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Estate Taxes and the Family-Owned Business

C. Lowell Harriss*

America's business leaders have lived to see many big changes in the structure of our economy. Few of these changes have been more important than the growth of federal taxes. Men of sixty may have begun their business careers before there was a federal income tax and men of fifty-five before the first federal estate tax. It would be a relatively young executive whose business life had been no longer than the period in which federal taxes have been, as they are today, a major factor in business and family decisions. A change such as this—big, new and closely related to many others—is extremely difficult to study satisfactorily. Experience and evidence are scanty. Isolation and measurement of effects are impossible.

A pointed example of a change which is not easily evaluated is the subject of this article—the effects of death taxes on family-owned businesses. Yet some business leaders—in striking contrast to their counterparts of the last generation or their friends who manage giant corporations—may feel that the problem is one of the most serious they face in the coming years. Is it, however, just a personal problem of the prosperous, or are there serious social implications?

ESSENTIALS OF THE PROBLEM

The essentials of the problem can be outlined simply. The estate tax is related to capital values rather than to income flows. It is sometimes half or three-quarters of the estate, so high that it cannot be made "painless." It is payable in one "chunk" and may be much too

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1 Though the literatures of jurisprudence and social philosophy have much to say about the disposition of property (before and) after death, and though there is considerable literature in economics on death taxes, the author has found little treatment of the problem which is the subject of this paper. There are doubtless many reasons—the relative newness of the problem (especially compared with the age-old problem of division of land at death), the fact that each case is in many important respects unique, the fact that economists have so often preferred to deal with general problems, etc. After this article was prepared, however, a privately published booklet, Mergeritis, by W. W. Vandevooer, appeared; late in the summer of 1949 its contents were summarized in Trans, Sept. 5, 1949, p. 53, col. 2. Over 100,000 copies had been distributed by October 1.
great to come conveniently out of "income." Moreover, payment must be made not in the assets on which the tax is imposed, but in cash (dollars) after death.

The estate and gift taxes have large loopholes and provide broad avenues of escape. Different families in essentially similar circumstances may pay vastly different total taxes, depending upon the extent to which they take advantage of methods of avoidance. The total tax will vary greatly depending on the level of common stock (and other asset) prices at the time of death or gift. The total burden is not adjusted to the size or, except crudely, to the economic or personal circumstances of the members of the family. Estates of the same dollar value and tax liability may differ tremendously in every other way. The broad categories we use for discussion and for the analysis of general problems are inappropriate for study of practical details. "Wealth" is not homogeneous. A government bond and a share in a family business are obviously different in many important ways.

A sizable estate consisting chiefly of a business would not normally have enough cash (and equivalent) to pay the tax (plus expenses). Somehow part of the interest in the business must be converted into cash. The amount involved may be very large in relation to the assets of the business, and the sale of such a share on reasonable terms may be difficult. The business as a going enterprise may die or suffer, either by contracting or by failing to grow as it otherwise could. Extreme personal hardship and economic loss to society are easily imagined.

The underlying theory of the estate tax presupposes some breaking up of large holdings of family wealth. Whatever one's views regarding the desirability of checking the creation, and even of hastening the disintegration, of private fortunes, it has been the intention of lawmakers to use the estate tax to do just that (as well as to raise revenue). It is not quite so clear that the tax is intended to force a redistribution of control of business management. Obviously, the estate tax, like any other, affects the payer adversely. But, we ask, are these adverse effects greater, and do they extend more generally through the economy, when the estate consists of a family-owned business than when it consists of equal amounts of other assets?

**TYPE OF CASE**

Despite infinite variation in details, certain general features of the type of case can be outlined. They typify something of the "American dream."
A man, a man and wife, or a small group, possibly brothers, starts from small or modest beginnings. They establish, or possibly inherit, a business. To make the most of their energies and ideas, they need resources—capital—with which to work. They put in savings, including possibly funds advanced by a friend or relative. Some capital is borrowed from a local bank, perhaps on little security except inventory and the prospects of the business. Other capital funds may be obtained from a lending institution on a mortgage on real estate, business or personally owned.

The business grows. If business is good, the chances are that the need for additional capital is great; the pressure to leave a large fraction of the profits of the good years in the business will be compelling. The capital grows chiefly by reinvestment. There are several reasons why reinvestment of earnings under such circumstances has been characteristic. The bank and other creditors may demand some repayment of loans. Cushions may be needed for the knocks of hard times. Profit prospects may be promising. Closely held businesses can often use capital to good advantage—or believe that they can. Capital is not easy to get from outsiders, especially equity capital on "reasonable" terms. Even huge businesses complain of the difficulties. For the "small" firm the problems are likely to be vastly more serious. Even if the demands for growth are not urgent and the prospective returns from new investment very high, tax considerations may impede reinvestment. The owners, in these days of tax consciousness, will generally realize that (if the business is incorporated) earnings reinvested escape personal income tax at least for the time being. The net yield from some other investment may have to be extremely high to equal that obtainable by leaving profits in the business. Whatever the balance of reasons, earnings are generally plowed back, and the profitable firm grows.

Most businesses, however, never grow to a size that will give their owners a death-tax problem. The ones that do are clearly exceptions. Presumably they have done a good job of what society wants. Once they have grown, survival is not uncommon; consequently, as a so-

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2 The literature on this subject is large, though inevitably not fully satisfactory. A convenient, competent summary and analysis is to be found in Kaplan, Small Business: Its Place and Problems (Committee for Economic Development, McGraw-Hill, 1948). Various studies of the Securities and Exchange Commission also bear closely on the subject.

3 Precise comparison of both the monetary and non-monetary returns is very difficult. See Shultz and Harriss, American Public Finance 447 (5th ed., 1949).
ciety ages, there will be more and more firms owned by a generation which inherited a good start. Though the owners may lack some of the brilliance, the energy, and the frugality of their parents, the members of this second or third generation will come to own substantial fortunes in family businesses. They will have received the business without paying much estate tax, but they will be able to pass the business on to their heirs only if a large fraction of their wealth goes to governments.

Whether built up or inherited by the present owners, the business will generally have certain characteristics which are relevant to the tax problem. The aggregation of people, equipment, organization, clientele, and "goodwill" has value as a unit. In addition to dollar-and-cents value it is likely to have non-marketable values of importance to some of those associated with it. Successful going concerns are not easily created, nor is the loss if they die (or contract) automatically equalled by the gain of someone else. Society, as well as the owner and his family, wants to see the business maintained as a going enterprise.

Yet society also wants to impose a substantial tax measured by the capital which a decedent had in the business. This tax must be paid just when a person who may have dominated the management passes from the scene. Death itself, of course, creates tragic and difficult problems. The tax adds more. Someone of the family may be ready to step into a position of management, though lack of ability, rivalry, and differences of interests within the family are not unknown. Other competent executives with extensive knowledge of the business may be able to take over. It is by no means certain, however, that they will have cash or the desire to buy part of the family interest. In these days of high personal income taxes it may not be common for children or junior officers to save large amounts (invested in liquid assets) by the time they reach middle age. The deceased owner's estate and his family will have some assets outside the business—a house, some durable consumer goods, some life insurance, and some assets.

4 In this country the number of such cases will certainly be greater in the coming decade than in the last.

5 A very important exception exists when property has been received in the form of a life estate which one or two successive generations can enjoy without payment of any additional estate or gift tax. As a practical matter it is probably more difficult to use life estates when the wealth is an interest in a family business than when it is in government bonds or a diversified portfolio of securities.

6 One must be careful not to attribute to death taxes the consequences of death.
easily marketed securities. The total of highly liquid assets, however, may be small relative to the tax that must be paid, plus other demands for cash. In the absence of prior preparation the type of estate with which we are concerned will not have access to enough liquid assets to pay the tax.

PROBLEMS OF PLANNING FOR ESTATE TAX PAYMENT

Thanks largely, though not entirely, to wide loopholes in the estate and gift tax structure, a good plan can save tremendous amounts of estate tax. The plan, regardless of the tax saving, can greatly simplify the problem of getting funds to pay the tax. Good planning, however, calls for a very high degree of technical competence, especially when the estate consists largely of a family-owned business. The difference between the tax results under good and bad planning may very well equal many years' savings; in fact, under present income taxes a person now at the end of his business life might well find it impossible to accumulate again, if he were to begin as a young man, as much wealth as he might lose for his heirs by the bad planning of his estate. We shall discuss later the extent to which businessmen today are aware of the need of estate planning. First, however, a brief catalogue of the problems of the estate with a family-owned business seems desirable.

Planning problems peculiar to estates with a family business

Rates of tax and the definition of the tax base are always subject to change, perhaps large change. The provision of the marital deduction in the Revenue Act of 1948, for example, makes a huge difference in tax under some circumstances. The tax treatment of certain types of property, and of property disposed of in particular ways, is some-

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7 The non-tax benefits of good estate planning can also be tremendous.
8 One might add to the topics noted here the possibility that the federal estate tax might be abolished or emasculated. Doubts today about the permanency of the tax may seem ridiculous. Yet for long there was hope that the New Deal, which put death tax rates up to problem-creating levels, would be repudiated. The Republican Party platform in the 1948 campaign contained a plank apparently advocating that the federal government withdraw from the field of death taxation, turning it over entirely to the states—the wording was a bit vague. If this were done, the result would probably be a substantial reduction in the country's total death tax collections. State rates now in effect are generally less than the federal; if something like the federal crediting device were not in force, states would probably feel enough competitive pressure among themselves to check great increases in rates. In view of the demands on the Treasury, however, it seems improbable that the federal tax will disappear in the near future.
9 The estimated annual loss of revenue is greater than federal collections for any year before 1937.
times uncertain and is always subject to change by legislation, administrative practice, or court decision. Methods of valuation of non-liquid property may change. The relation between the estate tax and the gift tax may change, or the income tax may be altered significantly. State death taxes may be revised.

The time of death is uncertain. The best arrangement if one lives five years may be far from the best if one lives thirty years. The size of the taxable estate may vary greatly if the major asset is a closely held business, even if tax rates are unchanged. Business will have its ups and downs, altering the tax valuation. Economic and social conditions are bound to change. The future size of the family and the relative positions of its members are not easily predicted, making it difficult to plan satisfactorily. Will the wife survive? Will a son or son-in-law be able and willing to take over management? What will happen if the father before his death gives up the power to control the business? Will the children and grandchildren be better and happier people if they receive some financial support and independence relatively early in life? What will happen to partners or other associates?

All of these and many other considerations must be taken into account, difficult as that will be, in making a good plan. A large element of gambling is inevitable. But the odds against one’s heirs can be reduced, and since the stakes can be very great, precautionary planning is unquestionably desirable. Such planning is especially important if the major asset is a family business.

The liquidity problem becomes acute. Some assets must be converted into cash to pay tax. They may have to be sold under conditions that will require sacrifice of apparent value. The property-owner is no longer free to pit his judgment against that of others in the market because of the compulsion to get cash to pay tax. Unlike liquidation for some other reasons, the dollars obtained will not be available to reinvest on equal, or possibly better, terms. The cash goes to the government.

Within the last twenty years conditions have existed in which a closely held business would bring, in the best market available, much less than the owner might reasonably expect to be the long-run value. If the pressure to sell is urgent, arising perhaps from insistent demand for dollars to pay taxes, there may be great danger of having to sell at a considerable sacrifice of long-run value. The markets for going
businesses are poor; there may be very few potential buyers. This condition may exist commonly where a business is large relative to the community in which it is located. The nation has so far failed to develop extensive institutions for gathering funds for equity investment on a wide geographical basis and placing them in small local firms. Relatively small businesses with good earning and prospects may have great difficulty getting equity funds even when billions of dollars of savings lie idle in banks or invested in low-yield securities.

When there is a functioning market for businesses as such, the person wishing to sell may find a "lumpiness," in that potential buyers will want the whole interest or at least enough to get control; nothing like a satisfactory price may be obtainable except by sale of more than is needed to pay tax—loss of control becomes part of the effective tax burden. The buyer may refuse to pay a price that reflects fully the value of control to the seller, especially when non-pecuniary values attach to control. The attitude of the buyer in insisting upon control may be reasonable because he may otherwise have inadequate protection of his investment. This consideration is unusually pertinent because the removal of the decedent from the direction of the business he built up may have added an element of uncertainty, threatening to weaken leadership and management. On the other hand persons with adequate funds, especially for lending, may be unwilling to participate in refinancing because they are unable or reluctant to assume control or managerial responsibilities and will not risk their funds where management is uncertain or where active control seems essential for the protection of one's position. Almost the opposite situation may arise, however, if the survivors are not able, or do not want, to retain control; in order to get rid of responsibilities of ownership and management, they may have to sell at a sacrifice of economic value.

10 Most of the discussion here is in terms of sale of the property. Yet in some cases borrowing or possibly other forms of financing might solve the problem. It is only to avoid complicating the discussion in the text that explicit reference is not made to this possibility more frequently.

11 Borrowing, especially when property can be mortgaged, is often easier, but it presents its own difficulties.

12 Limitations of space make it impossible to discuss the reasons (a) why separation of ownership and control of "small," closely-held businesses will seldom appeal to investors and (b) why debt financing is disliked beyond rather narrow limits. Though not always beyond sound criticism, the reasons have so much merit and standing that reasonably satisfactory solution of the problem analyzed in this paper is not likely to be found in a material change in attitude on these two points.
Furthermore, potential buyers, knowing or suspecting that the estate is in pressing need for cash, may offer less good terms than if they felt the seller could hold out. Persons under compulsion to sell are at a disadvantage. Death is an event which can hardly be concealed. If it gives rise to compelling pressure to sell, buyers are likely to be aware of that fact. The heirs will probably suffer.

A business man may also worry that heirs and executors may not be able and willing to negotiate to get the best possible terms in seeking necessary cash. The widow, children, family lawyer or bank may have little or no skill in liquidating a business. Such fears may be well or poorly founded, but they undoubtedly add to the general uncertainties about the liquidation.

A final relevant consideration—that the group of potential buyers of closely held businesses may be limited by the fear of anti-trust prosecution—must not be ignored. Established firms with the experience that might give them the best prospects of successful operation may be unwilling to risk the danger of anti-trust action attached to the purchase of competitors. The danger of such prosecution will tend to be greatest if the purchaser is a large element of the industry; yet the large firms may have easiest access to capital markets and hence be able to offer the best terms, especially liquid assets.13

So it goes. Though today's problems seem great, those after death may well be greater. The best possible solution will likely be painful, but the pain of the worst solutions may be excruciating. Not only may the heirs suffer, but the business, the hundreds of persons interested in it (as employees, consumers, suppliers or investors), and society may suffer from preventable loss.

MAGNITUDE OF THE PROBLEM

The critical reader may already have begun to ask himself, "Is the over-all problem really serious? Are we getting unduly agitated about troubles which in the broad scheme of things are insignificant?"

Perspective is not easily secured. Total estate and gift tax revenues are not large as tax revenues go. In the 1949 fiscal year they yielded the federal Treasury about $800 million, 2 per cent of total revenues. State collections are now very much smaller than federal, though death taxes have about the same relative importance. The more important factor for the problem discussed here is the absolute level of revenues. It has risen greatly and is now twice as high as a

13 Only a firm of substantial size may be able to offer securities of its own which have an active market.
decade ago, even allowing for the revenue effects of apparently depressed stock prices and the marital deduction. Yet high as the total seems to one accustomed to think in terms of the magnitudes of the past, it is small relative to other pertinent magnitudes, to total new saving, to business profits, to reinvested earnings, and to income tax collections. If annual estate tax payments are compared with other totals in today's economy, it may well be asked whether the tax can be very important to the economy as a whole. The answer, if there is one, can be found only after looking at individual cases, especially family-owned businesses.

About how many family businesses are likely to face significant problems arising out of the estate tax? Compared with the total business population of about 3,600,000 non-farm businesses, the number must be small indeed. Yet it is very difficult to make any reliable estimate. The uncertainties and variations are tremendous, much greater now than before enactment of the marital deduction. But even before 1948 the possible variations in individual situations were huge. Two men with exactly the same net worth and basic business investments could then, as they can now, arrange their estates to have vastly different tax liabilities. Whether or not a man makes use of methods of altering the tax will depend largely upon conditions peculiar to his own situation, conditions which our general statistics do not illuminate. We must guess, we hope intelligently.

The practical problem is to find what resources should be reasonably available to pay taxes. The specific exemption is $60,000. In addition there is the gift tax exemption of $30,000, as well as gift tax exclusions of $3,000 each year for each donee. These amounts are in effect doubled in those cases in which advantage is taken of the marital deduction. Whereas the absolute minimum exemption under the federal law is now $60,000, the practical maximum may frequently be as high as $250,000; it can be even higher if systematic use is made of the annual exclusions offered under the gift tax.

If an estate qualifies for only the specific estate tax exemption, the resources needed to pay tax on $160,000 net assets will be about $21,000 (sometimes more if the state death tax is more than the federal credit). Yet in other cases there will be no tax at all on total transfers of $160,000 or even on much more. The tax would range, therefore, from about 13 per cent of the estate to nothing. Payment

14 Estates of non-resident aliens are ignored as unimportant for the problem of this article.
of 13 per cent in cash might present difficulties though they would probably seldom be great. It is conceivable that where full advantage can be taken of the marital deduction an estate of $500,000 could be transferred with a total tax of no more than about $25,000, or 5 per cent of net assets, an amount which should present no serious payment problems. If reasonably full and successful use were made of the gift tax opportunities of distributing an estate, much larger amounts could be passed without incurring tax liabilities of as much as one-tenth of the assets transferred.

Clearly, variations in individual circumstances will make large differences in the total liability. Consequently, it is difficult to measure the number of cases in which a family business may be severely pressed to pay estate taxes. As a general rule, however, few estates of less than $200,000 should face difficult problems from the federal estate tax. With intelligent planning—use of gifts and the marital deduction—but with no great effort at liquidation before death, an estate should probably not face serious difficulties even if it were as large as $500,000. Yet if gift opportunities were not used successfully or if a spouse did not survive, an estate of $500,000 invested in a closely held business might have a very hard time getting the $130,000 needed to pay estate tax.

Of the returns filed in 1945, 2644 were for net estates of more than $200,000 (before deduction of the specific exemption but after all debts and contributions were deducted). Of these, 987 were over $400,000 and 695 were over $500,000. By no means all of these estates, either at death or any time prior, had consisted largely of an interest in a closely held business. Because of some rise of values and increases in net wealth since the mid-1940's the numbers today would be greater—except for the effects of the marital deduction, which in the aggregate will probably more than offset the effects of economic growth.

Unfortunately, our knowledge of the way fortunes are built and the way their ownership is distributed is very meager. Some of today's fortunes were inherited. Some have been built up by professional practice and others by men who have been employees rather than owners of businesses. Others have depended largely upon the growth of a business in which the ownership was narrowly limited.16 By no means all of the last group of cases fall in the class in which liquida-

16In view of present tax rates this form may tend to be relatively more frequent in the future since it may provide the easiest way to keep earnings out of the taxable (personal) income stream and convert them to capital gains.
tion to pay estate taxes is important. Some owners will get out of the business or shift their interest before death for reasons other than taxes.

Decedents with large estates are generally beyond middle age, even beyond the age often thought of as normal for retirement from active business. Of the returns filed in 1945, for example, more than half (1,591 out of 2,644) of the estates over $200,000 were of persons who at the time of death were over 70 years old; 417 (one-sixth) were for persons over 80 years old. Of the 787 estates over $500,000, 492 were of persons over 70 years old. Many of these estates of persons well along in years, or estates of women, though originally consisting of interests in closely held businesses, would in any case have been readjusted and reinvested before death. The estate tax would add relatively little to the problem.

The writer would be surprised if in the near future there were as many as 500 taxable estates a year, or fewer than 300, in which the major asset was a family-owned business and in which the difficulties arising out of the tax were critical, so that the heirs might suffer real loss in excess of the tax, or the business might have to contract more than nominally. There would probably be at least twice as many, however, in which the tax would put on pressures which were more than troublesome. There would be many more which would face critical or embarrassing problems if deliberate preparations had not been made before death to forestall trouble. If methods of avoiding the estate and gift tax were reduced substantially (as the author believes they should be), the number of businesses affected would be much greater, running possibly to several thousand a year. These estimates, of course, are subject to a wide range of possible error especially since terms are so hard to define, and we know so little about the effects of the marital deduction. Cases will, in fact, range from a few that are

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16 Only 21 decedents in the ten year age span of 40 to 50 had estates over $500,000; there were 69 in the group aged 50 to 60. Space limitations make impossible an adequate analysis of the data on the relations between age and size of estate; the author hopes to treat the subject at greater length in another article.

17 One "normal" adjustment is the gradual transfer of management and ownership to children. If there were no children to take over, sale would probably be made outside the (immediate) family.

18 The numbers would be somewhat higher if estates made up of real estate were included. One great difficulty of estimating is that we as yet have almost no data based on post-war deaths. Yet we know that profits (in dollar terms) in the war and postwar periods have been high by former standards. Some family-owned firms have participated generously in this prosperity. But how many? and to what extent? and will the fortunes contract or expand before their owners die?
exceedingly difficult to those with no real problems. The dividing line might be drawn anywhere within a large range.

At any one time, of course, the number of persons concerned about prospective death tax and making plans for payment are far greater than the number whose estates are actually in the midst of the situation. Probably at least ten, possibly fifteen to twenty, times as many such cases exist constantly. For some, the change of business fortunes removes the potential troubles while others who should be concerned are either not fully aware of the potential problems, or are poor in forecasting the change which will occur in their affairs. It would seem, however, that there will today be from perhaps 5,000 to 10,000 persons more or less actively facing the problems of adjusting an estate consisting largely of a closely held business in order to prepare for payment of estate tax which will be more than a nominal fraction of the estate. For most of them the adjustment, though unpleasant and costly, should not be more difficult than dozens of business problems which have been successfully met.

These numbers may well seem low. Yet it must be remembered that the estate tax is by no means a mass tax. Moreover, only one percent or so of adults die leaving taxable estates, and almost all of them leave too little to bring a heavy estate tax. As long as the estate and gift taxes are progressive with rather low rates in the first brackets, the majority of estates affected will be burdened slightly compared with those at the extremes. Finally, as will be shown later, estates as a whole seem to be highly liquid.

Assuming that the number of businesses is of this order of magnitude, what is the volume of economic activity affected? A few of the firms will be very large, though it seems inconceivable that the future will see any cases as big as the most famous of recent years, the Ford Motor Company. The assets (and sales) of the average business affected, however, are likely to be much larger than the net estate of the owner. The firms in estates with serious problems probably have total assets of not less than $500 million in an average year while the

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19 This condition is doubtless more than ordinarily true today because of the newness of accumulations built up in recent years.

20 Many times this number will be preparing for the effects of death, but to them the tax will be of incidental rather than major importance. The estimates in the text are frankly little more than (informed) guesses. If business continues to prosper as it has in the past few years, the estimates will need substantial upward revision.

21 This is true not only because there will often be others with some ownership in the business but also because businesses are usually bigger than the net worth of the owner. In addition to the equity and debt funds which the owners invest, businesses
firms whose principal owners are actively concerned about death taxes may have total assets well above $5 billion.\textsuperscript{22}

There is great variation in the amount of business done in a year by firms of equal size. For some the annual sales are several times the value of assets while for others total assets may be about equal to, or less than, sales.\textsuperscript{23} Similarly, the volume of employment varies tremendously among firms with the same net worth. And it will vary even more from estate to estate. Few very small firms will be involved, however. If there are 400 firms a year in estates affected seriously and if on the average they have 200 employees, the total number of employees involved would be 80,000. Probably at least ten times as many are employed by firms whose owners are actively adjusting their affairs to take account of prospective death tax. Whether or not these figures are even reasonably close to the actual figures it is impossible to say from the data on hand.\textsuperscript{24}

In the total economy these firms may not seem to bulk very large. Yet their value may well exceed their size because they have an unusually large element of dynamism, growth, flexibility, and competitiveness. Unfortunately, we have no way to evaluate such characteristics, though to many economists they seem extremely important. If family-owned businesses are notably well endowed with these characteristics, the firms are likely to be far more valuable to the country than the size of their assets or other such measure would suggest. The writer believes this is the case.

AWARENESS OF POTENTIAL PROBLEMS

To what extent are the owners of closely held businesses aware of the potential problems of estate tax payment? This question, like so many others raised in this paper, can be answered only by drawing on scattered sources and by the use of impressions rather than measurable quantities. The author's conclusion, with which he has found considerable agreement, is (a) that almost all men whose estates will face such problems are aware of their probable existence but (b) that in most cases the impressions of the probable severity of

\textsuperscript{22} These estimates are perhaps far from true figures, but it is likely that any error is one of understatement.

\textsuperscript{23} The difference in annual sales between a business consisting of apartment buildings and one consisting of the same equity in a grocery store can be very great.

\textsuperscript{24} For some years an extreme case can raise the total far above normal. Very large firms are generally beyond the scope of this paper because even though one or two men may own large parts of the business the stock will have developed something of a market.
the problem and the details and possible methods of solution are far from adequate.\textsuperscript{25}

It is impossible for a man in business today not to be aware of federal taxes. Though the estate tax, unlike the income tax, is not something he faces each quarter, it receives enough reference for him to realize more than vaguely that it exists. His attorney will raise the issue when he makes or changes his will. If he borrows from a bank, his banker may raise the question. And, by no means the least important, life insurance agents make this a major selling point. Life insurance selling staffs are numerous and industrious, and they probably contact in some way or other most prosperous businessmen (except those beyond the customary insurable age) every year or two; the provision of liquid funds at death, perhaps for payment of tax, is an important selling argument with which the agent will be familiar.\textsuperscript{26}

The businessmen likely to be affected are probably poorly informed of the precise nature and possible methods of solving the problem. Estate taxation is an extremely complicated matter touching on many other subjects which are complicated and very personal—wills, insurance, finance, personality, family relationships, death. There are inevitably many uncertainties. There are probably few advisors in the country with really first-rate command of the subject. The persons from whom a businessman gets his other tax advice, or his legal advice, or his financial advice may not be fully competent to handle estate tax problems; life insurance agents and trust company officials may have certain biases growing out of their preoccupation with their own special businesses and perhaps with their own interests. Even more important is the fact that conditions change constantly so that what is the best plan at one time may need substantial modification before long. Yet a businessman may not know when such is the case—he can hardly expect to keep constantly interested in such an unpleasant and lugubrious subject as his own death.

\textbf{LIQUIDITY STATUS OF ESTATES}

In recent years estates on the average have been liquid enough so that no over-all embarrassment should have been encountered in

\textsuperscript{25}For the most part our experience with very high estate taxes has been confined to a period of very good business, though capital markets during much of the time have been depressed in the sense that earnings and assets have been capitalized at rates which by historical standards and the yields of high-grade bonds seem low.

\textsuperscript{26}Among other things, the changes in estate tax treatment of life insurance in recent years have tended to keep the tax in the mind of agents and insureds.
getting cash to pay estate taxes. A more detailed study which the writer has made of estates for which returns were filed in the three years 1942-45 revealed the following general conclusions:27 When estates were grouped by size, all groups except those with net assets per estate of over $3 million (including only 88 estates) had (a) cash, (b) government bonds, (c) life insurance, and (d) two-thirds of "other" bonds in excess of the tax due; for all but 9 of the 88 largest estates such liquid assets averaged 89 per cent of tax, but for the largest 9 (over $10 million each) they averaged only 37 per cent of the tax. These four types of liquid assets totalled enough to pay all debts and taxes except for the groups of estates over $1 million where in most cases the deficiency was less than 15 per cent. Assuming that one-half of corporation stock was liquid, all groups of estates had liquid assets substantially greater than tax.

If the tax payable was that under the 1942 schedule (which was higher than the rate applied on many of the estates in the study), which is still effective, the cash, government bonds, two-thirds of "other" bonds, and life insurance were greater than the tax in all groups except those with 88 cases over $3 million each. If one assumes that half of corporation stock was liquid, funds would have been readily obtainable for taxes and debts for all but one group, that with the 9 estates over $10 million each. If, on the average, marital deduction equal to one-fourth of the net estate had been available, the margins of liquid funds available for payment of tax and debts would have been larger, and only the few groups of very largest estates would have been pressed.28

These figures tell us much, and yet they tell us little. We see from them clearly that as a group estates subject to federal tax contained enough liquid assets to pay debts, costs of settlement, and taxes. In most cases, even assuming no use of the marital deduction, debts and taxes could have been paid with very little sale of corporation stock. Yet stock is by far the most important single constituent of taxable estates. The over-all picture is clear and apparently comforting.

27 Harris, Liquidity of Estates and Federal Estate Tax Liability, 64 POL. SCI. Q. 533 (1949).
28 Estate tax returns filed in 1945 revealed a liquidity status not essentially different, as far as concerns the subject of this article. The very largest estates, however, had higher proportions of government bonds so that tax and debts could have been paid with very little selling of stock or other assets. Unfortunately, the author has not had time to analyze the 1945 data in as much detail as those for 1942-44. Inspection and sample checks of the data, however, have convinced him that the picture was not much changed.
Yet the data are seriously deficient for the study of the problem of this article. They are totals or averages applying to groups of data. The groups contain some individual cases which will be very different from the averages. No large fraction of cases can be a great distance from the average, but there can be enough in all the groups to make up a total which constitutes a significant problem. The data do, however, limit the apparent seriousness of the problem more narrowly than may popularly be supposed. There cannot be very many hundred cases a year seriously short of liquid assets at death.

This fact, however, fails to tell us as much as we need to know. The apparently high liquidity status at death may have been attained only by liquidation before death, prompted chiefly by the prospect of estate tax liability. Without doubt this condition does prevail, though to what extent there is absolutely no way of knowing. It is probably increasing as a result of growing tax consciousness, of greater publicity of potential payment problems, and of the growing number of older persons. Liquidation before death has both advantages and disadvantages for the taxpayer and for society. On balance it is probable that since the time of death is unknown, persons planning in advance for tax payment will tend to adjust much earlier than is needed. Consequently, larger amounts of funds than are used in any year will continually be held in fully liquid forms, primarily for payment of estate tax. These funds are not available for investment in family-owned businesses. The total withdrawal from potential equity investment is, therefore, larger than the inherent, aggregate necessities of tax payment require. The figures, therefore, may easily be interpreted as confirming the suspicion that the estate tax is tending to drive funds from family-owned businesses to more highly liquid forms. Unfortunately, the amounts involved are completely unknown. Though they are probably small in relation to total national wealth or even to new savings, they may have a large influence at a strategic point in the economy.

SOLUTIONS AVAILABLE TO THE BUSINESSMAN

What solutions does the owner have? What can he do to minimize trouble? There are two general types of (partial) solution. One is to reduce his tax (taxable estate). In one sense this is an evasion of the

29 An interesting illustrative case is discussed by Wormser, Hilgedag, and Cohen, Estate Planning: The Case of Mr. Burch, NEW YORK UNIVERSITY SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 629-677 (1949).

problem. For the Treasury it means loss of highly desired revenue. For the economy it means, in addition to loss of revenue, that the tax is not fully effective in checking the cumulation of economic inequality or in treating equally taxpayers in essentially similar circumstances. The Treasury (and the author) are on record that methods of avoiding death and gift tax should be reduced; if this were done, owners of family businesses would have less opportunity to meet their problem by avoiding the tax. The other solution is to assure the availability of cash or its equivalent. In most cases some combination will most probably seem to offer the most promising solution. Fundamentally, of course, there is no easy or pleasant answer.

**Philanthropy**

If the estate is very large, and perhaps even if it is relatively small, the best answer may be to transfer some of the business to a charitable trust or corporation (within limits permitted by state law). No estate or gift tax will be imposed on this part of the estate. If the transfer is made during life, perhaps year by year, substantial income tax saving (within the 15 per cent limit) can be obtained. The net loss to the heirs may be surprisingly small. Under present laws it is generally possible to establish a charitable organization which the owner and his family can control if they wish and into which some or all of the ownership of the business can be placed. The examples of the Ford estates come to mind at once. Conceivably, part or all the business could be so transferred that future earnings would not be subject even to corporation income tax.

Even if the family loses more ownership than if only enough stock were sold to pay estate tax, it can still in effect retain a very great deal of control.\(^32\) This possibility raises some challenging issues. The role of privately and closely controlled, tax exempt institutions in our society needs careful and continuing analysis.\(^33\) Despite dangers of abuse and waste, the increase of wealth earmarked for "philanthropic" purposes and not subject to political control has much to be said in its favor as a slight offset to the tremendous growth of the power of

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\(^32\) The possibilities of using philanthropies to save taxes while retaining extensive control are illustrated in *Investigation . . . of Textron . . . Report . . . Committee on Interstate and Foreign Commerce*, Sen. Rep. 101, 81st Cong., 1st Sess. (1949) and the hearings that preceded the report.

\(^33\) One does not ordinarily think of investments of philanthropies as the basis of dynamic, imaginative business growth. Government, however, may seem little better.
government. It may provide, though not cheaply, a way of diffusing power. But these issues take us beyond the proper scope of this paper. More information is certainly needed. As a solution of the problem of the family-owned business facing difficulties in payment of estate tax, this alternative will be adequate in some cases, but in others it will seem distasteful, unsuitable, and very often inadequate.

These is little basis for saying how much use is being made of this general type of solution. The extent is probably growing. If one could see the wills and estate plans now being drafted, one would probably find a well-marked trend, with the future destined to witness much larger totals than shown by available figures. The latest years for which data are available show somewhat higher percentages of large estates being left to charitable and similar institutions than in the period before very high estate taxes.\(^3\) What part of this total, or of the increase, is family-owned businesses is not distinguished.

It is not essential that the family use a special foundation. Gifts and bequests can be given to one or many existing institutions or to community trusts; and if the interest is of appropriate size or form (non-voting stock), the family may be able to maintain essential control of the business and a good source of income, especially salaries.

The attitudes of institutions receiving such interests will vary, but it would seem that a family ought to be able to arrange the transactions so that there would be no great difficulty. This method has one aspect which deserves explicit mention—part of the business can sometimes be put into a form which though it can be given away could not be sold; whereas there might be very great difficulty selling income bonds or long-term bonds or non-voting shares of stock in a closely held business, they could be given away (as in the Ford estate) without great trouble, and the tax saving might conceivably be greater than the loss in price if sale were made.\(^3\) The feasibility of plans which involve issue of special securities depends upon many circumstances, not all of which will be favorable.

Funds must, of course, be raised to pay the tax on whatever re-

\(^3\) One great difficulty, among many, of evaluating such a trend is that one cannot know for certain how the revenue lost thereby will be recouped, if at all.

\(^3\) Harris, *Federal Estate Taxes and Philanthropic Bequests*, 57 J. Pol. Econ. 337 (1949). On the average all estates reporting left about 7 per cent of the net economic estate to philanthropies. Much the highest percentage, 30.3, was from nontaxable estates, but estates over $10 million each average 12.4 per cent.

\(^3\) The greatest benefit will likely result when gifts of securities with large unrealized capital gain, qualifying for income tax deduction, are made before death.
mains in the estate. Since it will be less than on the whole estate, however, the amount of cash needed will be smaller and more easily arranged in advance or after death. Possibly, however, sale of control will be more difficult if philanthropies have a substantial interest in the ownership.

Gifts before death.

Another method of cutting the amount of the total tax is to distribute some of the business before death. As noted earlier, most decedents with estates large enough to involve substantial amounts of tax are more than 70 years old at death. Very few are less than 55. In general, therefore, persons with large estates have many years to make gifts. The tax advantages of distributing assets to heirs by gift rather than bequest are ordinarily large, and sometimes huge. The tax advantages of gifts are often underestimated.\(^{37}\)

Although the tax advantages of gifts can now be very great,\(^{38}\) the owner of a family business may have unusual difficulty in using them fully, much more so than the person with an estate in diversified stocks and bonds. The uncertainties of the future make forecasting of the size of the estate and the optimum distribution by gift subject to a wide range of error. Moreover, the prospect of losing control of the business may seem highly obnoxious, preventing the owner from making anything like full use of gifts; to assume retention of his position of power in the firm, he may have to keep at least 51 per cent of the voting shares; the person with an estate in government bonds faces no comparable problem. A man may not want to see his children or grandchildren independent, or he may find that the ownership of property by minors creates troublesome difficulties. It may not be easy as a practical matter to divide up the interests in the business so that they can be given away.\(^{39}\) The donee may die before the donor. Finally, the owner of a business may hesitate to give up the cash needed to pay gift tax, not only because the firm may need it badly

\(^{37}\) Earlier versions of this article summarized the tax advantages and disadvantages of gifts. To avoid duplicating discussion in other articles in this symposium this material has been deleted. Special reference is made to Mr. Looker's article, \textit{supra} p. 44. See also \textit{Montgomery and Wynn, Montgomery's Federal Taxes—Estates, Trusts and Gifts}, 1948-49 c. 1 (1948).

\(^{38}\) These are other advantages—savings in probate costs, guidance of the distribution, early assistance to children, etc. See generally \textit{Shattuck, An Estate Planner's Handbook} (1948).

\(^{39}\) If the business is not incorporated, the practical difficulties may be very great. However, even when a fraction in the ownership cannot be given, a note or other debt may be given.
but also because he may have to take it from the business in a form that will make it subject to personal income tax. Each case will be dominated by considerations largely peculiar to it.

What do we know about the extent to which gifts are made before death? The figures available, plus impressions gained from interviews with informed observers, support the conclusion that the volume of gifts is far smaller than tax considerations would justify. To minimize taxes, much more than half of the wealth should ordinarily be given away—three-quarters is probably a good rough figure though it is apt to be too high for estates under about $300,000. Gifts, therefore, should total from perhaps twice to three times as much as the net assets owned at death. Yet total gifts reported for gift tax purposes in 1944 (before any deductions except charitable gifts) were only $422 million, about one-eighth of the amount in estates reporting. Over the period since the gift tax was enacted in 1932 reported gifts have totalled about one-fourth of the amount reported for gross estates. Certainly, to the relief of the Treasury, nothing like full use was made of gifts.

Has there been a tendency for gifts to rise? Detailed data available through 1944 show little if any upward tendency—the average from 1940-44 was less than two-thirds the average for 1934-37. Though we have no figures on the volume of reported gifts since 1944, we have the figures of the amount of gift tax collected. These collections in the 1948 fiscal year were twice those of 1944; the increase must be explained largely, though not entirely, by the fact that there are more gifts. A decline in the 1949 fiscal year can easily be explained by the first year’s use of the marital deduction. The volume of recent gifts, therefore, must have been maintained, possibly increased, although far from the optimum taxwise.

The value of these figures for the purposes of this paper are limited. They include only gifts reported for gift tax purposes. Yet large amounts can be transferred without being reported. A return is supposed to be filed if a donor made gifts of $3,000 to any one donee

40 U. S. Treasury, Bureau of Internal Revenue, advance sheets prepared for Statistics of Income for 1945, Part I. Another much less satisfactory bit of evidence is that on the average less than 4 per cent of the gross estate reported ordinarily consists of property given away before death; however, executors are not likely to admit that gifts should be included in the estate so they will naturally incline to understate; therefore, gifts which are eventually included do not get into the figures we receive. Some discussion of economic and social effects of gifts will be found in Harris, Gift Taxation in the United States (American Council of Public Affairs, Washington, 1940).
during the year; obviously large amounts can be distributed without any need for a report that will get the figures into published data. We have little way of knowing for certain, but the author has been told by several persons who are familiar with the financial affairs of wealthy families that large and growing use is made of the annual exclusion.

Clearly, the tax structure now offers legal ways to avoid large amounts of transfer tax by making gifts to heirs before death. Despite the real practical difficulties, and the many reasons for disliking to make gifts, owners of family businesses would probably be well advised to make more extensive distributions in the form of gifts before death if there seems to be prospective danger of a "squeeze" by the estate tax. This conclusion seems especially valid for persons who can make small annual gifts, beginning perhaps while they are in the middle forties or early fifties. For estates which may run to from $150,000 to $500,000 a huge saving in death tax can be obtained. For larger estates, the dollar total of tax saving may be greater, but the percentage may be less impressive. As a corollary, it may be wise to capitalize the business so that "ownership" may be easily distributed, e.g., non-voting common stock or income bonds or non-cumulative preferred stock.

Extensions of time for payment of tax. Of the second group of methods to minimize impact of taxes—those involving adjustments for payment of a tax whose amount is more or less determined—attention will be given first to extensions of time for payment of tax.

The Commissioner of Internal Revenue upon application from the executor may extend the time for payment for as much as ten years with interest at 4 per cent. The estate with a family-owned business is just the type of case the provision was designed to aid. In some respects this solution seems economically the most sensible of those in this group. The adjustment can be adapted to the conditions which exist when the tax must be paid. Any earlier adjustment cannot so precisely fit the facts which develop. The decedent and his business need not tie up funds in relatively liquid forms for years before death when the funds could be used productively in the busi-

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41 Special provisions applying to gifts of future interests will be ignored here.
42 I.R. Rev. Code § 822(a)(2). State provisions vary greatly, but in most cases additional time can be granted at the discretion of an administrator or court; interest is charged.
ness. The owner need not give up his control. Overadjustment is not necessary, i.e., no excessive accumulation of liquid funds is required. For the owner there is the advantage that realization of capital gains can be delayed until after death so that amounts accrued up to death permanently escape income tax.

There are disadvantages, however. The executors and heirs may not be as competent as the owner to liquidate well, and some liquidation will probably be needed if the tax is large. The more or less sudden death of the key man may hurt marketability. From the taxpayer's point of view there is an uncertainty which is a disadvantage; he cannot be certain of being allowed the time which the Commissioner is authorized to grant. The Commissioner's standards are not expressed definitely enough for a person to know whether his estate can count upon getting the time. He cannot get a closing agreement that will assure his heirs of five or ten years to pay the tax. Moreover, liquidation after death may not be easy. Buyers may try to take advantage of the necessity of the estate and offer less good terms than if negotiations were being made before death gave rise to the tax liability. Earnings after death may not be large enough, after payment of income taxes, to cover 4 per cent interest and leave much for reduction of the principal of an estate tax. If sale is delayed beyond a year after death, the sale price cannot definitely be used as the valuation for determining tax liability.

Estates with closely held businesses would probably benefit from greater use of the opportunity of getting extensions of time to pay tax. The awareness of the existence of the possibility of an estate receiving an extension seems to be limited. It is probable that few businessmen have more than a vague notion of its existence, if they have any notion at all. (Life insurance agents who may play an active role in disseminating general information about estate tax payment problems would probably not be inclined to emphasize that extra time can be obtained.) It probably seldom enters planning.

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43 One claim sometimes made for death taxes is that they will raise a given amount of revenue with less adverse effect on business than the income tax because they are not paid until after the business career has ended and therefore need not affect day-to-day business decisions. To the extent that death taxes are anticipated, however, and funds for payment are accumulated before death, this advantage disappears. If more than is needed to pay the tax eventually due is accumulated, the death tax may be worse on this score than the income tax.

44 The author believes that there are ways in which the extension provision and its administration could be improved. Discussion of such points is not possible within the space limits of this article, however.
How much use is made of the extension provisions? Data are not compiled regularly. Some statistics are available for the three years 1946 through 1948, but their interpretation is difficult. The number of applications increased sharply from 144 in 1946 to 268 in 1948, but it was still a small percentage of all estates, though it may have been a high percentage of cases potentially needing more time. These data do not include information about the number of informal inquiries which may have been made and discouraged. Of the applications filed, 55 per cent were granted, compared with 40 per cent in 1946, though the full time or full amount requested may not have been granted.\textsuperscript{46} The reasons for rejection are not shown. In addition a small number of requests for extensions of time to pay deficiency tax were made and almost uniformly granted. The amounts extended ranged from under $2,000 in one case to three cases over $2 million each. The time granted ranged from three months to two years, though in several cases earlier extensions had already been granted, and at least six cases with total extensions of more than four years are clearly indicated. The cases with the longest grants are by no means always cases involving large amounts.

It would seem, therefore, that in relation to the total economy, or to the total number of cases affected by the estate tax, extensions are probably not very important, although in relation to the number of estates with problems arising out of the dominance of a family-owned business, they may be aiding materially. The extension provisions, however, are probably serving very inadequately to forestall liquidation and overadjustment before death.

\textit{Life insurance.}\textsuperscript{48}

A common method of providing liquid funds is to use insurance. The simplest and undoubtedly most frequent case is that in which a businessman takes out more life insurance than he otherwise would in order to accumulate more liquid funds for payment of tax. When insurance is used, the insured can be fairly confident that from the time the policy is issued he can count on the amount of cash provided for even though he were to die the next day. Insurance has other attractive tax and non-tax features,\textsuperscript{47} but it also has disadvantages.

\textsuperscript{46}Applications are frequently returned to the executors with a request for more complete information, and often nothing more is heard of the matter. In the statistics such cases are grouped with the rejected cases, yet they are not truly rejections.\textsuperscript{46} See \textit{Laikin, Death, Taxes and Your Business} (1948); the material originally appeared in \textit{Trusts and Estates.}\textsuperscript{47} State death tax laws commonly provide very generous treatment for life insurance.
One of the apparent disadvantages is that the proceeds of the insurance will generally be included in the taxable estate and incur tax. Although some complaints commonly made about this condition seem to the author to be without merit, there is no doubt that more insurance is required to provide a given amount of net cash to the estate than if the insurance itself did not incur tax.

Search for some way of getting insurance which will be available to the estate and yet not be part of it has continued for many years. Various methods have been devised. They build up outside of the estate an asset which can be used to buy non-liquid assets of the estate, thus giving the executor access to cash. Frequently, arrangements are made fixing the terms of sale. Where the business is a partnership or a closely held corporation, each owner may take out policies on the others, or the corporation may do so. Trusts may be provided to handle the settlements. Specific agreements are commonly made to settle the terms upon which the decedent’s interest will be purchased. However, by no means all families or businesses will be able to work out an arrangement that will keep the insurance proceeds out of the taxable estate.

Insurance involves costs which the insured must pay, costs which the ordinary buyer will find impossibly difficult to calculate. Consequently, the net cost of the estate tax to the taxpayer and to society is increased when insurance is purchased to help pay the tax. Moreover, there are special disadvantages for family-owned businesses. Insurance premiums may draw off funds which the business might use to good advantage in current operations; since insurance companies put almost none of their assets in equities of closely-owned firms, whatever savings (or even pooling of funds for payment of risk, i.e., pure term insurance) go into insurance are withdrawn from the supply of savings available for equity investment in family-owned

48 If funds used to pay the tax are not part of the tax base, the same revenue can be obtained only with higher tax rates. This general question is discussed in Harriss, Proposals to Exempt Life Insurance Used to Pay Estate Tax, 5 Tax L. Rev. 119 (1950).

49 Expenses (above payment of benefits) of U.S. life insurance companies in 1948 were 16.9 per cent of premium plus investment income. For various reasons this expense rate was about one-tenth above the long-run average. INSTITUTE OF LIFE INSURANCE, 1949 LIFE INSURANCE FACT BOOK 42 (1949). The net cost of insurance is a concealed but not unimportant cost of estate tax compliance.

50 The loss (after tax) of the income that the savings in the policy would have earned if the insured had invested the funds will generally prove very difficult to compute. In the case of term insurance the comparable problem is insignificant.
Insurance cannot always be purchased (e.g., poor health); once purchased, it may not be easily changed, and consequently the arrangement may prove to be embarrassingly inflexible. The tax treatment of insurance has been subject to significant change in the last decade, creating uncertainty which makes confident planning impossible; new changes may upset plans. The handling of insurance which A owns on the life of B when A dies presents difficulties. Special arrangements, particularly those designed to keep insurance proceeds out of the insured’s estate, may be self-defeating. Although the author has only limited information, he suspects that time will prove many plans to be extremely clumsy. As businesses change, as families develop and disintegrate, and as taxes are altered, insurance plans made today may seem wasteful and restrictive.

How much use is made of insurance? The amount of life insurance outstanding has increased greatly in recent years. One of the many selling points has been that insurance will provide a method of accumulating liquid funds to pay death tax. The over-all purchases by owners of family businesses would probably seem small in relation to the total, yet in relation to the prospective tax liability it may well be substantial.

The volume of insurance in taxable estates has increased considerably though it is still well under one-tenth of gross assets. The

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51 At the end of 1948 the assets of U.S. life insurance companies were invested as follows:

<table>
<thead>
<tr>
<th>Investment Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Government securities</td>
<td>30.2</td>
</tr>
<tr>
<td>Foreign government bonds</td>
<td>2.0</td>
</tr>
<tr>
<td>State, local, other bonds</td>
<td>2.2</td>
</tr>
<tr>
<td>Railroad bonds</td>
<td>5.4</td>
</tr>
<tr>
<td>Public utility bonds</td>
<td>15.7</td>
</tr>
<tr>
<td>Industrial and miscellaneous bonds</td>
<td>12.9</td>
</tr>
<tr>
<td>Mortgages</td>
<td>19.5</td>
</tr>
<tr>
<td>Real estate</td>
<td>1.9</td>
</tr>
<tr>
<td>Policy loans</td>
<td>3.7</td>
</tr>
<tr>
<td>Stocks</td>
<td>2.6</td>
</tr>
<tr>
<td>Cash and miscellaneous</td>
<td>3.9</td>
</tr>
</tbody>
</table>

The total was $56 billion compared with $31 billion in 1940 and $19 billion in 1930. 1949 LIFE INSURANCE FACT BOOK, op. cit. supra note 49, at 48.

52 In effect what is removed from the tax base is the difference between the face value of the policy B has on A and the cash surrender value of A's policy on B.

53 At the end of 1948, life insurance (other than group, industrial and veterans') in force in the United States was $132 billion; in 1940 and also in 1930 it was $79 billion, in 1935 $71 billion. 1949 LIFE INSURANCE FACT BOOK, op. cit. supra note 49 at 8.

54 Taxable returns filed in 1935 had insurance equal to 5 per cent of gross assets and 56 per cent of the reported tax before deduction of state credit. Taxable returns filed in 1945 had just twice as much insurance; it was almost 7 per cent of gross assets and
figures provide no basis for judging how much insurance was on the lives of owners of family-held businesses—in fact, to the extent that plans succeed in keeping insurance out of the insured’s estate the data which are perhaps most important will not appear in the figures. As the persons dying come to include more of those whose period of active business life was in the years when insurance sales were high, especially the 1940’s, the total of insurance appearing in estates will certainly increase. Growing use of insurance is to be expected, not only because it has real (non-tax) merits but also because of the active selling effort that goes into its marketing.

There are aspects of this growth which will disturb the person concerned with the preservation and expansion of family-owned businesses. The major source of capital for such businesses is the savings of the owner and his family. Yet, as noted above, to the extent that families put their savings into life insurance, the capital available for the business will not grow. In a broad economic sense the death tax becomes converted, rather crudely, to a form of income tax.

Arrangement for purchase of business interest after death.

Another solution is to enter into arrangements for the purchase of parts or all of the business after the death of an important owner. Formal contracts can be drawn up to set the terms of sale; the values or methods of valuation settled upon, if reasonable, can apparently be made to determine the value which will be used for estate tax purposes. Agreements of this sort are frequently and conveniently tied in with an insurance agreement (perhaps using a special increase in salary) to provide some of the funds. Children or key employees may carry policies on the life of the principal owner. Partners may insure each other. The agreement may be tied in with a profit sharing or pension plan or a charitable organization. Purchase of the owner’s interest on an installment basis may be provided, though if this method is used, funds for taxes may not be received in time.

37 per cent of reported tax. Statistics of Income, Part I (for 1934 and preliminary 1944), op. cit. supra note 40.

35 Some of the savings can be borrowed back. Though life insurance companies charge a higher rate of interest on such savings than they pay, the insured can ordinarily get a more favorable rate from a bank. If the firm borrows on the policy, the net cash received at death will, of course, be reduced by the amount of debt outstanding.

56 An important consideration is that capital gains are not considered as realized when the agreement is made. Since the sale is not completed until after death, gains accruing before death are never subject to income tax.

57 For a more complete analysis and citations see Cohen, Restrictive Agreements for Purchase of Stock: Effect on Estate and Gift Tax Valuations, New York University
Such contracts can help provide for an orderly settlement (of both tax and non-tax problems) and can give a measure of assurance that would otherwise be lacking. The owner can control the business until his death. Valuable incentives may be given these officers long before they have any significant investment in the business. They, the firm, and the economy as a whole may benefit materially from this added stimulus to management. Society may obtain the fruits of the identification of management responsibility and interest long before some of the managers put capital into the business. Though there is yet no basis for evaluating the general effects of such plans on the management of closely-owned firms, there seem to be clearly promising potentialities of constructive results in many cases. A non-revenue objective of progressive death taxes is to check the cumulation of economic inequality, to give more nearly equal opportunity to the members of each new generation, to provide incentives and to distribute rewards more nearly according to economic contribution and less according to inheritance. The arrangements for bringing in as new owners (who in effect transfer some of their savings so that the taxes of the former owner can be paid) persons who manage the business but who would not otherwise get to own much or any of it, constitute probably the clearest, most direct means of achieving this important non-revenue objective.

One disadvantage is that an agreement definite enough to be effective may not be sufficiently flexible for best, or even good, results. What is good today may not be so attractive ten years from now. Though most family-owned businesses could probably make adjustments without significant difficulty, there will be some in which differences of opinion or family conflicts or the interests of minors or some other restriction will seriously complicate adjustment. Complications are greater where more than one family is involved. Legal difficulties growing out of corporate charters or state laws, or rights of creditors, or interests of minority stockholders, or employment contracts may prove very troublesome. New persons may be admitted to the plan only with difficulty. Changes in tax and other laws may upset arrangements otherwise satisfactory. The mobility of officers may be reduced because of difficulties in sale or adjustment of interests in plans. What is a good working team may break up. The plan

Fifth Annual Institute on Federal Taxation 54-75 (1947). See also Laikin, op. cit. supra note 46, especially the appendix of “illustrative clauses” for possible use in agreements.
itself may provide a source of conflict within the group. Moreover, the plan will be of little help if the purchasers do not have liquid assets.\textsuperscript{88} Insurance or other financing plans involve costs and tie up funds which may be badly needed in the business. This type of plan is not well adapted to attract outside investors unless the date of death is reasonably certain. The existence of such a plan may make later recapitalization more difficult.

There appears to be a clear trend toward greater use of stock-purchase agreements, though there seems to be no basis for measuring the trend or the magnitudes because of the highly individual nature of the arrangements. Most common, apparently, is the plan providing for funding by life insurance, with trusts often used to execute the details. The growth of these plans is not an unmixed blessing for society.\textsuperscript{89} Inflexibility may seriously hamper the family-owned business in adjusting to changing events. Admitting that such plans often seem to offer the owners a good solution, one can still deplore the potential restrictive effect on the business and the family over ten or twenty or thirty years. Finally, many plans are drawn by persons not sufficiently able or painstaking to do the best job possible; families and firms are likely to find ahead much trouble and expense which might have been avoided;\textsuperscript{69} the problems are relatively new in our society, and not many persons have yet had the experience and training necessary to give the very best advice.

\textit{Accumulate liquid assets.}

Another obvious type of adjustment is to accumulate assets other than insurance which can be easily sold for cash. Some of the stock (or debts of the business held by the owner) may be sold. The difficulties of making a satisfactory sale are very great especially if the business is not large. In recent years stock of giant firms has sold at very low capitalizations of earnings and for low fractions of book value; the small, unknown firm can hardly expect to get even equally attractive terms. No sale at all may be possible without loss of control. And tax (at capital gains rates) must be paid. Sometimes, however, a market may be arranged with key employees or a pension or

\textsuperscript{88} It is, of course, not necessary that they own enough liquid assets. Borrowing with the stock as collateral will often be feasible.

\textsuperscript{89} The plans in addition absorb time and attention of the businessman and involve him in legal, insurance, and trust costs which may be far from negligible.

\textsuperscript{69} The problem illustrates well the fact that in buying specialized services the consumer may be inherently incapable of judging quality or of comparing the results he will get from different possible specialists.
profit-sharing fund. The business itself may sell assets (perhaps concluding a sale and leaseback of real estate) or fail to reinvest all depreciation allowances.

Saving out of current income may be increased—in effect putting the real burden of the death tax in the years before the death.\(^6\) Investment policy may be revised to put greater emphasis on highly liquid assets. Non-liquid real estate or art objects or investments may be sold and the proceeds put into highly liquid investments.\(^6\) An unhurried liquidation managed by the businessman may get better prices than the executor could get. Sale to employees may provide the kind of broadening of management interest and incentive mentioned in the preceding section.

To varying degrees this method has the general economic disadvantages already noted when investments are put in highly liquid form. The capital is not available for business expansion. More serious, perhaps, is the fact that the family may have few assets outside of the business which it can sell. The aid that can be obtained by liquidation of non-business assets, or by special saving, before death will often be slight.

Proceeds of liquidation may be held by the business owner or may be given to his prospective heirs. Sometimes they may be accumulated by the heirs or by business associates who have prospective purchasers of stock. They may be left in the business. When the assets are in the decedent's estate, they obviously form part of the death tax base. There are likely to be strong tax arguments for trying to get the accumulation of liquid assets into the hands of prospective heirs. However, family considerations, such as the reluctance to make children independent, may outweigh the tax aspects. If the liquid assets are in the business, not only will its taxable value be increased, but also there may be difficulty in getting them into the estate for payment of tax. The cash may have become part of the working capital of the business which can be spared only at the sacrifice of profits.

\(^6\) The tax reduction effected by the income splitting of the 1948 Revenue Act should make it much easier for many prosperous families to increase their saving, just as the marital deduction reduces the need for liquid assets in many estates. There are, of course, good tax reasons, as well as business reasons, why the family may not want to disburse corporation profits as dividends.

\(^6\) Obviously, capital gains tax considerations must be taken into account. The existence of a method of (some) permanent avoidance of tax on capital gains (holding the assets until death) complicates estate planning because it creates another important tax consideration. Though space limits preclude adequate discussion, the author would like to record his belief that the tax structure could be improved by removing the exemption from income tax of capital gains unrealized at death.
ment of tax. The cash may have become part of the working capital. The estate tax may force some such contraction. Even though the business has liquid assets it can spare, they may be distributable only as dividends which will be taxable under the personal income—cases in which, though corporation income tax will have been paid, the owners will not have paid personal income tax on the reinvested earnings. Tax provisions are designed to limit the avoidance of personal income tax on property withdrawn from a corporation to which it has been income. One may with good reason dislike the double taxation of corporation earnings paid out in dividends—the author certainly wishes that this system had not grown up. But, since the system does exist, the reasons for checking avoidance by some taxpayers when others must pay are persuasive. The taxpayer will naturally search for loopholes. Yet as the law now stands, no wide loophole is available. The law looks with great suspicion on transactions between a closely-held corporation and its major stockholders. Use of the corporation's cash to repurchase stock held by the major owner is likely to create income tax liability at regular rates, and even if the favorable capital gains treatment is obtained, the tax may seem high because of a low basis. If the corporation is in debt to the owner, however, cash may be used to retire the debt.

Some help may be found in recapitalizing the business to get securities which can be more easily distributed, marketed, or pledged against a loan. Yet the family-owned business may be plagued by the closeness of its ownership; the Supreme Court has held that the issuance of certain new securities (debentures) to common stockholders by such firms will be taxed as dividends (assuming adequate "earnings and profits" accumulated since March 1, 1913). It may be possible, however, to declare stock dividends, such as an issue of new preferred, which can be sold without incurring tax at more than the

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63 See, for example, Int. Rev. Code § 115(g). A distribution in liquidation, however, may qualify for tax treatment as a capital gain (or loss).

64 Proposals have been made to permit corporations to repurchase stock and in effect treat the gain as a capital gain (technically treatment as partial liquidation). Report of the Special Tax Study Committee to the Committee on Ways and Means of the House of Representatives, 80th Cong., 1st Sess. 28 (1947).

65 This consideration may add another tax advantage of using debt rather than equity forms in corporation capitalizations.

66 Somewhat complicated provisions of the statute are involved. Int. Rev. Code §§ 112(b)(3), 112(g)(1), 112(f)(1) and others. See Adams v. Commissioner, 331 U.S. 737 (1947) and Bazley v. Commissioner, 332 U.S. 752 (1947); Tarleau, Corporate Recapitalizations as Affected by the Adams and Bazley Cases, New York University Sixth Annual Institute on Federal Taxation 266-278 (1948).
rates of capital gains. Or the preferred stock might be used for gifts, leaving the major owner with common stock of much lower value yet with voting power to control the firm. Because the state of the law is somewhat uncertain, and the facts in individual cases (previous capitalization, position of minority stockholders, state law, creditors' rights, etc.) will have an important bearing on the outcome, taxwise and from other points of view, one must be cautious in generalizing. It may be concluded, however, that recapitalizing may make the use of other devices easier. The liquidity of a large business may be increased by public sale of some of the new securities, depending upon the general condition of the capital market.

Dispose of the business as such before death.67

A different type of solution is to sell the entire business before death for assets that will be liquid. But to whom? Who with cash or similar assets will want to buy a family-owned business? And on reasonable terms? What may be the effects?

In some ways the most attractive type of purchaser is a large corporation which has relevant experience and can reasonably hope to operate successfully so that it can offer good terms, which can offer its own securities having a wide market, and which can conclude a tax-free reorganization.68 If a "sale" to such a corporation is completed, the former owner realizes no capital gain; he gets securities having for him the basis of the securities of the business which he transferred. He can hold this stock until he dies, his executor can sell an actively traded issue, and no capital gain will be recorded on the appreciation up to the time of the decedent's death. Another closely-held business, or key employees, cannot offer stock which will have a wide market in the volume needed to pay estate taxes. A sale for cash will give rise to income tax liability on the capital gain.

Though members of the family may retain jobs, the family nature of the business is destroyed. This tends to create larger business units, to concentrate business in larger firms, and to divorce ownership and management. The growth of the concentration of business can be criticized on many grounds, but the issues raised are beyond the scope

67 For a discussion of related tax problems see Stock, Purchase and Sale of a Corporate Business, 27 Taxes 627 (1949). For a specific example see the case discussed by Vandeveer, op. cit. supra note 1.

68 Int. Rev. Code § 112(b)(3). Yet some types of businesses may have great difficulty finding buyers that can meet these conditions, e.g., automobile dealers and local service firms of many types.
of this article. However, the checking of industrial monopoly is a national policy of long standing. If the estate tax stimulates such concentration, the effects should be eliminated. The question raised here is whether the estate tax adds significantly to concentration. Unfortunately, it is most difficult to isolate reasons for these concentrations.

The numerous mergers of the 1920's preceded heavy death taxes and seem to have been dominated by other considerations. In the late 1930's there was another wave of mergers, largely in distribution. There have been several hundred recorded mergers annually in recent years. The Federal Trade Commission, from sources it reports as incomplete, has learned of 2,450 mergers of manufacturing and mining concerns from 1940 to 1947, with an upward trend evident in the more recent years. Total assets of these firms were $5.2 billion, 5.5 per cent of the 1943 assets of all manufacturing firms in the United States. Well over half of the firms merged had assets under $1 million and almost all of the others had assets not over $4 million. Yet more than one-fourth of the acquiring firms had assets over $50 million and about half had assets over $10 million.

In its published studies the Federal Trade Commission makes no mention of the tax considerations we have been discussing. Testimony of men in close contact with actual cases, however, affirms that estate tax considerations have played an important part in specific cases. There is little reason to doubt that the estate tax has had some tendency to stimulate mergers. As the tax has been reducing personal concentration of wealth, it may have added to forces making for concentration by firms. Yet we know nothing about the over-all quantities. We cannot measure the significance of this force, although the cumulative effect over a period of years may be great. Nevertheless, this solution may sometimes be the best for the businessman, if not for society, although not all families will have equal access to it. Some kinds of businesses may not lend themselves to large-scale ownership. Other factors may outweigh tax considerations so that mergers cannot be concluded. Potential buyers, fearful of anti-trust prosecution, may be unwilling to make offers. Some firms may be unable to learn about opportunities.

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69 See, for example, Federal Trade Commission, Report . . . on the Merger Movement: A Summary Report (Washington 1948). Mergers of firms engaged in "commerce," such as retail trade, are not included.

70 Would the Federal Trade Commission, if it felt that federal tax laws were partly responsible, state such a belief publicly?
Merger is not the only method of sale, of course. Going concerns can sometimes be sold outright, perhaps with management retained. Less attractive tax consequences may be outweighed by other features. Although potential buyers may be of many types, the most common is probably the family or group which has capital which it would like to invest and build into large capital gains (which need not be realized); perhaps this is one of the most likely ways to build a fortune in America today. A profitable business whose earnings can be reinvested offers such an opportunity. Each case is unique, and the outsider can have little basis for generalization.\textsuperscript{71}

CONCLUDING COMMENT

Many students of taxation have urged that our estate and gift taxation “system” be tightened to close wide loopholes and to increase tax revenue. For reasons which are not appropriately discussed here, the author subscribes to this general view. Yet it should be clear that any substantial tightening of the system to get additional revenue would make the adjustment of the family-held business just that much more difficult than it is today, with many more businesses affected.

The estate tax is a tax on capital and may for that reason be a desirable supplement to taxes on consumption and on income. But the tax is not payable in the capital on which it is imposed. It must be paid in dollars. Some assets are not easily convertible to dollars. A prerequisite to reform and to tightening the system is careful overhauling of the provisions for payment of tax. What can be paid easily by one estate may be a crushing burden on another of equal size but different pattern of investment. There is no easy, simple solution. High taxes are burdensome. Family businesses suffer and with them the general economy. The real burdens can be reduced, however, and the bad results for society alleviated.\textsuperscript{72}

\textsuperscript{71} The appearance of advertisements in financial papers offering to buy businesses outright is not uncommon. The terms offered and the motivations are not easily learned by an outsider.

\textsuperscript{72} In view of the apparent failure of private (and government) financial institutions to develop to meet “adequately” the “needs” of small and closely owned businesses, it would not seem safe to assume that even if no specific provision is made in the tax our economy is sufficiently free, flexible, and responsive to assure that private profit-seeking institutions will arise to meet needs at a reasonable price.