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Penny Berger
Wright & Rembolt

David A. Ludtke
University of Nebraska College of Law, dludtke@remboltlawfirm.com

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Commentary

By Penny Berger*
and David A. Ludtke**

Pitfalls and Traps of Tax Reform

I. INTRODUCTION

The Tax Reform Act of 1976[1] was the most significant amendment of the Internal Revenue Code[2] since its major overhaul in 1954. The Act dealt with a wide variety of income, gift and estate tax matters with particular emphasis on tax shelter arrangements.

Unfortunately, but not unexpectedly, the Act reflected and extended that unique and mystifying legalese found only in the Internal Revenue Code. Due to the heavy-handed draftsmanship, most of the provisions of the Act can be understood only after successive readings and reference to the somewhat convoluted legislative history.[3] A greater difficulty, however, in interpreting the Act arises from its incidental or secondary effects. The Act clearly has an effect on Code provisions and business transactions which was not anticipated by Congress. Thus, new and complex tax traps have been created which must be identified, analyzed and subjected to the scrutiny of tax planners.

The purpose of this commentary is to identify five major potential tax traps[4] which stem from the Act, so that practitioners

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* A.B. 1966, Bernard College; M.A. 1967, Columbia University; J.D. with distinction 1975, University of Nebraska. Associate, Wright & Rembolt, Attorneys at Law, Lincoln, Nebraska.

** Professor of Law, University of Nebraska. A.B. 1961, Harvard College; J.D. 1968, University of Michigan. Member, American, Nebraska State and Washington, D.C. Bar Associations.

1. Pub. L. No. 94-455, 90 Stat. 1520 (1976) [hereinafter cited as the Act].
2. Int. Rev. Code of 1954 [hereinafter referred to in text as the Code].
3. There were no estate and gift tax amendments in the original reform act proposed by the House of Representatives. On September 8, 1976, the Conference Committee added the estate and gift tax amendments and by special procedure the House agreed to accept such amendments as part of the Tax Reform Act of 1976. As a result, the estate and gift tax amendments became law without legislative hearings on the proposals or statutory language.
4. A sixth major trap has been identified in Comment, *New Restrictions on Tax Shelter Limited Partnerships*, 56 NEB. L. REV. 300 (1977). As that comment points out, under the Act a partner may not be entitled

may analyze and hopefully avoid these particular pitfalls. These potential traps are in the following areas: (1) corporate buy/sell agreements; (2) lump sum distributions from pension plans; (3) subchapter S elections; (4) minimum tax on tax preference items; and (5) preferred stock bailouts.

II. BUY/SELL AGREEMENTS

Under the Tax Reform Act, assets held by a decedent no longer receive a free step-up in basis at death.[5] As a result, the sale or redemption of stock upon death pursuant to a buy/sell agreement will constitute a taxable transaction. Unfortunately almost all existing buy/sell agreements were drafted when the free step-up in basis negated any significant income tax impact upon sale or redemption. Such buy/sell agreements, therefore, typically do not plan adequately for a taxable sale or redemption.

In general, if a stockholder sells stock to a third party pursuant to a cross purchase buy/sell agreement, the shareholder realizes capital gain or loss on the difference between the basis of his stock and the amount received on the sale.[6] Similarly, if the corporation redeems stock of a shareholder, the redemption may be treated as a distribution in part, or as a full payment in exchange for the stock, as opposed to a dividend.[7] Under prior law, the characterization of a corporate redemption as a sale or exchange of stock had a significant additional impact for redemptions from an estate

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to a full deduction for partnership losses if the amount which he has at risk in the partnership is limited. However, the basis of his partnership interest is reduced anyway by his full pro rata share of partnership losses. This reduction eventually could result in income to the partner even though the partnership had no income and the partner had not been permitted to fully utilize the losses of the partnership.

5. Under prior law the basis of property held at death became the fair market value of the property at the date of the decedent's death or the alternative valuation date. I.R.C. § 1023, *as enacted by* Act, *supra* note 1, § 2005(a)(2), provides that with respect to decedents dying after December 31, 1976 inherited property carries with it the decedent's basis, subject to a number of adjustments and exceptions including a "fresh start" rule as of December 31, 1976.
6. I.R.C. § 1001.
7. I.R.C. § 302 treats a stock redemption as a distribution in part or full payment in exchange for the stock if the redemption is (1) not equivalent to a dividend, (2) substantially disproportionate, or (3) a complete termination of the stockholder's interest. I.R.C. § 303 provides similar exchange treatment under certain circumstances when the stock of such corporation constitutes a significant portion of the decedent's estate.

or its beneficiaries, because the basis of the purchased stock for the estate or the beneficiaries was stepped-up to its estate tax value. If the sale or redemption occurred shortly after the stockholder's death, there was little, if any, gain subject to tax.

Because, under prior law, purchases or redemptions subsequent to the death of a stockholder resulted in little or no income tax liability for the estate or the beneficiaries, practitioners were relatively free to create a variety of formulas for payment of the purchase price. Payment formulas were essential if the buy/sell obligation did not provide for an outside source of funds, such as an insurance policy on the life of the decedent. Without such a funding vehicle, the buy/sell agreement normally had to provide that the payments could be made over a period of time out of the earnings of the business. For example, a typical entity buy/sell agreement might provide for an immediate, partial payment in cash by the corporation in a specified amount or an amount equal to that which could be withdrawn under section 303 for death taxes and costs of administration. The remaining amount would be represented by notes payable at some future time when the corporation presumably would have sufficient earnings to complete the purchase.

Although such payment formulas might accurately reflect the ability of the corporation or its remaining stockholders to pay for the decedent's stock, such formulas do not take into account the fact that such sales or redemptions now will constitute taxable transactions. The major pitfall may be the possibility that the decedent's estate or beneficiaries could be taxed immediately upon the entire purchase or redemption price despite receipt of only a portion of the purchase price in cash. A severe hardship on an estate and beneficiaries could result when cash flow and liquidity problems arise due to estate taxes and other debts and costs of administration.

A variety of techniques may be used to deal with this problem. At the very least, existing buy/sell agreements should be reviewed to insure that any existing staggered payment formula satisfies the requirements for installment reporting under the Code.[8] The basic requirement, of course, is that no more than 30 per cent of the selling price be received in the year of sale.[9] In computing payments received in the year of sale, allowance should be made for interest if the bonds or notes do not specify an interest rate of at

8. I.R.C. § 453.
9. I.R.C. § 453(b)(2)(A)(ii).

least six percent.[10]

Another possible solution may be to fund the buy/sell agreement adequately with insurance so that the entire purchase price may be paid immediately. This alternative may significantly increase the annual cost of maintaining the buy/sell agreement and is dependent upon the insurability of the parties to the agreement.

The taxable nature of sale or redemption also raises a question of the desirability of the purchase or redemption price now contained in many buy/sell agreements. Many agreements contain a price formula which constitutes a bargain purchase price for the stock.[11] Stockholders realize that it is not desirable to overburden the continuing enterprise. Also, any increase in the purchase price would result in an increase in estate taxes. In any event, many buy/sell agreements now in existence reflect a willingness on the part of stockholders to accept a bargain price for their stock in the event of death. Stockholders may decide to adopt a bargain price because it represents the amount which they want to derive from their ownership interest or, in the case of a family held business, that amount which would be required to support a surviving spouse. Because amounts received may be reduced significantly by federal income taxes imposed as a result of the carryover basis provision of the Act, the pricing provisions should be reviewed to ensure that the stockholders know exactly how many after-tax dollars will be available to the estate or beneficiaries as a result of a purchase or redemption.

Occasionally, the availability of insurance may result in a purchase price which exceeds the actual value of the stock. In such cases, consideration should be given to reducing the purchase price so that a portion of the insurance could be transferred eventually to the stockholder's spouse. Such a transfer should result in a reduction of federal income taxes when the stock is redeemed.

It also may be possible to reduce the total tax impact of death combined with a stock redemption by having the corporation redeem the stock prior to death. If the redemption is made prior to death, the income taxes applicable to the redemption will be removed from the gross estate, reducing estate taxes.

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10. I.R.C. § 483; Treas. Reg. § 1.483-1(d)(1)(ii)(B) (1966).
11. Book value probably is the most frequently used reference for determining the selling price of stock pursuant to a buy/sell agreement. A purchase at book value, however, is not reflective of the true value of the stock because accounting records do not reflect the actual value of corporate assets. In addition, intangible assets such as goodwill, customer lists, and trade secrets typically are not reflected on the corporation's books.

In summary, typical corporate buy/sell agreements have been affected significantly by the Act's amendment instituting a carry-over basis rule. Buy/sell agreements currently in force should be reviewed to take into account the possible imposition of federal income taxes upon sale or redemption after death, including the possibility of qualifying future payments for installment reporting. In addition, stockholders should be made aware of the possible effect of federal income taxes so that they may re-evaluate their sale or redemption prices.

III. LUMP SUM DISTRIBUTIONS AND POST-MORTEM DEATH PLANNING

Before the Tax Reform Act, the Code provided that death benefits payable to the beneficiary of a corporate employee under a qualified pension plan, or to the beneficiary of a common law employee under a Keogh Plan, were excluded from the participant's gross estate to the extent attributable to employer contributions and as long as the beneficiary was not the executor of the participant's estate.[12] No exclusion was available, however, for death benefits paid to a decedent's beneficiary under an Individual Retirement Account (IRA) or under a self-employed person's Keogh Plan. The Act made the estate tax exclusion available to beneficiaries receiving distributions under an IRA or under a Keogh Plan established by a self-employed person. At the same time, the Act removed the exclusion where the payment is in the form of a "lump sum distribution" rather than an annuity.[13] As a result, any plans which provide for a mandatory payout of death benefits in lump sum form will guarantee the inclusion of such benefits in the decedent's federal gross estate, giving rise to potential estate tax under section 2039 in addition to income tax under section 72.[14] For gross estates of less than $120,000 in 1977 there should be no problem. Many shareholders in professional corporations, many partners in law firms, and many shareholder/officers of closely held corporations should investigate possibilities of other modes of distribution.

For those recently-drafted employee benefit plans, or plans which were amended to comply with the provisions of ERISA,[15] there is probably little danger that the mode of distribution will

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12. I.R.C. § 2039 (prior to enactment of the Act, *supra* note 1).
13. I.R.C. § 2039, *as amended by* Act, *supra* note 1, § 2009.
14. I.R.C. § 72.
15. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974).

cause a problem. Those practitioners whose clients have purchased insurance-funded plans, however, should check the contracts under the plan to see if death benefits are payable automatically in lump sum form. In any case, the plan should provide for optional forms of payout so that the estate tax exclusion under section 2039(c) can be retained if needed.

The definition of "annuity" under section 72 for income tax purposes differs greatly from the definition under section 2039 for purposes of the estate tax exclusion. The income tax regulations define "amounts received as an annuity" as "amounts which are payable at regular intervals over a period of more than one full year from the date on which they are deemed to begin, provided the total of the amount so payable or the period for which they are to be paid can be determined as of that date."[16] The estate tax regulations provide that "the term 'annuity or other payment' as used with respect to both the decedent and the beneficiary has reference to one or more payments extending over any period of time."[17] Thus, comparison of these regulations before the Act, indicates that any annuity which would have satisfied the income tax definition probably also would have satisfied the estate tax requirement.

Although it is impossible to forecast what the new estate tax regulations under section 2039, as amended, will provide, the legislative history indicates that the older, more liberal definition of "annuity" under section 2039 no longer will be available. According to the Conference Committee Report,

> the exclusion [under section 2039] will be available if the distribution from an individual retirement account to the beneficiary consists of an annuity contract or other arrangement providing for a series of substantially equal periodic payments to be made to a beneficiary (other than the executor) for his life or over a period extending for at least 36 months after the date of the decedent's death.[18]

Although it is true that the report speaks of distributions from IRA's, under section 2039(e) there is a question whether the term "annuity" would have any different meaning for other qualified plans under the same section—particularly when the intent of the amendment was to equalize treatment of beneficiaries of IRA's and those of other types of qualified plans. Thus, it is possible that even if the practitioner has provided for a payout in his qualified plans which would qualify as an annuity under

16. Treas. Reg. § 1.72-1(b) (1956).
17. Treas. Reg. § 20.2039-1(b) (1972).
18. H. CON. REP. No. 94-1515, 94th Cong., 2d Sess. 624 (1976).

section 72, he may not have insured the estate tax exclusion under section 2039(c).

Assuming that this problem has been overcome successfully, the critical problem of timing the election to receive either an annuity or a lump sum distribution remains. There is no problem of timing if the participant elects, before death or retirement, the form of payout to be made in the event of his death. The best time, however, to decide whether or not there is a need for the estate tax exclusion is after the death. Is the exclusion available if the beneficiary waits until the benefits are payable to decide the method of payment, or will some doctrine of constructive receipt be applied to deny the exclusions? Unfortunately, neither the Act nor ERISA speaks directly to the subject of post-mortem death planning.

Consider a plan which provides that death benefits are payable "in lump sum or such other form as the participant shall elect—or as the beneficiary shall elect if no such election was made by the participant." If the participant dies before having made an election, has the beneficiary any greater right to a lump sum distribution under such a provision? The answer is not easy. Although it is true that the beneficiary has the right to choose when and how the money will be distributed, no money at all is distributed until the method has been chosen. Although there is no substantial restriction on the beneficiary's right to receive the money, there is no right of withdrawal until the election is made.

There is surprisingly little case law on the problem of constructive receipt under section 2039(c). The few cases available deal with the *participant's* right to receive funds from the trust rather than the *beneficiary's* right. They focus on whether or not the taxpayer's right to the money is subject to substantial limitations or restrictions beyond his control.[19] There probably would be constructive receipt under the plan provision quoted above if the beneficiary were to select the mode of distribution after the death of the participant.

Kappel v. United States[20] is one of the few cases that dealt with the issue of constructive receipt at the beneficiary level. In *Kappel*, the trustee of a qualified plan of a closely held corporation maintained annuity contracts which named the plan participants as beneficiaries. The trust distributed the proceeds of the annuity contracts, but not to the beneficiaries directly. Rather,

19. *See* Northern Trust Co. v. United States, 389 F.2d 731 (7th Cir. 1968); Estate of Harold S. Brooks, 50 T.C. 585 (1968); Rev. Rul. 77-34, 1977-6 I.R.B. at 30.
20. 369 F. Supp. 267 (W.D. Pa. 1974).

the proceeds were used to purchase investment annuities which named children of the plan participants as the new beneficiaries. Holding that there had been constructive receipt of the proceeds, the court stressed the fact that the original benefithe proceeds, the court stressed the fact that the original beneficiaries of the contracts were also the trustees, the members of the Board of Directors who controlled the trustees' appointments, the beneficiaries of the trust and the principal shareholders of the employer which was the settlor of the trust. As a result of their complete domination, the court concluded that "when the trustees had possession of the money, it was the same as the beneficiaries having possession."[21] Whether another court would come to a similar conclusion when faced with a situation involving an independent, third party fiduciary and no actual distribution, is uncertain.

Apart from principles of constructive receipt, is there any statutory authority for allowing a post-mortem election? The committee reports provide that:

> Generally, satisfaction of the 3-year payment standard will be based on the payment provisions of the account or the settlement options, if any, *elected no later than the earlier of the date the estate tax return is filed or the date on which the return is required to be filed* (including extensions of time to file.)[22]

Clearly, the drafters of the Act contemplated post-mortem elections where settlement options exist in the contract.[23] It would appear, therefore, that post-mortem elections should be available to beneficiaries, at least where no prior, unrevoked election was made by a participant. It is harder, however, to say whether the committee report language will help a beneficiary successfully to revoke a participant's election and to receive the estate tax exclusion under section 2039. Arguably, the 60-day option period available for income tax purposes to obligees of contracts under section 72, including qualified plans, is some evidence of public policy in favor of allowing recipients the choice of a form of payout.

IV. THE MINIMUM TAX AND INSTALLMENT REPORTING

Under prior law, the Code imposed a ten per cent minimum tax on tax-preference items in excess of an amount equal to $30,000

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21. *Id.* at 276.
22. H. CON. REP. No. 94-1515, 94th Cong., 2d Sess. 624-25 (1976).
23. Compare the time period available for making the "election" under I.R.C. § 2039, as amended, with the 60-day period after death allowed for income tax purposes under I.R.C. § 72(h).

plus the taxes otherwise owing for such taxable year.[24] One major tax-preference item is the deduction allowed for one-half of long-term capital gains. In order to avoid or reduce the impact of the minimum tax on a capital gain transaction, several commentators suggested election of installment reporting, apparently on the theory that the tax-preference item would be allocated to each separate year.[25] In this way, the taxpayer could make use of the $30,000 plus taxes paid base in each year.

The Tax Reform Act amended the minimum tax provision by increasing the tax rate to 15 per cent and providing that the tax is applicable to the excess of tax preference items over the greater of $10,000 or the regular tax deduction for the year, which in the case of an individual, trust or estate is an amount equal to one-half of the federal income taxes otherwise imposed.[26] As a result of this amendment, taxpayers who already have elected installment reporting to avoid or reduce the minimum tax on tax preference items may be worse off than if they had not done so. In addition, in order to fit with the 30 per cent limit for amounts received in the year of sale, the taxpayer may have foregone part of the benefit of the $30,000 plus taxes paid base in the year of sale.

There is no easy answer for taxpayers who find themselves in this predicament. Once the installment method of reporting is elected for a particular sale, that election may not be revoked, even by an amended return.[27] The election has been held irrevocable even when a taxpayer made the election on the basis of erroneous information,[28] and there is no reason to believe that a statutory amendment altering the effect of the election would change this result.

The new minimum tax rate and reduced base are applicable to tax years beginning after December 31, 1975, and will affect substantially more taxpayers than did the old law. Although previous elections of the installment method of reporting may prove disadvantageous as a result of the amendments to the minimum tax, taxpayers contemplating a capital transaction still may wish to consider the installment method to reduce their minimum tax on future tax-preference items.

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24. I.R.C. § 56 (prior to enactment of the Act, *supra* note 1).
25. *See generally* 48 TAX MNGM'T (BNA) (4th ed. 1975); 269 TAX MNGM'T (BNA) (1973).
26. I.R.C. § 56, *as amended by* Act, *supra* note 1, § 301.
27. Marks v. United States, 98 F.2d 564 (2d Cir.), *cert. denied*, 305 U.S. 652 (1938).
28. Ivan D. Pomeroy, 54 T.C. 1716 (1970).

V. SUBCHAPTER S ELECTION

Although election of subchapter S treatment under the Code may be of significant advantage, there is a continual risk that the election inadvertently may be terminated. Under prior law, a subchapter S election terminated when stock was transferred to or acquired by a new stockholder unless the new stockholder consented to the election.[29] In order to alleviate the problem of inadvertent loss of a subchapter S election, the Tax Reform Act provides that the election continues unless the new stockholder elects within 60 days to terminate the election.[30]

The automatic continuation of a subchapter S election may constitute a serious tax trap for the unwary. A continuation of the election means that a new stockholder, such as an estate or trust, is taxable on its pro rata share of undistributed taxable income.[31] The corporation, however, is not required to distribute such income. If the parties anticipate maintaining the election after the death of a stockholder, they should provide for a minimum income distribution each year. If a new stockholder fails to consider whether to terminate the election and does become subject to taxes without receipt of income distributions, the only alternative may be to transfer the stock so that another holder may terminate the election. If, however, transfer is restricted by the articles of incorporation, bylaws or stockholders agreement binding upon transferees, the new stockholder might be unable to avoid income taxes on the corporation's undistributed taxable income.

VI. TAINTED, PREFERRED STOCK

The Code provides that, under certain circumstances, preferred stock will be considered tainted so as to give rise to ordinary income upon its sale or redemption.[32] The taint is imposed to prevent stockholders from extracting corporate earnings at capital gain rates without giving up control of the corporation.

Under prior law, the taint on preferred stock was removed by death because the estate acquired a new basis in the stock. In addition, the sale or redemption of the stock generated no gain for the

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29. I.R.C. § 1372(e)(1) (prior to enactment of the Act, *supra* note 1).
30. I.R.C. § 1372(e)(1)(A), *as amended by* Act, *supra* note 1, § 962.
31. If the new stockholder is an estate, the period within which it must act to terminate the election ends 60 days after (1) qualification of the personal representative or (2) the last day of the taxable year of the decedent-stockholder's corporation, whichever is earlier. I.R.C. § 1372(e)(1)(B), *as amended by* Act, *supra* note 1, § 902.
32. I.R.C. § 306.

ordinary income taint to be applied against. Under the Tax Reform Act, there is a potential gain and the taint will not be removed at death by way of the transferred basis. Because the taint is not removed, the Code appears to require that the redemption be treated as a dividend distribution to the extent that the corporation has earnings and profits.[33] If the redemption is made pursuant to section 303 to pay death taxes, the regulations appear to allow capital gain treatment.[34]

If a taxpayer is caught with tainted stock, which is subject, for example, to a buy/sell agreement at death, there are several alternative methods for escaping the taint. Briefly, such methods include complete termination of the interest of the estate or beneficiary, partial or complete liquidation, change of the preferred stock into common stock in a recapitalization, or simultaneous disposition of the underlying stock with respect to which the tainted stock was issued.[35]

VII. SUMMARY

The Tax Reform Act of 1976 will have a profound effect on business and personal matters. In addition to learning the many specific amendments, practitioners must rethink their transactions to beware of the indirect as well as the direct effects of the Act.

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33. I.R.C. § 306(a)(2).
34. Treas. Reg. § 1.303-2(d) (1966).
35. *See generally* 85 TAX MNGM'T (BNA) (2d ed. 1973).