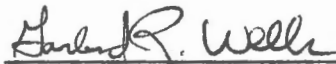


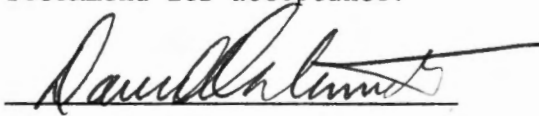
To the Graduate Council:

I am submitting herewith a thesis written by Carolyn Graves Stubbs entitled "Estate Taxation of Forestry Enterprises: A Case Study of Family Ownerships." I have examined the final copy of this thesis for form and content and recommend that it be accepted in partial fulfillment of the requirements for the degree of Master of Science, with a major in Forestry.



Garland R. Wells, Major Professor

We have read this thesis and
recommend its acceptance:





Accepted for the Council:



The Graduate School

ESTATE TAXATION OF FORESTRY ENTERPRISES:

A CASE STUDY OF FAMILY OWNERSHIPS

A Thesis

Presented for the

Master of Science

Degree

The University of Tennessee, Knoxville

Carolyn Graves Stubbs

August 1983

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ABSTRACT

This thesis was written by the case study approach. Presented was a real case study of a large, multigenerational, family forest ownership. Estate planning procedures, including the creation of new forest business enterprises by incorporation and partnerships with family members were documented. The family members' goals of passing on the managed forest land in an unbroken form, while minimizing federal estate and income taxes were examined.

The study objectives were:

1. To evaluate by contrast the two administrative management decisions, i.e., the advantages and limitations of partnerships versus incorporation as applied to the forest estate.
2. To analyze all of the case decisions regarding forest business organizations and estate planning for the purpose of identifying the existence of principle(s) favoring the decision of choice.

The thesis was organized in such a manner to serve the purpose of classroom instruction in an envisioned senior-level forest management course.

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CHAPTER I

INTRODUCTION

Overview of the Problem

In the south, large forest holdings of 500 acres or larger are often the most actively managed for timber production. Forest management plans providing for sustained-yield forestry often have planning horizons longer than the tenure of the owners. A single timber rotation is often multigenerational. Without estate planning, the perpetuation of the large forest estate as a profit producing economic entity is usually threatened.

Federal income and estate taxation provisions double-tax inherited property, since landowners or their heirs pay both on appreciation of the asset (including inflation) and on all income derived from it. In forestry, heirs must often sell all (or part) of their land and timber in order to pay death taxes. This has caused many family holdings to be either broken up with associated lower productivity or transferred to forest industry. The stability of private forest management programs depends on estate planning to avoid the forced liquidation of immature stands or distressed sales of either land or timber.

There are several approaches of insuring continued management of forest estates: long-term timber lease, corporate trusteeship, incorporation, and family partnerships are some examples.

Study Objectives

This study examines an actual case of a large family forest holding that was divided by death. Estate planning of the residual properties led to two different forms of business organizations providing for future heirs, namely, incorporation and partnership of family members. The common goals of both actions were to maintain family ownership and prevent future fragmentation.

The objectives of the study were twofold:

1. To evaluate by contrast the two administrative management decisions; i.e., the advantages and limitations of the partnership versus incorporation as applied to the forest estate.
2. To analyze all of the case decisions regarding forest business organizations and estate planning for the purpose of identifying the existence of any principle(s) favoring the decision of choice.

Despite the known diversity in forest ownership goals and situational factors, do specific patterns exist that are common to all forest estates? Do key determinants exist that favor specific administrative management options and can they be identified?

Forest Business Organizations

The estate tax (an excise tax on the right to transfer property at death) has put tremendous pressure on continuous timber production and on the stability of family ownerships.

Rising land and timber values, along with inflation, have increased the value of southern timberland above its immediate income potential. This has resulted in higher potential estate tax brackets for many large forest land ownerships.

The landowner's concerns to minimize income taxation and to pass his assets on to his descendants with the lowest possible estate tax has led to the study of alternative forest business organizations combined with estate planning tools that may achieve these goals.

In Tennessee, the shift from individual ownerships has been toward the business organizations of corporations and partnerships. Table 1* breaks down the large ownerships (500 acres or larger), in Tennessee, by ownership class. It indicates that in 1976 there were 197 nonindustrial forest corporations that collectively controlled 939,300 acres. The partnership organizations are included in the multiple ownership class, which numbers 10 ownerships with 14,800 acres. These figures indicate that these organizations, especially corporations, are important forms of ownership in Tennessee.

The undivided ownership class should also be noted. It generally represents those estates which have not yet been distributed to individual heirs. In the past, this has in part been due to the owners dying intestate (without a will) and beneficiaries owning undivided interests in the estate. Regardless of the reason, this form of ownership has many drawbacks. Estate shrinkage, diversity of interest

*As analyzed by Charles C. Niehaus in a Master's thesis, The University of Tennessee, Knoxville.

Table 1

Number and Acreage of Large Nonindustrial Private Forest Estates
(500 Acres or Larger) by Ownership Class in Tennessee, for 1976

| Ownership Class | Number of Ownerships | Percent of Total | Number of Acres | Percent of Total |
|---|-------------------------|---------------------|--------------------|---------------------|
| Individual | 1034 | 73.4% | 1,157,100 | 49.5% |
| Corporate | 197 | 14.0 | 939,300 | 40.3 |
| Divided ^a (2 owners) | 100 | 7.1 | 125,800 | 5.4 |
| Multiple ^b (more than 2 owners) | 10 | 0.7 | 14,800 | 0.6 |
| Undivided | 62 | 4.4 | 82,100 | 3.5 |
| Institutional | 5 | 0.4 | 15,700 | 0.7 |
| Total | 1408 | 100.0 | 2,334,800 | 100.0 |

Source: Tennessee Division of Forestry, 1976 (14).

^aTwo owners, usually joint between husband and wife.

^bMore than two owners, frequently the heirs of a settled estate.

among members, and unstable ownerships are excellent examples of the need for estate planning. Perhaps a better organizational structure would help perpetuate management and productivity of the estate.

Table 2 divides the total commercial forest land of Tennessee into ownership classes for 1980. As shown in the table, the corporate form is again a major ownership class since it holds a significant portion of all private commercial forest land. It is important to note that this is other than forest industry corporations, where processing plants are involved.

Partnership organizations fall under the category of individual ownerships. Although the exact percentage they contribute is not distinguishable from the data, it is reasonable to assume they will become an important ownership class of the total commercial forest land in Tennessee, if current trends of other regions, such as the far west, become adopted in the state.

Purposes of a Case Study

The use of the case study approach has been recognized as a significant method for teaching. As Guttenberg (6) points out, the case study approach avoids the complexity of the pure theoretical method. In a case study, an individual firm is singled out and treated as an independent study. The approach is inductive as opposed to deductive logic. One looks at a single example, collects personal data, and analyzes the firm, per se, to determine which overall guiding principle(s) may be involved in the case.

Table 2
 Area of Commercial Forestland by Ownership Classes--
 Tennessee 1980

| Ownership Class | Area in Acres (thousands) |
|-----------------------------|------------------------------|
| <u>Public</u> | |
| National Forest | 557.2 |
| Other Federal | 267.8 |
| State | 318.1 |
| County and Municipal | 16.7 |
| Total | 1,159.8 |
| <u>Private</u> | |
| Forest Industry | 1,247.8 |
| Farmer | 4,548.1 |
| Miscellaneous Private: | |
| Individual | 5,023.4 |
| Corporate | 924.9 |
| Total | 11,744.2 |
| Total Nonindustrial Private | 10,496.4 |
| All Ownerships | 12,904.0 |

Source: Birdsey, 1980 (2).

In this study, a similar approach was used. The case study outlines the family history of an estate which was originally fragmented upon the death of the owner. Several different estate planning devices were employed by his descendants in attempting to prevent further fragmentation. The case was analyzed to see if there exist specific guidelines or principles for choosing each organizational planning device. An alternative hypothesis would be that all decisions should be made on a case by case basis due to their uniqueness.

The thesis is divided into three major parts: (1) the literature review supporting the introduction to the case study approach and concepts related to the case, (2) the procedure and the case development, and (3) the analysis and discussion of the case itself. It is envisioned by the writer that parts 1 and 2 would be appropriate for a classroom case study in a senior level course in forest resource management.*

*The class assignment of Chapters 26 and 33, or "The Tax Climate" and "The Case Concept," respectively, in the textbook Forest Resource Management: Decision-Making Principles and Cases (5) would be supplemental reading.

CHAPTER II

LITERATURE REVIEW

The Case Study ApproachThe Importance of Case Studies

Individually, case studies can not be completely used to predict a generalization of the effects death taxation has on all estates; however, collectively they can be an important way to demonstrate taxation's impact in forestry.

In 1953, Hall, in discussing forest taxation research, expressed the opinion that death taxes were a major drawback to maintaining sustained-yield operations and ownership stability on forest lands. Hall emphasized the complexity of the problem and suggested that the case study method was the best approach to determine its extent. However, he recognized that to obtain successful case studies the full cooperation of forest owners is essential (7).

Case witnesses are frequently used in lieu of written cases. For example, they did furnish considerable evidence during the hearing before the Subcommittee on Estates and Gift Taxation of the Committee on Finance prior to the passage of the Economic Recovery Tax Act (ERTA) of 1981. Testimony by farmers, foresters and small businesses supported the need for legislation to ease the heavy tax burden of the small entrepreneur and their estates. Actual case witnesses contributed about 25% of all witnesses supplying testimony at the hearing. Generally,

constituents with evidence of real problems can carry much more "weight" than so-called expert witnesses (15).

Robert Weil, of Weil Brothers Cotton, Inc., was an important case witness exemplifying the fact that estate taxation had a deleterious effect on the perpetuation of closely-held businesses. Whether cotton, tree or other types of farming, estate taxes and illiquidity hinder passing family businesses to younger generations. Weil pointed out in his testimony that with high estate and gift tax rates, owners of small family businesses have four options:

1. liquidation of the business
2. small corporations can sell stock to the public
3. embarkation on legal but sometimes complex tax avoidance schemes
4. sell out to a larger business.

The latter choice of selling out to a larger company was the least complicated and most frequently used method to avoid realizing losses from excessive income or death taxes (15).

William H. Stimpson, chairman of the board of Gulf Lumber Company, in Mobile, Alabama, addressed the problem that excessive federal estate taxation endangered the United States' long-run timber supply. According to Stimpson, the United States is headed for a shortage of timber in the next few decades. The excessive estate taxes force premature cuttings and deters investment in reforestation on private forest land. Stimpson endorsed federal tax provisions that take into account the initial high capital inputs, the long-term capital investment and the

uninsurable risks that surround forestry. Forestry is also competing with other economic sectors that usually pay much higher net returns on investment (15).

A letter from the Society of American Foresters (S.A.F.) to the subcommittee combined the views of Weil and Stimpson. The S.A.F. policy was that federal tax provisions should support forest conservation and promote stable ownership patterns. As they stand, estate taxes impose double taxation of forest lands--on the transfer of the appreciated asset and on income derived from it (15).

The Society's letter also pointed out that estate taxes often force drastic cuttings to pay estate tax liabilities, and that these premature and/or excessive harvests are detrimental to intensive management plans. Such large harvests could also flood local markets, forcing down prices. Prices offered during distressed sales are frequently so low that all (or part) of the estate may have to be sold either to a large real estate developer (subdivider) or to a forest industry. Moreover, death may be untimely with respect to market cycles, forcing the property to be sold at low (trough) prices in order to settle the estate within a reasonable or legal time frame (15).

American Institute of Inheritance

In an article published in the Timber Tax Journal in 1965, James G. Yoho (16) examined the impact the "American institute of inheritance" had upon the breakup of large estates. The "American institute of inheritance" is the widespread idea on the part of landowners that regardless of the number of heirs one has, the estate must be equally

distributed among them. Yoho cites George Lucas' Master's thesis at Auburn University on this topic. In Lucas' thesis, an important finding was that the "American institute of inheritance" was more of a cause for fragmentation of estates than were the expected death taxes. The equal inheritance approach is often backed by state laws of descent (3).

Siegel (12) issued a more recent interpretation of the point. Explaining that the "American institute of inheritance" is similar in concept to French civil law, and unlike the English common law where the eldest son usually inherited the landed property. In civil law all heirs share equally regardless of sex and even Will instructions are overridden by the code. The same effect can happen in many states if the landowner dies intestate. Children would share equally or in some proportion with the spouse, who frequently receives a life's interest. This scenario may be what Lucas was observing in his early study, rather than a positive step to divide the property equally.

In an article published in 1982, Jeffery Rosenfeld (11) expanded on the problem of the "American institute of inheritance" with the observation that life styles and marriage patterns of Americans are becoming more and more complex. The present trends of divorce and remarriage result in estate owners frequently having step-children and step-grandchildren or no heirs at all. This creates interesting problems for estate planning with many lines of descent. The complexity of this problem furthers the need for intensive estate planning.

Attorney and Advisor Bias

Attorney bias in estate planning can be a major limitation to the case study approach. Lawyers often favor a specific organizational method due to its history of favorable district court rulings. The method that has been widely used and examined in their specific legal district logically would be the one they more enthusiastically endorse. Often times it is the only primary plan of action they will recommend to their clients with an interest in estate planning. Such a bias could limit the usefulness of the case study approach, because the method observed being used by the landowner might not reflect the owner's individual needs but more likely reflects the preference of one's attorney and the practicality of avoiding later court challenges.

Tax accountants, likewise, may be biased toward either one business organization or the other. Such bias could be from bad personal business experiences and/or challenges made by the Internal Revenue Service in audits of their clients.

Corporations and Partnerships

In 1980, Peale (8) explained that estate planning was necessary to retain an owner's control over his land and to insure its passage to younger generations while minimizing tax and expense liabilities. Rising land and timber values, along with inflation, have increased the necessity for estate planning to meet these goals.

Peale made the points that the illiquidity of forest lands results in extreme financial pressure for estate executors, forcing the sales of

timberland. Problems arise in finding a buyer; the price paid is usually discounted below the actual market value. To insure complete transfer of all land and assets to the beneficiaries and continuous management plans on the death of the owner, the owner must choose one or more estate planning tools that best meets his situation (8).

Life insurance, an authorized will, and full use of federal legislation, such as the Unified Tax Credit and Special Use Valuation, are essential to estate planning; but when a large estate is involved, a more intricate organization, such as a family corporation or a partnership capital freeze, is needed to establish a thorough management plan.

Corporate Capital Freeze

Incorporation is a widely used planning method to ensure continuous management of forest land (13, 10, 9). However, a corporation is a complex entity which is strictly controlled by state laws.

The major benefit of the corporate form is the corporate capital freeze. It is frequently proposed as an effective corporate organization devise for the intent of managing the real property of a single landowner and his family, namely the closely-held corporation. With the use of two types of stock, preferred and common, the corporation can be used to freeze the assets of the elder generation and shift future growth to the younger generation. This can be obtained by distributing the preferred share to the older members proportional to their contributions of real property to the corporation and the zero value common shares to the heirs without a contribution requirement (1).

The preferred stockholder freezes the value of his contributions at its fair market value at the date of contribution. Under the specifications of the corporate chapter, the preferred stock has a set preference value per share and upon liquidation or dissolution, all asset value above this preferred interest is distributed to the holders of common stockholders.

This freeze prevents inflation and increasing land and timber values from being added to the preferred shares, and upon the death of the preferred shareholder his estate tax liabilities are held to a minimum.

The corporate form has many inherent advantages. One obvious advantage is limited liability. That is, the maximum loss that a shareholder in a family corporation could realize is the value of his or her stock. The value of the stock would be low and normally discounted since it would have little value in the market. Another advantage is the ease of gifting stock to younger generations. Real estate, including timberland, is not always easily divided and fragmentation is usually undesirable to overall productivity. Another advantage of corporations is that insurance needs of the manager, president or principle head can be met as deductible* premiums to the corporation, while providing some liquidity to their estate.

When creating a corporation, certain characteristics must be met. Powers (10) established the following list to summarize these characterizations:

*These are deductible only for \$50,000 group term insurance.

1. A directed business objective created to turn a profit
2. A designated management group
3. Continuity of management and existence
4. Limited liabilities
5. Transferable interest
6. Associates

The drawbacks of incorporation must also be considered. The procedures involved to form a corporation require extensive legal advice and, therefore, are most often costly. The employment of an accountant is also recommended to establish a working accounting system for the new business.

The most often objectionable characteristic of a corporation is the restricted flexibility due to corporate by-laws. An example is the difficulty in transferring property in or out of the corporation (1).

The taxation of a family corporation can also be a deterrent for using this planning method. Sizemore (13) approached the question of ownership forms with a case study comparison between the individual ownership and the corporate form. In his 1967 study, Sizemore concluded that the individual form of ownership would be preferable to the corporate form largely because of corporate double taxation as compared to rates on personal income. Since 1976, tax laws have been significantly changed and now favor even more the individual owner.

The following corporate tax rates, for 1983 and after, are listed in the Internal Revenue Code:

| <u>Income</u> | <u>Rate</u> |
|------------------------|-------------|
| First \$25,000 | 15% |
| Over 25,000 to 50,000 | 18 |
| Over 50,000 to 75,000 | 30 |
| Over 75,000 to 100,000 | 40 |
| Over 100,000 | 46 |

Long-term corporate capital gains are taxed at the lower of the appropriate tax rate or flat rate of 28%.

Taxes could be the determining factor for not choosing a corporate form but for those landowners with a large income from a business other than real estate, the additional income that they receive from this land would be taxed at their high personal tax bracket.

In the long run, for the high income landowner, it would be best to keep their personal income to a minimum and tax the entire long-term capital gains from the real estate at the 28% corporate rate.

The issue of double taxation of corporate dividends concerns many estate planners. The income of the corporation is taxed at the corporate level and then taxed at the personal level of the shareholder upon distribution of dividends. This action can devastate the financial return from a corporation. This disadvantage can be avoided by waiving the right to receive dividends and using salaries, which are deductible by the corporation, can be warranted to provide income to the shareholders.

*Excluding alternative minimum tax considerations which could increase the tax to 25%.

The above disadvantage is especially a problem of a forest corporation that is chartered to both buy and sell timberland. The qualification for long-term capital gains is more difficult to meet, since the corporation would be considered in the real estate business rather than an investor in real estate. However, with a timber processing plant, the corporation could qualify under Section 631(a) (IRC).

Another disadvantage of corporations involves timberlands containing minerals and/or oil and gas. Depletion allowances (percentage depletion) on royalties are unavailable for corporations but are available to individual proprietors. Thus, individuals having royalty income production or such potential from timberland would either lose their depletion allowances or have to separate the land and timber from the minerals at the time of incorporation.

Partnership Capital Freeze

The partnership agreement is an accepted alternative to incorporation to obtain the goals of continuous management and minimizing estate taxation. The family partnership is similar to the closely-held corporation, in that the partnership freeze can be used to halt future appreciation on property placed in the organization.

Demorest (4) discussed this newest technique of freezing and its similarities to the corporate form. The partnership freeze, like the corporation, may entail two types of interest--preferred and common. These correspond to their corporate counterparts in the way they are distributed and the shift of future growth to younger generations.

Powers (10) has described in more detail the characteristics of the partnership capital freeze. The partnership form is not subject to double taxation. All profits or losses are distributed among the partners and then taxed at their individual personal tax rates.

The establishment and altering of a partnership are designated as tax free under the IRC Section 721(a), as is the corporation under Section 351. The partnership is less restricted and can be molded to fit personal interests (10).

When creating a partnership, care must be taken to not inadvertently create a corporation. If the majority of the corporate characteristics, as listed under the corporation capital freeze section, are filled by the partnership agreement then it too can be treated or taxed for federal income tax purposes as if it were a corporation (10).

The partnership also has its disadvantages. The most serious is the fact that each partner's liability is unlimited. Not only are partner's specified contributions involved, but all of their respective personal assets could also be at stake.

The continuity of management and existence of a partnership is not as stable as that of a corporate form, but for many purposes this will not produce a hinderance and can be an advantage if it is to be terminated.

CHAPTER III

PROCEDURE AND CASE

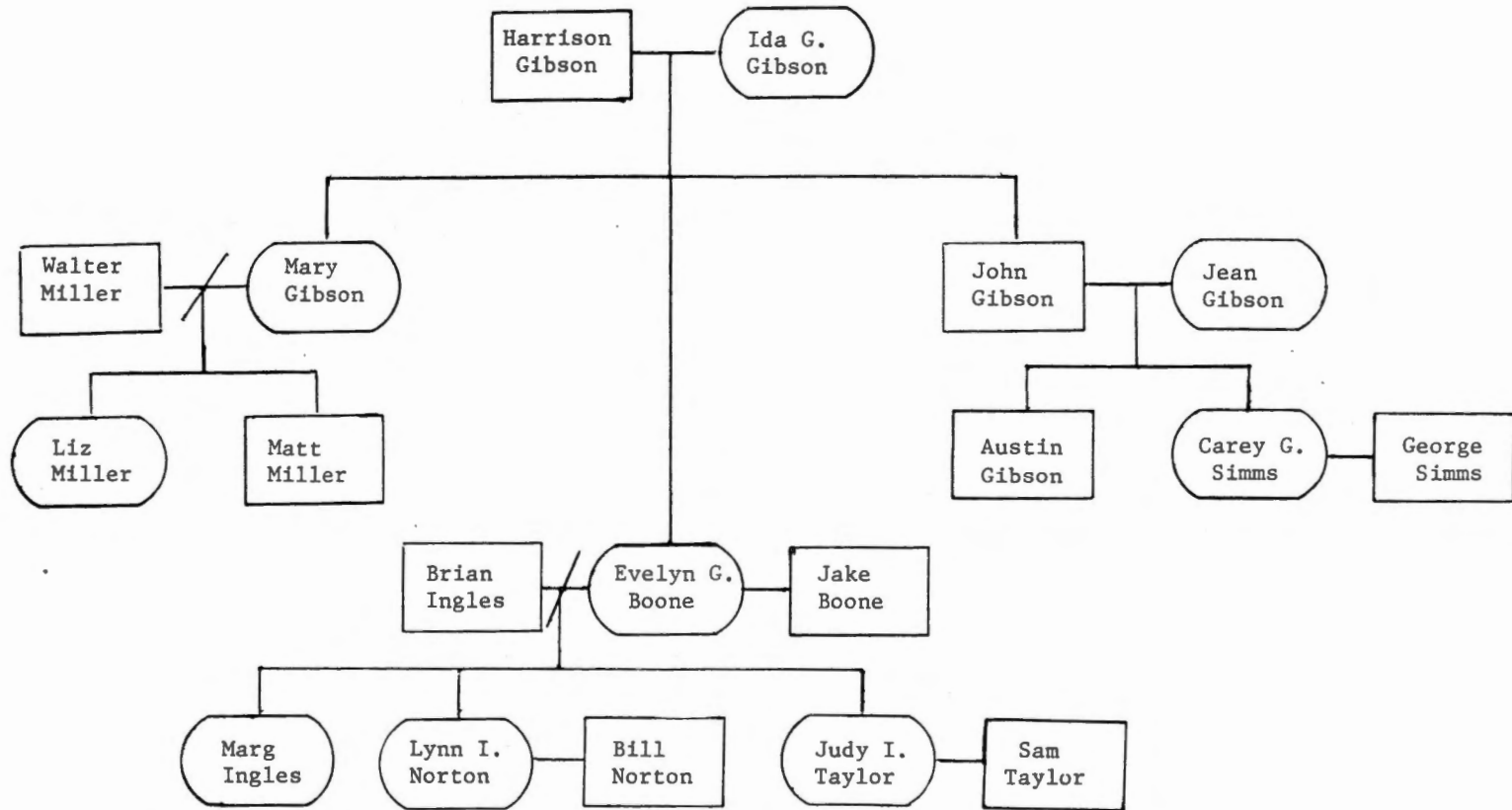
The case involved one family, Harrison Gibson and his heirs. Upon initiation of this study, the total confidence and cooperation of the individuals involved were achieved. This is a major obstacle that makes most case studies incomplete or impossible due to failure to gain access to financial affairs and obtaining the confidentiality for the personal information gathered. To respect this confidentiality, fictitious names have been substituted for all actual names in this case study.

The case involves the establishment of two business formations and it is important to note that their completion was by the fall of 1981 and all new changes in tax provisions of that time were in part taken into account.*

Acquisition of Case Information

The first step in information acquisition was to construct a family acquisition tree, see Figure 1, which established the lines of descent. Harrison Gibson, the head of the tree, began the family's acquisition of real estate and it was upon his death that the first estate fragmentation occurred and the need for estate planning became apparent. Within eight

*Both the 1976 Tax Reform Act and 1981 Economic Recovery Tax Act had sweeping death tax reforms, which were generally known but neither from a practical standpoint were fully comprehended nor tested in the courts at the time of the case. Since the case's construction, additional changes by Tax Equity and Fiscal Responsibility Act of 1982, affecting partnerships and corporations to a "minor" extent, was passed.



[A slash (/) through marriage lines indicates divorce.]

Figure 1

A Three Generation Family Acquisition Tree for the Family of Harrison Gibson

years of his death, two of his three children, John and Mary, sought legal advice from the same tax lawyer. The result of his recommendations were two different organizational forms--a family corporation and partnership. The reasons behind choosing the different estate planning tools are the subject of this thesis.

The next steps in developing the study were the personal interviews with Mary and John to learn the reasons they chose a partnership and corporation, respectively.

Copies of both agreements and correspondences with the tax lawyer were obtained and summarized. Mary and John discussed their separate initial meetings with the lawyer and the advantages and limitations as he presented each business arrangement to them. Both parties had given the lawyer detailed records of their assets, liabilities, and business interests, which were essential to effectively planning the estates. These records were also made available for use in this case study.

After the tax lawyer was contacted, he contributed information concerning each organizational form. The tax lawyer in this case was perhaps exceptional, in that, he harbored no bias for the use of one estate planning method. His objectivity allowed analysis of the individual cases to develop plans that best fit each individual's specific needs and allowed the testing of the hypothesis that unique circumstances may shift from one business formation option to the other, i.e., partnerships versus corporations where timberland is involved. The alternative hypothesis would be that individual circumstances are so indeed unique that they alone determined the form of business when combined with estate planning needs.

The Case Study

Acquisition of Property

Harrison Gibson began his acquisition of land in the early 1900's upon the inheritance of 120 acres from his father. After his marriage in 1918 to Ida Graham, he increased his holdings by paying off a mortgage on her family's home and farm. In early 1929, he purchased 320 acres under term payments from a relative, and completed the payments 11 years later. According to Harrison's account reported by his heirs, having to pay \$12 per acre during an economic depression made this property, out of all he eventually acquired, the most expensive and the most difficult to obtain.

In 1931, Harrison renovated and began operating his father-in-law's cotton gin, which had been shut down since 1916. It helped supply him with capital to further increase his land holdings. During this time, the local bank was desperate to rid itself of the land they had acquired through foreclosure of loans and debts. The directors felt the land holdings were a burden to the financial soundness of the bank and approached Harrison with a deal to buy this property from them under the lenient terms of "whatever and whenever" he was able to pay. The landholdings and its property taxes were such a financial burden for the institution that they were willing to even give him portions of it to decrease the bank's liability. These transactions resulted in approximately 460 acres of more land for Harrison.

In late 1939, Harrison expanded into the lumber business by starting a sawmill. When negotiating to purchase timber from local

landowners to supply his sawmill, the landowners also wanted him to buy the land on which the timber was situated. Their reasoning behind this was not to be stuck with cut-over, "worthless" land with a property tax burden. This situation opened up many opportunities to purchase acreage.

Harrison had always wanted "more land than he could hunt on" but was weary of accumulating too much land because of the reminder that his grandfather had had problems in paying land taxes. He later commented that "if he had not been so cautious, he easily could have accumulated over 100,000 acres."

Harrison acquired most of his 10,000 acres from 1940 to the mid-1950's. When the cost went above \$15 per acre, the price seemed too high. He did, however, purchase 500-600 acres after the mid-1950's for \$50 per acre.

In late 1950, Harrison began gifting property to his three children, John, Mary and Evelyn. By his death in September 1972, Harrison had equally disposed of approximately 6,500 acres. In accordance with his will, the remainder of his estate was divided one-half to his wife, Ida, and the remaining one-half to be split among his children. The actual division of property was not specified, so the estate employed a forester to cruise and more equitably distribute the estate.

The death of Harrison resulted in the first fragmentation of the estate and measures have since been made to prevent further separation. Ida has left her portion of the estate, not to her children, but to her

grandchildren. The portion to be distributed to each grandchild will be the same as if a generation had not been skipped, that is, each grandchild's portion will be determined by their parent's theoretical one-third share divided among themselves and their siblings. In this case, John's children, Austin and Carey, will each receive one-sixth of Ida's estate, Mary's two children, Matt and Liz, will also receive one-sixth each and Evelyn's three children, Mary, Lynn, and Judy, will each receive one-ninth.

Most of the children and grandchildren of Harrison are now acutely aware that estate planning is necessary for continuous management and to prevent further fragmentation and possible forced sales.

John and Mary, along with their immediate families, have chosen different organizational methods to obtain these objectives. Evelyn has chosen to remain as an individual proprietor and her immediate family is not actively participating in the management of the timberland.

The Family Corporation

Upon consultation with a tax lawyer, the choice of a closely-held corporation seemed to be the estate planning vehicle that best fit John's goals and business situation. John owns and operates a pulpwood company and has been acquiring forest land in addition to the land inherited from his father. John was concerned with freezing his assets at their present value and transferring all appreciation to his children. The pulpwood company is a Subchapter S corporation, so the assets that will be included in the new corporation are cattle and timberland.

Following an initial meeting between John and his tax lawyer, the lawyer wrote the following letter to recap their office conversation of freezing the value of real property transferred to the corporation by use of two classes of corporate stock.*

FACTS

John Gibson, hereinafter referred to as Owner, desires to stop the appreciation on value on a tract of 3,500 acres of land, which is valued at approximately a million dollars, an undivided one-half interest in a tract of 1,200 acres of land which is currently valued at approximately \$180,000, and on a herd of cattle which is currently valued at approximately \$50,000. The owner indicates that he will never sale the land and that he does not wish to receive income from the land which would be taxed at his high income tax bracket. He states that he needs no income for his future security except for the wages he will earn as an employee of the corporation. The Owner also states that he desires to avoid the state corporate franchise tax on his appreciating investment in the corporation, if possible. At the same time, he desires to retain the voting control of the corporation.

INTRODUCTION

The basic purpose of the corporate capitalization by the use of two classes of stock is to freeze the value of the corporate stock in an estate and shift the growth in the business and the appreciation in value to a younger generation. All shareholders will be family members. The basic reasons that the corporate capital freeze was selected by the Owner are that he did not want to realize income from the corporation individually, that there would be no rental income to the corporation, that he is in a high income tax bracket, and that he is not concerned about the control of assets inside the corporation if he has voting control of the stock. Additionally, the Owner does not desire to sale his real property at any time and can foresee no situation in which he or anyone would desire to dispose of the real property prior to his death.

*Personal correspondence with an anonymous tax lawyer, Albany, Georgia.

THE PLAN

The plan is to form a Delaware Corporation which will avoid the state corporate franchise tax on accumulated state assets and to issue stock in two classes, voting preferred and nonvoting common. The voting preferred stock will have preferences of \$100 per share upon liquidation and noncumulative dividends of \$8.00 per share per year. The voting preferred stock will not share any assets in excess of \$100 preference and will be paid dividends only from current income. In addition, only the voting preferred stock will have voting rights in the corporation. The other class of stock will be nonvoting common stock, which will have no preferences. The nonvoting common stock will share in dividends only after the dividends have been paid to the preferred shareholders and will share any assets of the corporation in excess of the preferred shareholder's liquidation preference. This nonvoting common stock is the class of stock which will be given to the children and will absorb future appreciation of the corporation. The Owner will have a cruise and a valuation of the real property made and the value established as of September 1, 1980.

STEPS IN CORPORATE CAPITALIZATION

The first step is to analyze the assets and earning power thereof and determine the minimum and maximum possible values of the assets which are to be transferred into the corporation. It is necessary to ascertain the value and it is recommended that you obtain an outside appraiser to appraise the assets as the Owner has done.

Step two is for the corporation to be formed and the issuance of the two classes of stock based upon the values obtained in step one. Also, gifts of the stock will be prepared and the gift tax cost, possible gift tax deficiencies, and gifts valued by the IRS must be determined. These are gifts which should be made to the parties who are the natural objects of the Owners bounty. In this case it would be his children and possibly his wife.

Step three requires comparison of the various available methods of freezing the value of the Owner's estate, installment sales which result in capital gains tax, and interest income and cash flow to the seller. Also, we would review possible gift tax resulting from IRS regarding valuation of property sold. We would determine the worst economic effect it could have on each individual. We will consider getting some cash or hard assets to the Owner with a minimum of income tax exposure. The reason we do not mind getting hard assets back to the owner is because these will

not be subject to higher valuation but are hard assets and would be available to take care and provide security for his wife after his death. This step is optional and can be done at a later time.

Step four will be the actual issuance of stock and it will be determined whether we are going to obtain any common stock or not. It is my recommendation that you do not retain any common stock. The preferred stock which you will obtain will be distributed to you from the new corporation and will have the entire current value of the corporation associated with it. At that time we may make a gift of approximately \$100,000 to your wife.*

The main reason a partnership would have been chosen would be to allow a flexibility in the sale of the land but John indicated that he is never going to sell the land. John would be taxed on the income from the partnership which would be a disadvantage. This would result in higher tax on John when the lower corporate rates would be available. John has the forestry knowledge that will allow him to be a consultant to the corporation, and in the event of retirement or disability he will be able to continue drawing a salary. John also personally owns large machinery, such as road scrapers and reforestation machinery, that can be rented to the corporation for further income.

Upon incorporation in the fall of 1980, the corporation had the authority to issue 2,950 shares in all classes of stock, which were divided into 1,475 shares of voting preferred stock which are without par value, and 1,475 shares of nonvoting common stock which also have no par value. The voting preferred stock will have the voting power of the corporation, a preference upon liquidation of \$2,000 per share and

*Personal correspondence with an anonymous tax lawyer, Albany, Georgia.

preference of \$160 per share, per year on any dividends paid from the current earnings during a fiscal year. The nonvoting common stock will have no voting power and will share all corporate assets upon liquidation in excess of the preference of \$2,000 per share for the voting preferred and will share all dividends in excess of the noncumulative preferred stock dividend of \$160 per share, per year.

The issuance of corporate stock is as follows:

John Gibson--489 shares of Voting Preferred

Austin Gibson--100 shares of Nonvoting Common

Carey G. Simms--100 shares of Nonvoting Common.

John's 489 shares of voting preferred stock with the preference of \$2,000 per share account for the \$978,000 appraised value of his initial asset contributions. This value is frozen and upon liquidation or death will be the total value of John's stock. All appreciation that accumulates will be transferred to his children who hold all common stock shares.

John has chosen for the corporation not to distribute dividends. His reasoning is that dividends are taxed twice, once at the corporate level and again at the shareholder's personal income tax level. There is, however, a minimum accumulated earnings credit of \$250,000 above which the accumulated earnings tax (a penalty tax on unreasonable accumulations) may come into effect. To keep accumulation of earnings below this amount, expenditures such as reforestation and the purchase of forestland, can be used by the corporation.

John is the president and treasurer of the corporation and his wife, Jean, is the secretary. They are entitled to receive salary

but have currently chosen to waive this right to avoid taxation at their high personal tax bracket. In the event their outside income diminishes, they have the option to receive these wages for their personal financial security. All accounting and organizational procedures are those determined under the General Corporation Law of the State of Delaware.

In addition to the corporation, Carey and Austin have also entered into a family partnership with their grandmother, Ida. Upon her death they each will receive one sixth of her estate. Ida contributed this one third of her estate to the partnership and is the only preferred interest partner. The value of the contributed property is frozen at its fair market value at the date of contribution. Austin and Carey are classified as regular partners and have contributed no real property to the partnership. Under the specifications of the agreement, all appreciation upon liquidation and dissolution is distributed to the regular interest partners. This use of two types of partnership interest allows Ida to retain the present value of her estate with no future increase. Her estate tax liabilities on this portion of her estate will remain at their current level.

The Family Partnership

Mary began considering her financial situation and that of her children and decided to seek professional estate planning advice. Upon the recommendation of John, she met with his tax lawyer, and after consultation it was apparent that a family partnership would be their best means of estate planning. They considered incorporation but Mary

could not justify any salary other than that from running the corporation, which would not be a sizable amount for such a small corporation and upon her retirement or disability she could not justify any salary from the corporation.

The flexibility of a partnership is to her advantage since she may want to dispose of portions of her land to her children for additional income. The transfer of money in the partnership is also more lenient than for a corporation. In the event that a partner currently needs money, he (or she) may draw out the amount needed and it is debited from their partnership account.

The partnership agreement went into effect in the summer of 1981 with Ida, Mary, Liz, and Matt as partners. Its formation was for the owning, management and farming of certain real property. The Gibson Family Partnership management and accounting specifications are stated in the agreement and authorized by all partners. What follows is a summary of the partnership agreement.

The accounting records of the family partnership contain two equity accounts for each partner: (1) a capital account and (2) an income and withdrawal account. The capital accounts contain the initial property contributed by each partner to the partnership and any subsequent contributions. Removal of any part of the capital accounts must be unanimously approved by all partners. The income and withdrawal accounts contain all operating profits and losses attributable to the partnership. If the income and withdrawal account of any partner has a debit balance due to excessive withdrawals, the debit balance is charged

to the partner's capital account and this constitutes a violation of the partnership agreement. If this situation occurs, the partner's share of the future profits are credited to the capital account until the original balance is restored.

A financial statement is drawn up each month to show the amount subject to withdrawal by each partner from his own income and withdrawal account. Each partner may then withdraw this amount from his account, with these withdrawals charged against his income and withdrawal account.

There are two types of partnership interest in the partnership: preferred interest and regular interest. The preferred interest is entitled to a preference of the assets upon sale, liquidation or dissolution of the partnership. The preferred interest has preference value equal to the proportionate value of the property the partners initially contributed as preferred interests to the total value of all property initially contributed by all partners. The value of the liquidation preference of the preferred interest remains frozen at the values determined by the appraised fair market values of all initially contributed property at the date of the agreement. The regular interest is entitled to all assets upon the sale, liquidation or dissolution of the partnership which are in excess of the preference of the preferred interest.

Regarding the revenues and expenses of the partnership, all accounts are brought up to date at the end of each month by offsetting the revenues with the expenses. Any net profit is credited

to the income and withdrawal accounts of each partner. The preferred interests are entitled first to any annual net profits equal to that percentage of the liquidation preference of the preferred interest. The regular interests are entitled to any net profits in excess of the income interest of the preferred partners.

Each partner contributed designated real property assets to the partnership and these are enumerated for each partner in the partnership agreement. These contributions total 2206.69 acres valued at \$710,919 for Mary, 596.81 acres valued at \$197,390 for Ida, 207.00 acres valued \$73,309 for Matt and 165 acres valued at \$60,709 for Liz and constitute preferred partnership interest. These contributions are converted to percentages of the total value of contributed real property for all partners and are exchanged for the following partnership interests:

| <u>Preferred Interest</u> | <u>Value</u> | <u>Percent of Total</u> |
|---------------------------|---------------|-------------------------|
| Mary Gibson | \$ 710,919 | 68.21% |
| Ida Gibson | 197,390 | 18.94 |
| Matt Miller | 73,309 | 7.03 |
| Liz Miller | <u>60,709</u> | <u>5.83</u> |
| | \$1,052,327 | 100.00% |

Matt and Liz also hold regular partnership interest that has zero value at the date of the agreement, since the liquidation preference is equal to the fair market value of property contributed by the donors.

The termination of the partnership may take three forms: general, death of a partner, or sale of the partnership. The general termination can occur if any partner gives written notice to all other members with

termination occurring sixty days after the date of the notice. Termination of the partnership occurs at the death of a partner. All assets are distributed and then the remaining partners may chose to reorganize and enter another partnership agreement. The sale of the partnership constitutes dissolution and all proceeds are distributed among the partners.

Regardless of the type of termination, the following steps of dissolution and liquidation are executed.

1. Payment of all partnership liabilities, obligations and liquidation expenses.
2. Distribution of the balance of the income and withdrawal account to the partners with a preferred interest.
3. Distribution of assets so that all partners with a preferred interest will receive total assets with a value equal to its liquidation preference.
4. Equalization of the income and withdrawal accounts of regular interest partners by distributing assets to the partner with the higher balance to reduce his balance to that of the other partners but not below zero.
5. Equalization of the capital accounts of the partners with regular interests by paying the partner with the higher balance assets sufficient to reduce his capital account to that of the next highest partner's account balance.
6. Division of the remaining assets of the partnership equally between partners with regular interest.

The partnership agreement in consideration of Internal Revenue Code Section 704(c)(2) treats all depreciation, depletion, or gain or loss of partnership assets as shared equally among the partners so to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

The Gibson Family Partnership is designed to manage the land of Ida, Mary, Matt and Liz. It is also designed to ease the estate taxation responsibilities upon the death of Ida. Matt and Liz are to receive one sixth of Ida's estate each and since this one third is the amount contributed by Ida to the partnership. Since all of the contributions are frozen at their value at the initial date of contribution, all of the future appreciation will be shifted to the holders of the regular interest. Under this organization, the portion of Ida's estate which will be inherited by Matt and Liz will not increase in value due to inflation and therefore the amount of estate tax will be held at its current rate.

CHAPTER IV

ANALYSIS

Problems of Forest Ownership Estates

Powell (9) concisely summarized the problem that occurs between estate planning and forestland management with his observation that the estate plan takes precedence over the forest management plan. Forest owners, when planning their estates with the aid of an attorney, do not usually incorporate the multigenerational aspect of forest rotations to the estate plans. The result is discontinued forest management at the death of the owner.

The following are the unique characteristics that surround forestry and must be approached when planning a forest estate:

1. Multigenerational rotations
2. The need for liquid assets upon death, as a result of the illiquidity of timber
3. Timber production is an investment, not an immediate source of returns
4. Understocked timberlands have low production but result in high appraisals
5. The American institute of inheritance results in fragmentation of the forest into small uneconomical forest tracts.

The previous characteristics of forestry, that exist among all forest estates, should be combined with the following estate planning objectives to develop a workable forest estate plan:

1. Minimize income tax
2. Prevent fragmentation
3. Keep the tree farm in the family
4. Provide continuous management
5. Provide periodic income to meet the needs of the owner
6. Minimize estate tax liabilities
7. Provide estate liquidity.

In the actual case which has been presented, John and Mary Gibson, consulted with a tax lawyer to plan individual business forms for their estates while Evelyn Gibson chose to remain an individual proprietor.

In the analysis of the case, the ownership plans, family corporation, partnership and individual, will be examined to determine if the forest estate planning objectives will be met on the death of the major landowners.

The partnership and corporation forms will also be examined to determine if any principle determinants exist that favor specific administrative management options or is the choice entirely on a case by case basis.

Corporation

John's corporate form, upon his death, will not be dissolved and all the management plans will remain intact. The tree farm will remain as a single entity with only the preferred stock transferred. If it is transferred to his wife, Jean, no estate tax will be generated due to the unlimited marital deduction. Another possibility is that John plans

to will his stock directly to his children. Estate tax will be due upon distribution to the children but the land will still remain intact. This eliminates the possibility of fragmentation but does limit the flexibility of ownership.

The value of this preferred stock was frozen at the fair market value of the land at the time of contribution to the corporation and that value will be used in the computation of John's estate taxes. The appreciation of John's contributed forest land and cattle was transferred to his children by the use of common stock. This avoided having the appreciation included in his estate forcing the estate tax upward.

During John's lifetime, the corporation met his financial needs. As an employee, John could receive a periodic salary and even in the event of his disability or retirement, John could be paid as a consultant to the corporation and continue to have financial security.

For John, at the time of incorporation, the corporation actually minimized his personal income tax liabilities.* He was in a high personal income tax bracket due to income from outside the corporation. So for John, taxing the capital gains at the corporate level was lower before ERTA than it would have been if taxed at the combination of his high personal tax rate and the personal capital gains rate.

No earnings from the corporation were distributed in the form of dividends, so the income was not double taxed, once at the corporate

*Since the time of incorporation, the 1981 ERTA has been passed and the corporate tax rates are no longer an advantage to John, but are now comparable to his personal tax rates.

level and again at the shareholder's personal level. The earnings were instead allowed to accumulate (to the maximum of \$250,000), reinvested in the land and/or used for the purchase of additional acreage.

For John, the corporation met all the objectives of forest estate planning. This was largely due to his situation, in that, (1) John could justify a continuous salary from the corporation, due to his expertise in the field, (2) his high personal income placed him in such a high tax bracket that the corporate tax rated no major disadvantage, and (3) he never intended to sell the land so the corporation could claim capital gains treatment.

Partnership

Mary Gibson's partnership will result in dissolution at the time of her death due to the specifications of the agreement. This could disrupt management unless a new partnership is created soon after her death by the remaining partners. The agreement also states that the partnership could be dissolved if only one partner wished to dissolve it. This is a good example of the flexibility the partnership offers, but also its instability.

The portion of land contributed by Mary to the partnership will be willed to her children. It will be transferred in the form of real estate as opposed to partnership interest. This could cause fragmentation if divided between the heirs and not reentered into a business form.

Mary's preferred interest in the partnership was frozen at the lands fair market value at the date of contribution and that value will be used in the computation of Mary's estate taxes. This freeze minimizes Mary's estate taxes by holding the land value stable.

Upon freezing Mary's interest, the appreciation was shifted to her children through the use of common interests. Not adding this appreciation to the value of her interest also holds down her estate tax liabilities.

The income flexibility is one of the major advantages of this business form. Earnings of the partnership are divided among the partners proportional to the amount they initially contributed. These earnings are then placed in individual partnership accounts and can be drawn upon (to the extent of the balance) by the partners to provide income when needed. This was a major reason Mary chose this business form because it provided her with the financial security she could not have had in a corporation.

Individual Proprietorship

Evelyn Gibson, an individual proprietor, is married to Jake Boone and has three children by a previous marriage. This leads to three hypothetical situations of Evelyn's land disposition that will be reviewed: (1) willing a life-time interest to her husband and upon his death the corpus to be divided among her three children, (2) putting her estate into a trust with life interests for her children and the corpus going to her grandchildren, and (3) willing her entire estate to be equally divided among her children.

All three situations have the common factor that the land will be fragmented. In the cases involving a trust, the division will be delayed but will eventually occur. This results in small and usually unproductive tracts and any existing management plans will probably be abandoned.

The Special Use Valuation can not be used in Evelyn's situation because a qualification for its use is that the qualified heirs must materially participate in the management of the farm or business, and her children do not.

Evelyn and her heirs can claim capital gains treatment and have income taxed at a maximum 20% (capital gains get 60% deduction, so 40% is taxed at a maximum 50%). In this case, the result is lower taxation than if they were incorporated and the same taxation as would be realized in a partnership.

The estate tax area is where the individual proprietor feels the most pressure. Evelyn's estate was not frozen and has continually appreciated in value. Her estate tax liabilities will be at their maximum and the financial burden will have to be met either by the heirs or by selling all or part of the timber or land.

The individual proprietorship does have the appealing advantage of unlimited flexibility. During Evelyn's ownership, she would have total control over the real estate and could manipulate the returns to suit her financial needs.

The individual proprietorship does result in minimum income taxation for most landowners, provides periodic income, and provides

flexibility in management. It does not, however, meet the important estate planning goals of minimizing estate taxation, providing continuous management, and preventing fragmentation.

Summary

A list, see Appendix, of possible questions concerning the case have been provided to bring out points of the case.

The corporation, in this case, meets all the estate planning goals and owner objectives. The partnership agreement meets most of the goals, except preventing fragmentation. This could be easily remedied by creating a new business form upon the dissolution of the existing one.

From this case study, the conclusion is made that the partnership form can be molded to be used by any landowner as an estate planning tool. Its flexibility allows the diversity that can meet the diverse needs of individuals. It does have the drawbacks of unlimited liability and the possibility of being easily dissolved and, therefore, could lead to fragmentation and discontinued management plans.

The guiding principles for choosing a corporation are: (1) can the landowner warrant using the corporate tax structure, (2) can he warrant a continuous salary from the corporation, and (3) does he foresee having or wanting to sell his land.

Its advantages over a partnership are its limited liability, the transfer of stock as opposed to real property (reduced fragmentation), the difficulty in dissolution, which offers more stability for continuous management and family ownership.

CHAPTER V

CONCLUSION

With the passage of the Economic Recovery Tax Act of 1981, the individual proprietorship may become a more accepted ownership form. The change that most affects estate planning, especially for estates with appraised values of less than \$1 million, is the Unified Tax Credit.

At its maximum credit, the Unified Tax Credit will be equivalent to taxing only those estates valued at more than \$600,000.

This change will cause estate planners to take a close look at their situation before opting for a more complex management form.

So, to say the choice of ownership forms is strictly due to the guiding principles presented is not entirely correct. The guiding principles are the determining factors, but they must be approached on an individual basis.

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APPENDIX

A set of questions relevant to the principles of the case are given below as examples for possible classroom discussion:

1. What are the unique characteristics of forestry that must be considered when planning a forest estate?
2. Given the annual gift tax exclusion of \$10,000 per donee per year, how efficiently can forest land be gifted under the three business organizations presented in the case?
3. Under what circumstances would it be advantageous to heirs for the owner not to use an estate tax freeze and allow a step-up in basis?
4. What personal circumstances of forest land owners seem to favor either partnerships or corporations?
5. Which owner had the best estate plan--John, Mary or Evelyn?
6. What changes (if any) has the 1981 Economic Recovery Tax Act (ERTA) had on this case?

VITA

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