exclude the benefit from gross income. Deductions for policies issued in the name of the sole proprietor could be disallowed.
- Medical reimbursement plans that discriminate in favor of highly-compensated employees are taxable to those employees. If the business employs individuals other than the employee-spouse, and those other employees need to be covered by the medical reimbursement plan due to the nondiscrimination rule, the cost to the employer can be prohibitive.
- The compensation paid to the employee-spouse needs to be reasonable for the services performed. Compensation includes wages paid and the medical reimbursement plan. There is no fixed standard for determining reasonable compensation. It is determined on the facts and circumstances of each case.
- If the spouse is actually an independent contractor of the business rather than a bona fide employee, the cost of accident and health insurance benefits that are provided to the spouse are not excluded from the spouse's gross income.
- The IRS could claim the spouse is actually a co-owner of the business rather than an employee. Factors that indicate co-ownership include joint ownership of business assets, joint sharing of profits, and joint control over business operations.

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- Non-tax issues could be a problem. Spouses don't always get along working together in a business relationship, particularly if one spouse is the boss of the other.

Court Cases

Court Case: The IRS contended a husband was not a bona fide employee of his wife's day care business. The court ruled in favor of the taxpayer. He had a contract to work for the day care, his wife had the right to control his activities, she set the amount of compensation he received, and she had a right to terminate his employment. The taxpayer also submitted written records of his work schedule, and that the work performed was integral to the day care's operation. Payments were made on account of the employer-employee relationship, not on account of the family relationship. *(Speltz,* T.C. Summary Opinion, 2006-25)

Court Case: Although the taxpayer and his spouse had a bona fide employment agreement, a deduction on Schedule F for health insurance premiums and medical expenses was not allowed under the provision for employee-spouse health insurance. The taxpayer failed to prove that the expenses for health coverage were incurred and paid by his spouse. The employer-spouse was the primary insured under the policy, and it was established that he incurred and paid the expenses in question, not his employee-spouse. The court determined that the amounts were not paid under an employee benefit program. *(Albers,* T.C. Memo 2007-144)

Court Case: The court ruled a farming taxpayer, whose wife was a bona fide employee, could reimburse her for medical expenses through a medical reimbursement plan set up for his employees, even though one of the reimbursements made was for a joint health insurance plan in the taxpayer's name. The IRS contended the wife could only be reimbursed for medical costs and insurance in her name. The Tax Court concluded that since the employee-wife had paid nearly all the premiums from an account in her name, the deductions were allowable. *(Frahm,* T.C. Memo 2007-351)

Court Case: The taxpayer hired his wife as an employee of his farm business. He paid her fringe benefits which included $15,000 to $20,000 of medical reimbursements that included medical expenses for his employee-spouse, their two children, and the taxpayer himself. This allowed the taxpayer to deduct his entire family's medical expenses on Schedule F. The IRS disqualified the entire amount received by the wife because the actual money originated from her and the taxpayer's joint checking account. The IRS claimed the amount paid to the wife wasn't compensation, it was just money going from one pocket into another pocket.

The Tax Court agreed with the IRS. If the wife didn't receive any compensation, that means there was no bona fide employment relationship between the taxpayer and his wife because the relationship lacked economic substance. In essence, the Tax Court found that the purported employment agreement was a mere formality.

The Court of Appeals rejected the Tax Court's argument that the taxpayer must look where the money comes from when determining if a bona fide employee arrangement exists. The Court of Appeals also dismissed the Tax Court's argument that funds for medical reimbursement must be paid from a separate account. The court said: "A separate account requirement would simply invite another structural layer: here, a separate account for the business of the farm, from which funds would simply be transferred to the general joint account and/or to [the employee-spouse's] separate account (plus, the business account would probably be in joint tenancy anyway because the business relied on (her) to do the bookkeeping)."

"The argument that [the employee-spouse] received no economic benefit because her financial position with a separate account was the same as without it ignores the reality of spousal employment. Combined gross income would obviously not change. Employment of a spouse in a small business is done to avoid decreasing the couple's income, which would result from paying an unrelated hired hand. And, to narrow these kinds of cases to situations where the employed spouse is setting up a completely separate asset portfolio with her separate account does not find a supporting requirement in the reported cases." *(Shellito,* T.C. Memo 2010-41, March 3, 2010, and *Shellito,* 10th Cir., August 24, 2011)

Hire Child to Work in a Family Business

Cross References

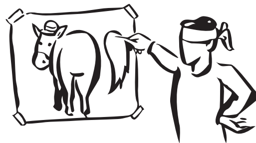
- Form 8615, *Tax for Certain Children Who Have Unearned Income*
- Form 8863, *Education Credits*

Tax Issue

The combined income tax plus self-employment tax of a sole proprietor can be more than 50% of the net profit from a family-owned business. Even if the business incorporates, the combined income tax and payroll tax on wages paid to the shareholder-employee can be more than 50%. If the business owner gifts money to a child, the child's earnings on the gifted money could be subject to tax at the parents' top tax rate under the Kiddie Tax rules.

Applicable Tax Law

- The top federal income tax bracket for a taxpayer in 2015 is 39.6%.
- Self-employed taxpayers pay self-employment tax at a rate of 15.3% of net self-employment income.
- Shareholder-employees and their corporations effectively pay FICA tax on wages earned at the same rate as a self-employed taxpayer pays in self-employment tax on earnings.
- A child under age 18 with unearned income in excess of $2,100 in 2015 pays tax at the parents' marginal rate if that rate is higher than the child's. This rule can apply to a child age 18 if the child does not provide more than half of his or her support with earned income. This rule can also apply to a child age 19 to 23 if the child is a student and does not provide more than half of his or her support with earned income.
- If a child under age 18 is employed by a parent's unincorporated business, the child's wages are exempt from FICA and FUTA.
- If a child under age 21 is employed by a parent's unincorporated business, the child's wages are exempt from FUTA.
- Wages paid to a child by a parent-owned business are deductible if the wages are paid for work done in connection with the parent's trade or business, the child actually performs the work in exchange for wages, and the wages are actually paid to the child.
- A dependent child's standard deduction can eliminate up to $6,300 of earned income for 2015.
- A dependent child can make a deductible IRA contribution of up to $5,500 in 2015 if the child has at least that much in earned income for the year.
- The 10% early withdrawal penalty does not apply to IRA withdrawals if used to pay qualified education expenses of the taxpayer, spouse, or any child or grandchild of the taxpayer or spouse.
- If a parent elects not to claim a child as a dependent, the child can then claim an education credit.



Tax Planning Strategies

A parent who owns a family business can hire his or her child to work for the business and shift income from the parent over to the child at a lower tax rate. If the child makes deductible IRA contributions with wages earned, the parent and child can convert contributions to a college savings plan into a current tax deduction. Future withdrawals from the IRA used for college avoid the 10% early withdrawal penalty and are generally subject to the child's lower tax rate. Tax on the IRA withdrawals may also be offset by an education tax credit or deduction.

Examples

Example #1: Dave is self-employed and is trying to save for his daughter's college education. His wife is an employee and an active participant in an employer-sponsored retirement plan. Their combined income is too high for Dave to make a deductible IRA contribution. Their income will also be too high to claim an education credit when it is time to pay for his daughter's college tuition.

Example #2: Assume the same facts as Example #1. Dave owns a lawn care service and employs his 16-year-old daughter, Stephanie, to help. She operates lawn mowing equipment and provides other legitimate services as an employee. During her summer vacation in 2015, she earned $11,800 helping her dad in his business. Assume Dave is in a combined 30% federal and state income tax bracket. The $11,800 in wages reduces his income tax liability by $3,540 and his SE tax by $1,667, for a tax savings of $5,207. Stephanie's wages are not subject to FICA or FUTA. If Stephanie contributes $5,500 to an IRA, she pays zero income tax.

Stephanie's wages	$11,800
IRA contribution	(5,500)
Standard deduction	(6,300)
Taxable income	$ 0

Example #3: Assume the same facts as Example #2, only now it is the year 2018. Stephanie has worked the past three summers for her dad and contributed a total of $16,500 to her IRA. Her IRA balance with accumulated earnings equals $18,000. She withdraws the $18,000 and uses the funds to pay for college tuition. Assume the personal exemption phase-out rules apply for 2018, and that Dave and his wife's combined income in 2018 exceeds the personal exemption phaseout so they get zero tax benefit for claiming Stephanie as a dependent. Assume they elect not to claim Stephanie as a dependent for purposes of the education credits. Also assume the standard deduction and tax rates for 2018 are the same as for 2015. Also assume Stephanie has no other taxable income for 2018. Her tax is calculated as follows:

IRA distribution	$18,000
Standard deduction	(1,050)
Taxable income	$16,950
Tax before credits	2,085
Education credits (not entitled to refundable education credit as a dependent)	(2,085)
Tax	$ 0

Example #4: Assume the same facts as Example #3, except Dave and his wife's combined income in 2018 is low enough to claim the American Opportunity Credit. Dave claims Stephanie as a dependent. Dave can claim a $2,500 education credit based on the money Stephanie spent on tuition. This credit offsets Stephanie's $2,085 tax on her IRA withdrawal.

Conclusion: This tax planning strategy helps Dave avoid tax on profits that he planned to use to help pay for Stephanie's college. Instead of taking after-tax money and saving it for her education, he is able to help pay for college with pre-tax dollars.

Possible Risks

- Wages paid to a child must be reasonable in relation to the services actually rendered. The IRS could claim the wages are too high and reclassify them as gifts. This risk is greater the younger the child is at the time of employment. For example, giving a 6-year-old child a salary of $20,000 a year to sweep the floors might be considered by the IRS to be an unreasonable wage.
- In Example #3, page 7-5, Stephanie might decide not to go to college and use her IRA savings to buy a new car once she turns 18 and moves out on her own. The tax planning strategy requires the wages to actually be paid to the child and under the child's control.

To claim wages are reasonable:

- The business owner should keep detailed records regarding the nature of the child's employment and the services they perform for the business.
- Records must also prove that wages were actually paid to the child by issuing the child a check. The child can then endorse the check back to the parent to get cash if necessary. Do not simply set aside money in a parent-controlled account for the purpose of paying expenses of the child.
- It may help to have the child fill out a timesheet or punch a time clock.
- The parent-employer must also comply with all child labor laws under the Fair Labor Standards Act.
- Issue the child a W-2 at the end of the year, even if the child is below the filing requirements.
- Quarterly payroll tax returns must also be filed even if there is no payroll tax due.

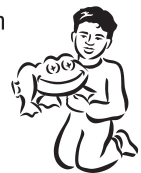
Court Cases

Court Case: The taxpayers employed their minor daughters in a dog breeding business. The daughters were each paid a fixed amount, representing what the taxpayers stated they could afford to pay them, not based on hours worked or a wage rate. The girls were not paid, but amounts were credited for them to draw against for personal expenses. They performed duties like cleaning, taking out the garbage, and lawn mowing. The court agreed with the IRS and ruled against the taxpayers stating the children were not bona fide employees. The court cited the lack of Forms W-2, payments unrelated to dates and hours actually worked, failure to maintain adequate records of employment, and compensation for services in the nature of family chores, as reasons for the ruling. *(Alexander,* T.C. Summary 2006-127)

Court Case: The taxpayers claimed deductions for wages paid to their children. The IRS disallowed some of the payments to the children as unreasonable compensation for services actually rendered and the court agreed. In order for compensation to be deductible, it must be reasonable in amount, it must be for services actually rendered, and it must be paid or incurred. The court noted that the taxpayers did not keep any records or books reflecting hours worked, jobs performed, or compensation paid. The only evidence of the compensation paid to the children was the uncorroborated testimony of the taxpayers. They offered no documentary evidence to support the claimed deductions for compensation. *(Martens,* 4th Cir., July 11, 1991)

Court Case: The taxpayers claimed deductions for wages paid to their three minor children. One child was age 12, the next was age 11, and the youngest was age seven. Each of the children performed a variety of services for the parent-owned business on a continuing basis after school, on weekends, and during their summer vacation, devoting considerable time and expending considerable effort. The services performed were necessary for the operation of the businesses and could not have been performed by the existing staff. Thus, had these services not been performed by the children, other employees would have had to have been hired. The IRS disallowed approximately 90% of the compensation paid to the children claiming it was unreasonable and excessive. The court noted that compensation is deductible only if it is reasonable in amount, based on services actually rendered, and paid or incurred. In ruling against the IRS, the court allowed most of the taxpayers claimed deduction. The court made a minor adjustment to wages paid based on the age differential between the three children. The court said an 11- and 12-year-old can generally handle greater responsibility and perform greater services than a 7-year-old child. *(Eller,* 77 T.C. No. 66)

✎ **Author's Comment:** Although the tax court in the *Eller* case made an adjustment for wages paid, the case illustrates that wages paid to a child as young as age seven can pass the reasonable compensation test.



Real Estate Transfer to Family Limited Partnership

Cross References

- IRC §2032A, *Valuation of certain farm, etc., real property*
- IRC §2036, *Transfers with retained life estate*
- Reg. §25.2512-1

Tax Issue

The value of real estate is included in the gross estate of a decedent at death. If a taxpayer has an estate that exceeds the estate tax exclusion ($5,430,000 for 2015), and the gross

estate includes real estate, a taxpayer could do some estate tax planning to minimize the future estate tax imposed on the value of the real estate.

Applicable Tax Law

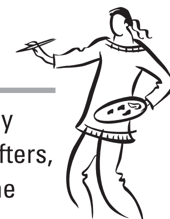
- The value of property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. (Reg. §25.2512-1)
- A gift of a partial interest in real estate generally qualifies for a valuation discount because the donee lacks the ability to market the interest. Likewise, a gift of a minority interest in real estate generally qualifies for a valuation discount because the donee lacks the ability to control the interest.
- The constructive ownership rules (ownership by members of the same family) are disregarded for purposes of determining the value of a minority interest discount. Consequently, a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest. (Rev. Rul. 93-12)
- The full value of property transferred (except for a bona fide sale for adequate and full consideration) is included in the gross estate if the decedent retained a significant interest in, or control over, the property transferred prior to the date of death (IRC §2036). In the context of a family limited partnership, the bona fide sale for adequate and full consideration exception is met where there is a legitimate and significant nontax reason for creating the family limited partnership, and the transferors received partnership interests proportionate to the value of the property transferred. The objective evidence must indicate that the nontax reason was a significant factor that motivated the partnership's creation. If there is no discernible purpose or benefit for the transfer other than estate tax savings, the sale is not bona fide within the meaning of IRC section 2036. (*Schutt,* T.C. Memo 2005-126)
- If the transferee partnership does not operate a legitimate business, and the valuation discount is the sole benefit for converting liquid marketable assets into illiquid partnership interests, there is no transfer for adequate and full consideration within the meaning of IRC section 2036. (*Schutt,* T.C. Memo 2005-126)
- The value of real estate used for farming or other trade or business activities is based on its use rather than its potential use (IRC §2032A). In order for this rule to apply, the real estate must have been owned by the decedent or a member of the decedent's family and used for farming or used in a trade or business. The decedent, or a member of the decedent's family, must have materially participated in the farming operation or trade or business. IRC section 2032A generally does not apply to real estate held for investment purposes.

Example: The value of land used by the owner for farming at the time of the owner's death is the value of the land used for farming rather than the potential higher value it has if sold and used for a housing development.

Tax Planning Strategies

By transferring real estate to a family limited partnership (FLP) prior to death, estate tax may be reduced on the value of the real estate at death. The taxpayer transfers the real estate to the FLP in exchange for general and limited partnership interests. Then the taxpayer can make gifts of the FLPs limited partnership interests to family members. These transfers would qualify for valuation discounts because they lack marketability (partial interests in real estate). Valuation discounts also apply due to lack of control, since the family members (the limited partners) have no control over any acquisition or disposition of property or distribution of income. The ultimate goal of the planning strategy is to reduce the value of the real estate that is subject to estate tax.

Examples

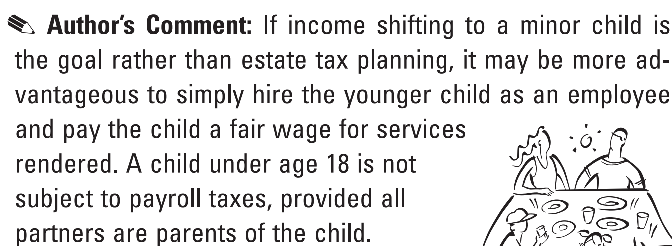


Example: Greg and Deb own property that they rent on a short-term basis as a retreat for crafters, artists, and other people interested in using the property as a vacation home. They have three adult children that are listed in their will as beneficiaries. Greg and Deb's combined gross estate exceeds their combined estate tax exclusion. The real estate used as a short-term rental activity is valued at $2 million. Greg and Deb desire to ensure that their family continues to operate the business after their deaths. They transfer the real estate to an FLP in exchange for general and limited partnership interests. Greg and Deb initially own general partner interests of 5% each and limited partner interests of 45% each. The limited partner interests are then transferred to their children over several years. Greg and Deb remain in control of the property as general partners. Although the gifts of the limited partner interests are included in the gross estate of Greg and Deb at their deaths, the $1.8 million value of the limited partnership interests [$2 million times (45% + 45%)] qualifies for substantial valuation discounts due to lack of marketability and lack of control.

Possible Risks

- The IRS can disallow the valuation discount if the decedent retains a significant interest in, or control over, the property transferred prior to the date of death, and there is no legitimate and significant nontax reason for creating the FLP. These are subjective concepts and open to interpretation. Transferring assets to an FLP to

operate a legitimate business is generally considered to be a significant nontax reason for creating the FLP. If the activity is not really a legitimate business, the IRS could claim that estate tax savings were the only reason for creating the FLP and thus disallow the valuation discount.
- There are many court cases involving valuation discounts on transferring securities to FLPs where the IRS claimed the transfers did not have significant nontax reasons for creating the FLPs.
- The IRS can disregard family members as holding partnership interests in cases where family partnerships are used for abusive income-shifting purposes. A family member will be recognized as a partner only if one of the following requirements is met.
  1) If capital is a material income-producing factor (such as a rental real estate activity), the family member must have acquired the capital interest in a bona fide transaction, which can include a gift or purchase from another family member. The family member must own and control the partnership interest. ***Note:*** Control for this rule means control over the partnership interest, as opposed to control over the partnership. A limited partner can own and control his or her limited partnership interest, even though he or she is not in control of the partnership by virtue of being a limited partner.
  2) If capital is not a material income-producing factor (such as a service business), and the partnership joined together in good faith to conduct a business, the partners must have agreed that contributions of each entitle the partners to a share in the profits, and some capital or service has been provided by each partner.



✎ **Author's Comment:** If income shifting to a minor child is the goal rather than estate tax planning, it may be more advantageous to simply hire the younger child as an employee and pay the child a fair wage for services rendered. A child under age 18 is not subject to payroll taxes, provided all partners are parents of the child.

Court Cases

Court Case: The court ruled that the full value of property owned by the decedent transferred to a family limited partnership shortly before her death was includable in her gross estate. After a diagnosis of Alzheimer's disease, the children were advised that a family limited partnership would have estate tax advantages due to valuation discounts that may apply to the partnership interest. The partnership agreement provided that the decedent contribute securities, plus a Florida condominium she owned, in exchange for an interest in the partnership.

The court said that if a decedent transfers property prior to death (other than a bona fide sale for adequate and full consideration) and retains certain specific rights or interests in the property that are not relinquished until death, the full value of the transferred property must be included in the decedent's gross estate at death. All three of the following requirements must be met for the property to be included in a decedent's gross estate under this rule.
- The property must have been transferred prior to death,
- The decedent retained an interest or a right in the transferred property that was not relinquished until death, and
- The transfer must not have been a bona fide sale for adequate and full consideration.

A decedent retains an interest or a right in the transferred property when he or she retains a substantial present economic benefit, not speculative and contingent benefit. In the case of a family limited partnership, factors used to determine whether a decedent retained an interest or right in the transferred property include commingling of funds, a history of disproportionate distributions, testamentary characteristics of the arrangement, the extent to which the decedent transferred nearly all of his or her assets, the unilateral formation of the partnership, the type of assets transferred, and the personal situation of the decedent. An assurance that the transferred assets will be available to pay debts and expenses of the estate after death means the decedent retains an interest or a right in the transferred property. The court noted that in this case, the estate was financially dependent on the partnership and needed approximately $200,000 from it to help pay estate liabilities, thus indicating the decedent retained an interest or a right in the transferred property.

Under the bona fide sale exception, transfers a decedent makes before death are not included in the decedent's gross estate if the family limited partnership is formed for a legitimate and significant nontax reason and each transferor receives a partnership interest proportionate to the fair market value of the property transferred. Facilitating a gift-giving plan is not a significant nontax purpose. In this case, the partnership was mainly a collection of passive assets, primarily marketable securities and rental properties that remained in the same state as when they were contributed. The same investment advisers and property managers managed the assets both before and after the transfers to the partnership. There was also a delay in contributing assets to the partnership. It was only after the decedent had been admitted to the hospital with pneumonia, two days before her death, that the partners finally completed their transfers.

The decedent's age and health at the time of the transaction strongly indicates that the transfers were made to avoid estate taxes. No valuation discounts were allowed. *(Erickson,* T.C. Memo 2007-107)

Court Case: The court ruled that securities transferred to a family limited partnership one year before the decedent's death qualified for a valuation discount, while securities transferred only a few weeks before death did not qualify for a valuation discount. After the final transfer, the decedent did not retain sufficient assets to satisfy her estate tax liabilities. Funds distributed by the family limited partnership were used to pay the decedent's estate tax liability, showing that at the time of the final transfer, the decedent retained the economic benefit of the securities transferred. Since the decedent retained a significant interest in, or control over, the property transferred prior to the date of death, there would have to be a legitimate and significant nontax reason for making the transfer to the family limited partnership. The court ruled that the decline in the decedent's health and the decision to reduce her taxable estate were clearly the driving forces behind the decision to make additional contributions to the family limited partnership. Without a nontax reason for making the transfer, no valuation discount was allowed. *(Miller,* T.C. Memo 2009-119)

Court Case: The court ruled that a family limited partnership had a significant nontax purpose of facilitating the decedent's buy and hold investment strategy because it helped reduce the decedent's worry that his heirs would sell his investments after his death. The IRS claimed it was not necessary to transfer stock from a revocable trust into the family limited partnership to perpetuate the decedent's investment philosophy and that the main reason for doing so was to obtain valuation discounts for gift and estate tax purposes.

The court disagreed with the IRS. The family limited partnership was formed primarily to put into place an entity to perpetuate the decedent's buy and hold investment philosophy with respect to his stock. His revocable trusts were scheduled to terminate at various intervals (such as at his death) and thus the trust assets would be distributed to the beneficiaries. The court agreed with the estate's position that a significant motive for the decedent's creation of the family limited partnership was to perpetuate his buy and hold investment philosophy, which could not be accomplished after death by his revocable trusts. *(Schutt,* T.C. Memo 2005-126)

Court Case: Although reducing estate tax through valuation discounts was a motivating factor in establishing a family limited partnership, the court ruled the decedent had valid and significant nontax reasons for establishing the partnership. The partnership was formed while the decedent was still in good health. An attorney had advised the decedent that limited partnerships were a good way to protect family assets from the risks imposed by the state of Mississippi's litigious atmosphere. The establishment of a family limited partnership is a customary response in Mississippi to possible lawsuits. Courts have ruled that preservation of the family business is a legitimate reason for establishing a family limited partnership. The court also recognized that the establishment of the family limited partnership helped to facilitate the management of timberland owned by the decedent. Courts have ruled that management efficiency is a legitimate and significant nontax reason for establishing a family limited partnership in cases where the real estate property required active management. The court also said that there were business activities that occurred with respect to the timberland. The partnership annually amortized timber expenses, and in one year it realized gain from the sale of timber cut from its land. Thus, valuation discounts on the transfer of the decedent's assets to the family limited partnership were allowed in calculating the decedent's gross estate. *(Shurtz,* T.C. Memo 2010-21)

Court Case: The estate of a decedent listed four legitimate and significant nontax purposes for the creation of the family limited partnership.

- To protect the decedent's assets during her lifetime, and, ultimately, to provide limited liability protection to the donees of the limited partnership interests,
- To create giftable assets that preserve value and cannot be easily liquidated in the short-term,
- To facilitate decedent's annual gifting program to her family, and
- To provide for the common management of the limited partnership assets during the decedent's lifetime and after her death.

The court ruled that the evidence did not support the above reasons for forming the family limited partnership. The reason for forming the family limited partnership must be an actual motivation, not a theoretical justification. The estate conceded on brief that the family limited partnership was formed to reduce the value of the decedent's gross estate for federal estate tax purposes and to avoid paying federal estate tax on the amount of the discount. The nontax reasons were discussed during the formation of the partnership as theoretical justifications that could be used in the event the IRS challenged the bona fide sale rule under IRC section 2036(a)(1).

Without a bona fide sale exception, the court needed to decide whether the decedent retained possession or enjoyment of property transferred to the family limited partnership, or the right to the income from the transferred property. The decedent transferred her assets to the family limited partnership when she was 88-years-old and in poor health. The estate argued that the distributions from the family limited partnership to the decedent were actually loans that did not constitute enjoyment of the underlying funds. The court disagreed. The decedent's children as general partners of the family limited partnership never intended to seek repayment of the loans during the decedent's lifetime. Thus, no discount on the value of property transferred to the family limited partnership was allowed in determining the decedent's gross estate. *(Rosen,* T.C. Memo 2006-115)

Court Case: Real property consisting of ice and roller skating rinks, and a lumber yard were transferred to a family limited partnership. Under IRC section 2036, the bona fide sale for adequate and full consideration exception is met where there is a legitimate and significant nontax reason for creating the family limited partnership. Courts have ruled that operating a legitimate business can be a significant nontax reason for creating a family limited partnership.

However, in this case, there was no discussion as to whether there was a nontax reason for creating the family limited partnership. Without this nontax reason, the court only needed to decide whether the decedent retained a significant interest in, or control over, the property transferred prior to death. The court said an asset transferred prior to death cannot be excluded from the decedent's gross estate unless he absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. Any retention of a property's income stream after transfer is clear evidence that the decedent retained possession or enjoyment of the property.

In this case, the decedent continued to enjoy the right to support and maintenance from all income that the family limited partnership generated. Only after the decedent's support needs were met did the children of the decedent receive their proportionate share of partnership income. Thus, the court ruled no valuation discounts were allowed on the transfer of the decedent's real property to the family limited partnership. *(Abraham,* T.C. Memo 2004-39)

Home Office Tax Benefits

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- Schedule SE (Form 1040), *Self-Employment Tax*
- Form 8829, *Expenses for Business use of Your Home*

Tax Issue

Many small business owners have an office in the home. Under the general rule for business use of a home, no business deduction is allowed with respect to the use of a home that is used as a residence by the taxpayer. This is true even if the residence is used in the taxpayer's trade or business. The general rule contains certain exceptions for business use and limitations on those deductions. One disadvantage to a home office is the specific requirements that must be met in order to claim a deduction for the business use of the home.

Applicable Tax Law

- To take a business deduction for a home office, a taxpayer must use part of his or her home under one of the following situations.
  - An area in the home is exclusively and regularly used as the principal place of business.
  - An area in the home is exclusively and regularly used as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.
  - In the case of a separate structure which is not attached to the home, the structure is used in connection with a trade or business.
  - An area in the home is used on a regular basis for storage of inventory or product samples.
  - The home is used for a rental activity.
  - The home is used as a day care facility.
- The exclusive use test is met if an area of the home is used only for business. The area can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition. This test is not met if the taxpayer uses the area for both business and for personal purposes. The exclusive use test does not need to be met for an area used for storage of inventory or samples or a home used as a day care facility.
- The regular use test means a taxpayer must use a specific area of the home for business on a regular basis. Incidental or occasional business use is not regular use.
- To satisfy the trade or business use test, the portion of the home used for business must be used in connection with a trade or business. If the business use is for a profit-seeking activity that is not a trade or business, the deduction is not allowed.
- If the trade or business has more than one location, to qualify for a business use of home deduction, the home must be the principal place of business for that trade or business. To make this determination, the following are considered.

  - The relative importance of the activities performed at each place business is conducted, and
  - The amount of time spent at each place business is conducted.
- Deductible home office expenses include real estate taxes, mortgage interest, homeowner's insurance, rent, repairs and maintenance, security system, utilities, casualty losses, qualified mortgage insurance premiums, and depreciation.
- Direct expenses include expenses that only benefit the area exclusively used for business and are fully deductible.
- Indirect expenses include expenses for keeping up and running the entire home, such as insurance, utilities, and general repairs. Indirect expenses are deductible based on the percentage of the home used for business.
- Unrelated expenses include expenses for the part of the home not used for business, such as lawn care or painting a room not used for business. Unrelated expenses are not deductible.

- Taxpayers may use a simplified option when figuring the deduction for business use of the home.
  - Standard deduction of $5 per square foot of home used in business (maximum of 300 square feet).
  - Allowable home-related itemized deductions are claimed in full on Schedule A, *Itemized Deductions.* (For example, mortgage interest and real estate taxes)
  - No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.
- The percentage of the home used for business equals the area of the part of the home used for business divided by the area of the whole house. Any reasonable method may be used to determine business percentage.

Tax Planning Strategies

Running a business out of a qualified home office can turn nondeductible housing expenses into legitimate business deductions. If a home office qualifies as the principal place of business, a portion of otherwise nondeductible expenses, including utilities, insurance, home repairs, and depreciation, can become deductible business expenses. A qualified home office can also turn nondeductible commuting expenses into deductible business mileage.

Examples

Example #1: Roya, a self-employed business consultant, lives in a two-bedroom apartment and uses one of the bedrooms as a home office. Roya's home office is her principal place of business. The total area of Roya's apartment is 1,200 square feet, and the bedroom used as a home office is 120 square feet. The business percentage of Roya's apartment is 10% (120 ÷ 1,200). Net income on Roya's 2015 Schedule C before the deduction for home office expenses is $50,000. Assume Roya's marginal tax rate is 25%. Roya's tax savings from the home office deduction is calculated as follows.

Rent ($900 × 12 months)	$10,800
Utilities ($100 × 12 months)	1,200
Insurance	500
Total	$12,500
Business percentage	10%
Home office deduction	$ 1,250

Roya's tax savings from the home office deduction is calculated as follows.

Home office deduction on Schedule C	$1,250
One-half SE tax deduction [($1,250 × 0.9235 x 0.153) ÷ 2	(88)
Net home office deduction	$1,162
Marginal tax rate	25%
Income tax savings	$291
SE tax savings ($1,250 × 0.9235 × 0.153)	177
Total tax savings	$468

The home office deduction takes personal expenses that are ordinarily nondeductible and turns them into deductible business expenses. Also, since Roya is a renter, there is no depreciation deduction subject to potential recapture upon the sale of the residence.

Example #2: Assume the same facts as Example #1, except Roya owns a home instead of renting an apartment. The business percentage of the home office is the same as the apartment she rented. Roya incurs the following expenses for her home.

Mortgage interest	$ 9,000
Real estate taxes	2,000
Utilities	1,200
Insurance	500
Depreciation	3,846
Total	$16,546
Business percentage	10%
Home office deduction	$ 1,655

Roya's tax savings from the home office deduction is calculated as follows.

Home office deduction on Schedule C	$1,655
One-half SE tax deduction [($1,655 × 0.9235 × 0.153) ÷ 2]	(117)
Net deduction for home office expenses on Schedule C	$1,538
Business portion of mortgage interest and real estate taxes that would have been deductible on Schedule A [($9,000 + 2,000) × 10%]	(1,100)
Net additional home office expenses	$ 438
Marginal tax rate	25%
Income tax savings	$ 110
SE tax savings ($1,655 × 0.9235 × 0.153)	234
Total tax savings	$ 344

Since the mortgage interest and real estate taxes were already deductible on Schedule A, most of the tax savings come from the reduced SE tax. Also, if Roya sells her home at a gain, the home office depreciation that was deducted is subject to recapture.

Example #3: Assume the same facts as Example #2, except Roya decides to use the simplified method of deducting expenses for business use of the home.

Home office deduction (120 square feet × $5)	$600
One-half of SE deduction [($600 × 0.9235 × 0.153) ÷ 2]	(42)
Net deduction for home office expenses on Schedule C	$558
Marginal tax rate	25%
Income tax savings	$140
SE tax savings ($600 × 0.9235 × 0.153)	$85
Total tax savings	$225

✎ **Author's Comment**: With the simplified method, Roya must still meet the tests for exclusive use and regular use of the office space. However, she will not need to be concerned with any depreciation recapture upon the sale of the home or if the office no longer qualifies for the deduction. The tax savings of $125 ($344 minus $219) by using the regular method might not be worth the additional time and paperwork needed to substantiate the deduction.

Example #4: Jennifer's principal place of business is in her home. She can deduct the cost of round-trip transportation between her qualifying home office and her client's or customer's place of business.

Example #5: Jennifer does not have a regular office and she does not have an office in her home. In this case, the location of Jennifer's first business contact is considered her office. Transportation expenses between Jennifer's home and this first contact are nondeductible commuting expenses. Transportation expenses between Jennifer's last business contact and her home are also nondeductible commuting expenses. Although Jennifer cannot deduct the cost of these trips, she can deduct the costs of going from one client or customer to another.

Possible Risks

- Any personal use of the home office will disqualify the home office under the exclusive use test even if the personal use is occasional or occurs in the evening after business hours.
- When a taxpayer sells his or her primary residence, gain attributable to the office in the home portion of the residence is excludable under the rules for excluding the gain on the sale of a principal residence with the exception of the post May 6, 1997 depreciation.
- The business use of home deduction is limited to the net income from the business with the exception of the business percentage of real estate taxes, mortgage interest, and casualty losses which are deductible even if there is a loss. All other business use of home expenses are limited to the net income from the business, and deductions not allowed are carried over to the following year if the regular method is used.
- Claiming an office-in-home deduction increases the risk of being audited.

Court Cases

Court Case: A taxpayer performed two activities out of his home office, a teaching activity and a writing activity. Because the writing activity was ruled to be a hobby, the taxpayer did not use the home office exclusively for his teaching activity. A home office deduction for the teaching activity was not allowed. *(Clark,* T.C. Memo 1989-598)

Court Case: A taxpayer was an employee for a hospital. In addition, he owned six rental units held for the production of income. The IRS denied the office-in-home deduction for the rental activity as it was not a trade or business. The court allowed the deduction and noted the personal efforts of the taxpayer to manage six units in seeking new tenants, in supplying furnishings, and in cleaning and otherwise preparing the units for new tenants. These activities were sufficiently systematic and continuous to place the taxpayer in the business of real estate rental. *(Curphey,* 73 T.C. No. 766)

Court Case: The taxpayer was a self-employed handyman working for an individual who owned three businesses. The taxpayer used one room of his home as a home office. He did not see clients or customers at his home, nor did he solicit business from others except the three businesses he currently worked for. Between assignments, the taxpayer was reached at home for the next assignment; however, he also received assignments while he was at a work site.

The taxpayer asserted that his home was his principal place of business as he was required to perform services at three different locations. He also alleged that because he received orders and directions for his services at home, his home office was, therefore, the focal point of his activity.

The court determined that the taxpayer's home office was not his principal place of business. The court noted that the most important parts of the taxpayer's activities were performed away from his home office at the business locations of his clients. The taxpayer also did not establish that he conducted substantial administrative or managerial activities of his trade or business at home. The occasional phone calls were not evidence enough that the taxpayer's home was the site of management or administrative activity related to his business. The taxpayer was therefore not entitled to claim a deduction for home office expenses. *(White,* T.C. Summary 2003-18)

Court Case: The taxpayer was a sole proprietor and operated a business out of his home occupied by the taxpayer, his wife and daughter. The taxpayer claimed approximately 70% of his home was used exclusively and regularly for business while the IRS disagreed stating the business portion was only 43%. The court agreed with the IRS. During the taxpayer's testimony, he acknowledged occasional uses of some of the home office rooms for personal purposes and stated that because personal use was minimal compared with business use, a deduction should be allowed. The court noted that exclusive use is narrowly construed which means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The taxpayer was not entitled to a deduction for any of the rooms that had occasional personal use. *(Rayden,* T.C. Memo 2011-1)

Succession Planning

Cross References

- Form 8863, *Education Credits*
- IRC §355, *Distribution of stock and securities of a controlled corporation*
- IRC §409A, *Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans*

Tax Issue

What happens if a key person gets run over by a beer truck? Better known as succession planning, many family run businesses fail to survive into the next generation because they fail to plan for unexpected events or passing control to other family members. Most small businesses do not operate under formal corporate formalities. Conflicts between siblings can make passing control from the founding owner to his or her children difficult. Family issues can complicate decisions regarding ownership, management, and other responsibilities. These conflicts can cause distractions, which in turn can result in ignoring or sacrificing the tax implications of a certain course of action.

Succession planning can also help when the key person is not the owner. Key employees often contribute to the success of a small business. Without proper planning, the continued success of the business could be in jeopardy in the case of death, disability, or other sudden loss of the key employee. Proper planning can also help to avoid potential problems caused by the key employee should the owner decide to sell the business to a big corporation.

To be effective, a succession plan should be implemented before the loss of the key person.

Applicable Tax Law

- A business deduction for the cost of education is allowed if all the following requirements are met.
  - It is required to keep the taxpayer's present salary, status, or job.
  - The requirement serves a business purpose of the employer.
  - The education is not part of a program that will qualify the taxpayer for a new trade or business.

- The Lifetime Learning Credit is 20% of the first $10,000 of qualified education expenses paid for all eligible students. For tax years beginning in 2015, the credit is phased out when modified AGI is between $55,000 and $65,000 ($110,000 and $130,000 MFJ). There is no requirement that the education be job related. There is no prohibition on claiming the credit if the education qualifies the taxpayer for a new trade or business.
- An employer may provide employees with up to $5,250 of tax-free educational assistance through an educational assistance program if the program meets certain requirements. Qualifying education generally includes any form of instruction or training that improves or develops the employee's capabilities. The payments do not have to be for work-related courses or courses that are part of a degree program. See IRS Pub. 970, *Tax Benefits for Education,* for more details.
- A nonqualified deferred compensation plan is any plan or arrangement between an employer and an employee to pay the employee compensation at some future time. These plans are usually used to reward highly-compensated employees and key executives without having to meet nondiscrimination rules that apply to qualified plans. Compensation deferred under the plan is not included in gross income of the employee to the extent that funds in the plan are subject to substantial risk or forfeiture.
- Life insurance premiums are nondeductible. Death benefits of life insurance policies are generally tax free.
- A spin-off of a corporation to form a new corporation is tax free under IRC section 355 if all the following are true.
  1) Stock or securities of a controlled corporation are distributed to shareholders with respect to their stock in the distributing corporation or to security holders in exchange for the distributing corporation's securities,
  2) The distribution must not be used principally as a device for distributing earnings and profits,
  3) The active business requirement of IRC section 355(b) must be met, and
  4) All the controlled corporation's stock and securities held by the distributing corporation, or enough to constitute control of the controlled corporation, must be distributed.

Tax Planning Strategies

A succession plan for a family business might address the following issues.

Key person life insurance. The business could purchase life insurance on the life of a key person. If the key person dies, the potential loss of business due to the loss of the key person could be offset by tax-free insurance proceeds paid to the business as owner of the policy.

Sibling rivalry. A business owner wishing to pass the family business to the children should plan for the success of the business in the hands of the children. Are they able to work together or will sibling squabbles cause the business to be at risk of failure? The business owner might consider splitting the business in two and allowing each child to own and run separate businesses after his or her departure. If the rules of IRC section 355 are

followed, the split up of the corporation can be a tax-free event. The succession plan could be implemented in the owner's will or by trust so that the business split does not occur until the death of the owner.

Qualifications and experience. Identify the education and skills of the business owner. If a family member replaces the business owner as the new manager, consider what would happen if this new manager does not have the same level of knowledge or abilities as the employees that he or she is expected to manage. If the new manager needs additional education, the business should consider the tax consequences of educating the new manager.

Unless a qualified educational assistance plan is in place, education expenses that qualify the individual for a new trade or business are not deductible. An alternative is to have the new manager pay his or her own educational expenses and claim the Lifetime Learning Credit. In turn, the business could increase the manager's compensation to offset the cost of education.

Another plan could be to hire the children to work in the business prior to the business owner's death, disability, retirement, etc. If the children receive on-the-job training during the owner's involvement in the business, any necessary additional educational costs after the departure of the owner may qualify as deductible business expenses since the children are already working in that trade or business.

Outside managers. If the family members that inherit the business cannot get along with each other, consider hiring a manager or other key person outside the family to help ease the transition. The outside manager is more likely to maintain an objective viewpoint and implement tax strategies that benefit the business rather than individual conflicting family members.

Business secrets. Key persons usually have some secrets or important knowledge locked up inside their heads that only they know about. If the key person is gone, that information is also gone. A procedures manual should be written by the key person that includes all important information vital to the smooth operation of the business. If the key person is not an owner of the business, the business could use some type of nonqualified deferred compensation plan to encourage the key person to cooperate and write down their secrets.

Technology. The younger generation may be more inclined to use the latest in technology while the older generation may be stuck in the past. A business owner may want to address this issue in a succession plan. The two generations should agree on a business policy implementing new technology prior to the business owner's departure to help ease the strain on the business owner giving up control.

Buy/sell agreements. A succession plan should consider some kind of buy-sell agreement which provides funding through life insurance for transferring ownership of the business. See *Business Financial Planning Chart,* page 8-2.

Estate planning. The estate tax could kill the business if there are not enough liquid funds available to pay the estate tax after the owner's death. See *Estates and Trusts,* Tab 12, for more details.

Sale of business. If no family members are able or willing to take over the business, the heirs may be forced to sell the business. Without a succession plan, the value of the business could decrease dramatically upon the death of the business owner. Key employees might step in and take advantage of the void caused by a lack of succession planning. Noncompete agreements with key employees should be written so that the agreement survives the death of the business owner. The noncompete agreement could be tied into a nonqualified deferred compensation plan for the key employee.

The succession plan could have the heirs sell the business to a key employee by converting the deferred compensation account into a down payment, with the rest of the sale price financed by the heirs. If the key employee does not wish to purchase the business, the payout of the deferred compensation account to the key employee could be contingent on the key employee cooperating with the sale of the business to a new owner.

Examples

Example: Keith owns a business that produces world class cymbals for drummers. The metallic formula for making the cymbals is a guarded secret and is an intangible asset of the business. The name of the cymbal has a history and reputation that also is an intangible asset of the business. His two sons stand to inherit his business, but they cannot get along, nor can they work together.

Keith decides to split his business into two, with each son inheriting a separate business from the other. One business retains the name of the cymbal, but uses a new metallic formula for making cymbals. The other business retains the original metallic formula for making cymbals, but uses a new name. To allow each son to succeed, the company split is made known to the public, along with the knowledge that the new-name cymbal retains the original metallic formula that has been a popular choice of customers, while the original-name cymbal has a new and improved metallic formula.

The business with the original name is allowed to continue to use advertising that highlights the name and reputation of the business for its long history of producing world class cymbals, and that it has developed a new and improved formula for making cymbals. The business with the original metallic formula for making cymbals is allowed to advertise the fact that

it uses the classic formula that gave the original cymbal its reputation. Each business is given a separate intangible asset to take advantage of in competing with each other.

Example: Bob owns a tax preparation business with several tax accountants as employees of the business. Bob dies, and the family decides the oldest son, Kyle, should take over managing the business. Kyle has a degree in business management, but has never prepared tax returns professionally for clients. In order to maintain the working relationship with the employees and gain their respect for future management decisions, Kyle decides to take additional courses at a local community college to learn how to prepare tax returns. Kyle pays for the course out of his pocket and claims the Lifetime Learning Credit. He also increases his bonus pay to offset the cost of the education, which is deductible by the business as compensation paid. The business does not have an educational assistance program. If the business were to pay the cost of his education directly, it would be nondeductible since the education qualifies Kyle for a new trade or business.

Example: Nancy is a key manager for a family-run business. Nancy is not related to any of the owners, nor does she own an ownership interest in the business. In order to prevent Nancy from running off with her knowledge and secrets to the competition, the company provides her with a nonqualified deferred compensation plan. The plan pays a bonus into a company-owned investment account in her name at the end of each year for 10 years. The accumulated funds, plus earnings, will be paid to Nancy at the end of year 10, provided she fulfills her employment contract, which includes a requirement that she maintains an updated procedures manual that details all her functions as a key manager. If she leaves the business before the end of year 10, she loses all rights to the deferred compensation. For tax purposes, the business does not deduct the contributions to the nonqualified deferred compensation plan and Nancy does not include the benefits in income until she is no longer at risk of losing the benefits at the end of year 10.

Example: Jeff is a key employee for a publishing business that sells a tax newsletter to tax accountants. Jim is the owner of the publishing business, and he recognizes that Jeff's talents are key to the success of his business. None of Jim's heirs have the ability to take over the business if something were to happen to Jim. Jeff could easily take his talents to the competition. In addition to pension benefits and other fringe benefits offered to all employees, Jim decides to give Jeff a nonqualified deferred compensation plan in which a bonus is paid into a corporate investment account each year for 10 years. Jeff is the only employee entitled to this benefit. Jeff is entitled to the entire accumulated account balance, plus earnings, after 10 years provided he remains employed in Jim's business for the 10-year period.

If Jim dies during the 10-year period, his heirs have the option to convert the balance of the deferred compensation plan into a down payment for Jeff to purchase the business from Jim's heirs, with the remaining purchase price financed by the heirs. The valuation of the business is pre-determined by Jim and written into the deferred compensation plan. The terms of the financing arrangement are also pre-determined by Jim and written into the deferred compensation plan.

If Jeff does not wish to purchase the business, or the heirs do not wish to sell the business, Jeff must cooperate with the heirs during the period they try to sell the business. After the sale of the business, Jeff is entitled to the entire account balance in the deferred compensation plan, regardless as to whether he decides to enter into an employment contract with the new owners. The business is not entitled to deduct the deferred compensation until it is required to pay out the benefits. Jeff is not subject to tax on the benefits until he is no longer at risk for losing the benefits. The business is subject to tax on earnings accumulated in the fund at the time they are earned.

Possible Risks

- A succession plan that goes against the wishes of the heirs of the business owner may not be followed after the departure of the business owner. Unless there is someone willing to legally enforce the plan after the owner is gone, the heirs could simply ignore the plan and do their own thing. For example, taking legal action to enforce the terms of a will can be expensive. If the executor for the business owner's estate is not compensated for these costs, he or she might not be willing to defend the terms of the will in court. That would allow the business owner's heirs to claim there is no will, which means the business assets pass to them through state intestacy laws.
- Life insurance is typically purchased for the benefit of the heirs of the individual. The concept of having the business as the beneficiary of the policy may not be appealing to the one being insured, or his or her heirs.
- If a bonus is paid into a corporate investment account as part of a nonqualified deferred compensation plan for a key employee, the funds are at risk of being lost if the corporation goes bankrupt or has other financial difficulties. The incentive for the key employee to remain loyal to the company may be reduced or lost.
- Incentives in a succession plan for a key employee not to compete may be too weak. The key employee may decide the financial rewards of starting his or her own business are greater than the incentive not to compete.

Court Case

Court Case: Pulliam Funeral Homes, P.C. is a professional service corporation owned 100% by Mr. Pulliam. The corporation operated three funeral homes located in the towns of Robinson, Oblong, and Hudsonville, Illinois. Prior to 1992, the corporation had not paid any dividends and had unappropriated retained earnings of $1.1 million. Mr. Deckard was a key employee of the corporation that worked at the Oblong facility. In 1991, Mr. Deckard purchased property in Oblong with the intent to construct and operate a funeral home in competition with Pulliam Funeral Homes, P.C. Mr. Pulliam and Mr. Deckard met in July 1991 and came to the following agreement. Mr. Deckard could purchase up to 49% of a new corporation in the Oblong location after a spin-off from Pulliam Funeral Homes, P.C. The new corporation would be called Pulliam-Deckard Funeral Chapel, P.C. Mr. Pulliam would initially own 100% of the new corporation (the spin-off corporation), and then sell 49% of his stock to Mr. Deckard for a 51%–49% split. In addition to the stock purchase agreement, Mr. Deckard signed an employment agreement with the new corporation, along with a noncompete agreement. The intent of the transaction was to be a tax-free spin-off under IRC section 355. The new corporation was formed as of January 1, 1992.

Mr. Pulliam initially received the down payment for the stock sale and the first annual installment. Mr. Deckard defaulted in 1994 on the installment sale, and his employment by the new corporation then ended. Mr. Deckard abided by his covenant not to compete. Mr. Pulliam reacquired almost all of the new corporation's stock as the result of Mr. Deckard's default. At all times after the new corporation was created, Mr. Pulliam was president and majority owner of the corporation and was in ultimate control of its operations. The IRS claimed the spin-off did not qualify as a tax-free spin-off under section 355 and determined that Mr. Pulliam received dividends of $789,500 from Pulliam Funeral Homes, P.C., which were not reported on his federal income tax return for 1992.

In court, Mr. Pulliam argued that there were strong corporation business purposes for the corporation to create a new corporation because it wanted to protect itself from any possible competition by Mr. Deckard in the funeral business in the Oblong area, and it wanted to reemploy Mr. Deckard as a key employee to operate and manage the Oblong facility. The IRS argued there was no corporate business purpose for distributing the new corporation's stock to Mr. Pulliam. The IRS claimed the purpose of the spin-off was to distribute substantial earnings and profits of the original corporation to Mr. Pulliam without being subject to the taxable dividend provisions of IRC section 301. The IRS claimed the business objectives of the corporation could have been satisfied without a distribution to Mr. Pulliam either by having Mr. Deckard purchase 49% of the new corporation's stock from the old corporation, or by having Mr. Deckard purchase newly issued stock in the new corporation directly from the new corporation.

The court noted that a nondevice factor for the spin-off must have a corporate business purpose to qualify as a tax-free spin-off, and that this factor must be greater than any device factor for the spin-off. The court noted that there were two strong corporate business purposes for the spin-off.

- If Mr. Deckard had carried out his plans to build and operate a funeral home in Oblong in competition with Pulliam Funeral Homes, P.C., it would have divided the funeral business in that area, thus having an adverse impact on its profits.
- The services of an experienced funeral director and key employee (Mr. Deckard) would have been lost.

Based upon these two factors, the court ruled that the strong corporate business purposes and nondevice factors outweigh and overcome the device factors so that the distribution of Pulliam-Deckard Funeral Chapel, P.C. stock to Mr. Pulliam qualifies as tax free under IRC section 355. *(Pulliam,* T.C. Memo 1997-274)

~ End ~