[JOINT COMMITTEE PRINT]

# PRESENT LAW AND PROPOSALS RELATING TO FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES

SCHEDULED FOR A JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

AND THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON JUNE 27, 1990

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PREPARED BY THE STAFF

OF THE

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## INTRODUCTION

The Subcommittees on Energy and Agricultural Taxation and Taxation and Debt Management of the Senate Finance Committee have scheduled a joint hearing on June 27, 1990, on proposals for changing rules relating to estate valuation freezes.

In the Omnibus Budget Reconciliation Act of 1987, the Congress enacted Internal Revenue Code section 2036(c), relating to the estate valuation freezes. On October 3, 1989, the Senate Finance Committee approved a provision that would have repealed section 2036(c), as part of the Senate Budget Reconciliation Bill (S. 1750 as reported by the Senate Budget Committee). In so doing, the Finance Committee indicated its concern for abusive freezes, and its intent to study alternatives to section 2036(c). The provision was removed from the bill by a Senate floor amendment deleting all revenue-losing provisions.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation in connection with the hearing, provides a discussion of the Federal transfer tax consequences of estate freezes, a description of prior and present-law tax rules, a discussion of issues relating to section 2036(c), and a description of proposed alternatives to section 2036(c). The Appendix presents data on Federal estate and gift tax collections.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present Law and Proposals Relating to Federal Transfer Tax Consequences of Estate Freezes* (JCS-21-90), June 22, 1990.

## I. SUMMARY

### *Estate freeze transactions*

An estate freeze is an estate planning technique that has the effect of limiting the transfer tax value of property held by an older generation at its then current value. Although sometimes reflecting the actual business relationships among the parties, the freeze transaction often is intended to pass appreciation in the property to a younger generation without incurring Federal estate and gift taxes while retaining all or a significant portion of the income or control over the property. The value of the retained rights may be increased through the retention of one or more discretionary rights which, under the "willing buyer, willing seller" valuation standard of present law, are assumed will be exercised so as to maximize the value of the owner's retained interests.

In one common form, the "preferred stock freeze," an owner of a corporation restructures the corporation to have two classes of stock: (1) preferred stock purportedly worth substantially all of the value of the corporation; and (2) common stock with purportedly little value. The owner then transfers the common stock to a younger generation while retaining the preferred stock. In addition, the owner might retain a discretionary right to require the redemption of the preferred stock at its par value, thereby increasing the value of the retained preferred stock (and decreasing the value of the transferred common stock) without regard to the amount of dividends the preferred stock may reasonably be expected to pay.

### *Code section 2036(c)*

Section 2036(c) treats an estate freeze transaction as inherently testamentary and, therefore, includes the value of the transferred interest in the donor's gross estate for Federal estate tax purposes. This treatment also reduces the pressure to properly value the retained interests, especially discretionary rights, in freeze transactions.

Section 2036(c) applies when a person transfers interests in property that are likely to appreciate while retaining an income or voting interest in that property. In doing so, it adopts in essence an incomplete gift approach that leaves open the final transfer tax consequences of the transaction. Section 2036(c) has been criticized as inexact and overbroad. In addition, opponents of section 2036(c) argue that lower Federal transfer taxes should be imposed on closely held businesses than on other forms of property.

### *Proposed alternatives*

The proposed alternatives reject the characterization of estate freeze transactions as inherently testamentary. Instead, the alter-

natives treat the transfer as complete at the time of the transfer. They generally provide various rules intended to determine the value of the transferred interest at the time of the transfer.

## II. AN OVERVIEW OF THE TRANSFER TAX SYSTEM

### A. Rates and Credit

*Estate and gift tax*

Generally, a gift tax is imposed on transfers by gift during life, and an estate tax is imposed on the taxable estate at death. The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative transfers. The estate and gift marginal tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million. After 1993, the top rate is scheduled to decrease to 50 percent.

The amount of estate and gift tax generally is determined by applying the unified rate schedule to cumulative taxable transfers and then subtracting the taxes payable for prior periods. The tax is first computed without any exemption, and then a unified credit is subtracted to determine the amount of estate or gift tax payable before the allowance of other credits. U.S. citizens and resident noncitizens are allowed a unified credit of $192,800, which effectively exempts the first $600,000 of transfers from tax. For a married couple, the unified credit potentially exempts the first $1,200,000 of transfers from tax. The benefit of the graduated brackets and unified credit is phased out after transfers exceeding $10 million, creating a top marginal tax rate of 60 percent for decedents dying prior to 1993.

*Generation-skipping transfer tax*

A generation-skipping transfer tax is imposed on certain transfers to a person two or more generations below the transferor. The generation-skipping transfer tax uses a flat rate equal to the highest estate and gift tax rate. Each transferor is allowed a $1 million exemption.

### B. Transfers Subject to Tax

#### 1. Gift tax

The gift tax is imposed on any transfer of property by gift whether made directly or indirectly and whether made in trust or otherwise. A transfer includes all transactions whereby property is passed to or conferred upon another regardless of the means or device employed in its accomplishment.

In *Dickman v. Commissioner*,[2] the United States Supreme Court held that an interest-free or below-market interest-rate demand loan resulted in a transfer for Federal gift tax purposes. In reach-

[2] 465 U.S. 330 (1984).

ing its conclusion, the Court emphasized that the right to use money is a valuable right, and that the failure to demand repayment over time passes wealth.[3] After the Supreme Court decision in *Dickman*, Congress enacted section 7872, which provides that certain loans bearing a below-market rate of interest result in (1) the borrower being treated as if he paid interest to the lender, and (2) the lender being treated as if he made an annual gift of the foregone interest to the borrower.

The first $10,000 of gifts of present interests to each donee during any one calendar year is excluded from Federal gift tax. A husband and wife may elect to treat a gift in fact made by one spouse as having been made one-half by each spouse. The net effect of this gift-splitting provision is to make the gift tax exclusions and credit of the spouse available to the donor. Thus, the first $20,000 of gifts of present interests is excluded when the non-donor spouse consents to split the gift. Although treated as a gift to its shareholders, a gift to a corporation generally is a gift of a future interest, not qualifying for the annual exclusion.[4]

The Federal gift tax generally is imposed only on the value of property actually passing to the donee net of tax. This is known as a "tax-exclusive" base.[5]

**2. Estate tax**

The estate tax is imposed on all property included in the "gross estate" of the decedent less allowable deductions. The gross estate generally includes the value of all property in which a decedent has an interest at his or her death (Code sec. 2031). In addition, the gross estate includes the value of certain properties not owned by the decedent at the time of death under certain circumstances. These include, generally, transfers for less than adequate and full consideration if (1) the decedent retained the beneficial enjoyment of the property during his or her life (sec. 2036) or the power to alter, amend, revoke, or terminate a previous lifetime transfer (sec. 2038); (2) certain property if an interest in such property is held within three years of death (sec. 2035); (3) the property was previously transferred during the decedent's lifetime but the transfer takes effect at the death of the decedent (sec. 2037); and (4) interests in certain annuities (sec. 2039). In addition, the gross estate includes the value of property subject to the decedent's general power of appointment (sec. 2041). Lastly, the gross estate includes the proceeds of life insurance on the decedent if the insurance proceeds are receivable by the executor of the decedent's estate or the decedent possessed at death incidents of ownership in the policy (sec. 2042).

No reduction in the gross estate is made for the portion of the estate used to pay the Federal estate tax. This is known as a "tax-

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[3] 465 U.S. at 336 and n. 7.

[4] *See Chanin v. United States*, 393 F.2d 972, 976 (Ct. Cl. 1968); *Heringer v. Commissioner*, 235 F.2d 149, 152 (9th Cir. 1956); *Hollingsworth v. Commissioner*, 86 T.C. 91, 105-108 (1986); Rev. Rul. 71-443, 1971-2 C.B. 337.

[5] See footnote 6, *infra*, for an example.

inclusive" base. Thus, the estate and gift taxes are computed on different bases.[6]

## C. Allowable Deductions

### *Marital deduction*

Both the gift and estate tax generally allow an unlimited deduction for property passing between spouses which will be includible in the gross estate of the recipient spouse.

### *Charitable deduction*

In determining the amount of estate and gift tax, a deduction is allowed for certain amounts transferred to certain organizations organized and operated exclusively for charitable, etc., purposes, to the United States or any State or local government, and to certain organizations of war veterans. Where the charitable transfer is of an interest in property that is less than the entire interest of the donor or decedent (e.g., a term or remainder interest), the gift must take certain specified forms in order to be deductible. In general, a charitable deduction is permitted for a term interest only if such interest is in the form of a guaranteed annuity or is a yearly distribution of a fixed percentage of the annually determined fair market value of the property. A charitable deduction generally is permitted for a transfer in trust of a remainder interest in property only if the trust is a pooled income fund, charitable remainder annuity trust, or charitable remainder unitrust.

### *Expenses, indebtedness, taxes, and losses*

In addition to the charitable and marital deductions, estate tax deductions are allowed for certain administrative expenses of the estate, certain indebtedness of the decedent, and certain taxes (sec. 2053). A deduction also is allowed for casualty losses incurred by the decedent's estate (sec. 2054).

## D. Valuation of Property

The value of property transferred by gift or includible in the decedent's gross estate generally is its fair market value at the time of the gift or death. Fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treas. Reg. sec. 20.2031-1(b)). This standard looks to the value of the property to a hypothetical seller and buyer, not the actual parties to the transfer.[7]

Accordingly, courts have refused to consider familial relationships among co-owners in valuing property. For example, courts allow corporate stock to be discounted to reflect minority ownership even when related persons together own most or all of the underlying stock.[8] Likewise, courts reduce the value of property to re-

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[6] For example, assuming a 50-percent rate and no deductions or exclusions, a death-time transfer of $100 results in $50 passing to heirs and a $50 estate tax. In contrast, a person with $100 can make a $66.67 lifetime gift while paying only $33.33 in gift tax.

[7] *See* Rev. Rul. 59-60, 1959-1 C.B. 237, 237.

[8] *See, e.g., Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981).

flect the effect of restrictions even when the restrictions exist for the benefit of family members.[9]

## E. Treatment of Small Businesses

### *Current use valuation*

If certain requirements are met, present law allows family farms and real property used in a closely held business to be included in a decedent's gross estate at its current use value, rather than its full fair market value, provided that the gross estate may not be reduced by more than $750,000 (sec. 2032A).

### *Installment payments of estate tax*

In general, estate tax must be paid within 9 months after a decedent's death. However, if certain requirements are satisfied and the executor makes an election, payment for estate tax attributable to certain interests in closely held businesses can be extended and paid in installments over 14 years (interest only for 4 years followed by from 2 to 10 annual payments of principal and interest) (sec. 6166). A special 4-percent interest rate applies to the deferred tax attributable to the first $1 million in value of the closely held business interest (sec. 6601(j)). Tax in excess of this amount accrues interest at the regular rate charged on deficiencies (sec. 6601(a)). To qualify for the installment payment provision, at least 35 percent of the value of the decedent's adjusted gross estate must consist of the value (net of business indebtedness) of an interest in a closely held business. Accrued interest is deductible in determining estate or income tax but not both (sec. 642).

### *Other extensions of time to pay estate tax*

If an estate is not eligible to defer estate tax under the installment payment provision, payment of the tax may be extended under the general estate tax extension of time to pay. An extension of time to pay tax for up to 10 years is permitted upon a showing of reasonable cause (sec. 6161). This extension is granted for a maximum period of one year at a time and can be renewed annually (as long as the reasonable cause continues to exist). Reasonable cause may exist where an estate does not have sufficient funds to pay the tax when otherwise due without borrowing at a rate of interest higher than that generally available (Treas. Reg. sec. 20.6161-1(a)(1), Example (4)).[10]

## F. Statute of Limitations

Generally, any estate or gift tax must be assessed within 3 years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the 3-year period. If no return is filed, the tax may be as-

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[9] *See* notes 34-47 *infra* and accompanying text.

[10] In addition, there are special income tax rules for certain distributions in redemption of stock included in the gross estate of a deceased shareholder. Such distributions are treated as sales (and not taxable dividends) to the extent of estate, inheritance, legacy, and succession taxes paid by the estate and the funeral and administration expenses allowable as deductions in computing the taxable estate (sec. 303). Because the basis of such stock is its fair market value at the date of death, generally little gain is recognized on the redemption.

sessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within 6 years after the return was filed.

Courts differ over whether the Commissioner may redetermine the value of prior gifts in order to determine the appropriate bracket and unified credit for the estate tax, notwithstanding the expiration of the gift tax statute of limitations [11]

[11] *Compare Smith Estate v. Commissioner*, 94 T.C. No. 55 (June 13, 1990) (Commissioner permitted to revalue gifts) *with Boatman's First National Bank v. United States*, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

## III. TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES PRIOR TO 1987

### A. General Description of Estate Freezes

An "estate freeze" is a technique that has the effect of limiting the value of property held by an older generation at its current value and passing any appreciation in the property to a younger generation. Generally, the older generation retains income from, or control over, the property.

To effect a freeze, the older generation transfers an interest in the property that is likely to appreciate while retaining an interest in the property that is less likely to appreciate. Because the value of the transferred interest increases while the value of the retained interest remains relatively constant, the older generation has "frozen" the value of the property in its estate.

In one common form, the preferred stock freeze, a person owning preferred stock and common stock in a corporation transfers the common stock to another person. Since common stock generally appreciates in value more than preferred stock, the transferor has "frozen" the value of his holdings in the corporation. Future appreciation in the common stock is not included in the transferor's estate.

An estate freeze can be achieved with almost any kind of property, including interests in active businesses, listed stocks, real estate and art.[12] The older generation may retain a variety of rights in a freeze transaction. Retained rights may include, for example, the right to vote stock, to receive income from property, or to control or use property. The retained right also may be the right to a fixed or variable amount, sometimes known as a "capital call" right. A capital call right may include (1) a right to "put" the frozen interest for an amount equal to the liquidation preference of the frozen interest; (2) a right to liquidate an entity and receive assets; or (3) a right to convert the nonappreciating retained interest into an appreciating interest.[13]

The retained rights in an estate freeze may be structured to lapse or terminate, particularly at death. Retained rights often involve discretion regarding the amount, timing, or fact of payment.

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[12] For one practitioner's list of commonly frozen assets, *see* B. Abbin, "The Value-Capping Cafeteria—Selecting the Appropriate Freeze Technique," 1981 *U. Miami Inst. Estate Planning* at 20-69 to 20-80.

[13] *See, e.g.,* W. Nelson and P. Genz, "New Uncertainties in the Equity Freeze: The Impact of Dickman on Capital Call Rights and Other Issues," 63 *Taxes* 999, 1001 (December 1985). *See also* R. Shattuck, "Taxpayers Try Estate Freeze Into Preferred Stock Convertible Into Constant Dollar Amount of Common Stock," 59 *Taxes* 323 (1981); D. Freeman, *Estate Tax Freeze: Tools and Techniques* at 2-30 to 2-32 (1985).

## B. Examples of Estate Freeze Transactions and Their Tax Consequences

### 1. Preferred interests in corporations and partnerships

#### *Description*

A common form of freeze relies upon a preferred interest in a corporation or partnership. This may involve recapitalization of an existing entity [14] or creation of a new entity.[15] The preferred interest may be created before or after the transfer of an interest to the younger generation.

The preferred interest may enjoy preferred rights as to income or management. It also may carry a right to liquidate, convert or redeem. The preferred interest may consist of either debt or equity,[16] and may involve S corporations as well as C corporations.[17]

In a corporate freeze, the preferred interest commonly provides for noncumulative dividends. In a partnership freeze, the preferred interest often is defined as a right to a fixed dollar amount (guaranteed payment) or a decreasing percentage of profits; distributions are often contingent upon cash flow.[18]

#### *Gift tax consequences*

The transfer of a residual interest in a corporation or partnership for less than full and adequate consideration is a gift. The fair market value of the residual interest is the price that a willing buyer would pay for it. Appraisers often determine such value through methods that consider the risks and potential returns for each interest over time. For example, corporate finance literature suggests that the common stock may be valued as a call option on the value of the firm, under which the common shareholders may purchase the firm by paying off more senior claims, such as bonds and preferred stock (the "option method").[19]

More commonly, appraisers determine the value of the common stock by subtracting the present discounted value of the anticipated dividends on the preferred stock from the total value of the corporation or partnership (the "discounted cash flow method"). The value of preferred stock is often determined by looking to comparable, often publicly traded, stocks. The position of the Internal Revenue Service is that the most important factors in determining the

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[14] *See* D. Freeman at sec. 2.

[15] *See* J. Wallace, "Overview of Estate Freezing Techniques and Attendant Estate and Gift Tax Problems," 15 *Real Property, Probate and Trust Journal* 71, 74-76 (1980); D. Freeman, at 2-41.

[16] *See* D. Freeman at 2-34 (noting that debentures may be substituted for equity).

[17] *See* B. Lemons and D. Child, "Using a Partnership Freeze to Shift Future Appreciation in Corporate Assets," 69 *Journal of Taxation* 84 (1988).

[18] *See e.g.*, D. Freeman at 3-60. *See generally*, J. Elias, "The Partnership Capital Freeze: A Path Through the Maze," 40 *Tax Lawyer* 45 (1986).

[19] *See generally*, R. Brealey and S. Myers, *Principles of Corporate Finance*, Chapter 20 (1988); J. Van Horne, *Financial Management and Policy*, Chapter 4 (1986); F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," 81 *Journal of Political Economy*, 637-654 (May-June 1973).

The trading on major exchanges of equity instruments with option type rights suggests that such rights affect market values. For example, it is possible to purchase on the American Stock Exchange, separately: a warrant, or call option, on the future value of a share of American Telephone and Telegraph; and the share of American Telephone and Telegraph subject to the warrant.

value of preferred stock generally are its yield, dividend coverage, and protection of its liquidation preference.[20] Voting, redemption, liquidation, and conversion rights also may add to the value of the preferred interest. All these rights are valued under the willing buyer, willing seller standard, without regard to how the parties actually holding the rights, in fact, will exercise them.

The recently decided case of *Snyder v. Commissioner*[21] illustrates the application of the willing buyer, willing seller standard. There, the taxpayer transferred publicly traded shares of a growing corporation worth $2,592,000 to a newly created holding company in exchange for 2,591 shares of preferred stock and 1,000 shares of common stock of the holding company. The preferred stock had a par value of $1,000 per share, was callable at the election of the preferred shareholders, and, in effect, could be put to the company at par.

The taxpayer transferred the 1,000 shares of common stock to a trust for the benefit of her grandchildren and valued the common stock at $1,000 (i.e., $1 per share). Although finding that the taxpayer did not expect to exercise the put option in the absence of unanticipated and extraordinary financial need, the U.S. Tax Court nonetheless held that the value of the common stock was $1,000, because a willing buyer would pay more only with some assurance that the option would not be exercised. Within five years of the transfer, the value of the publicly traded stock had increased to $5,340,000. If the preferred shareholders had elected to have the preferred shares called at that time, the value of the holding company after the redemption would have been $2,748,000 (i.e., $5,340,000 minus $2,592,000).

The failure to exercise rights in an arm's-length manner after the initial transfer of common stock may give rise to a gift under the reasoning of the *Dickman* case.[22] Prior to the *Dickman* case, there was authority that waiver of an undeclared dividend for a business purpose did not constitute a gift.[23] Since the *Dickman* case, the Internal Revenue Service has held in several private letter rulings that the failure to exercise rights can give rise to a gift.[24] Commentators have questioned whether the *Dickman* case creates a gift in such situations.[25]

### *Estate tax consequences*

Where an individual retains enjoyment of, or the right to income from, transferred property, the gross estate includes the full value of such property (sec. 2036(a)). In addition, the decedent's retention of the right to vote corporate stock that was given away results in the inclusion of that stock in the estate (sec. 2036(b)). In the pre-

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[20] *See* Rev. Rul. 83-120, 1983-2 C.B. 170.

[21] 93 T.C. No. 43 (Nov. 2, 1989).

[22] *See* note 2, *supra*. *See Snyder* at 28-29 (stating that *Dickman* generally does not apply to an equity instrument but nonetheless finding a gift by reason of the failure to exercise a conversion right that would have permitted accumulation of unpaid dividends).

[23] *See Collins v. Commissioner*, 1 T.C. 605, 609 (1943), *nonacq.*, 1943 C.B. 29; Rev. Proc. 67-14, 1967-1 C.B. 591.

[24] *See* LTR 8723007 (Feb. 18, 1987) (finding a gift on the failure to declare a noncumulative dividend); LTR 8726005 (March 13, 1987) (finding a gift on the failure to exercise conversion right); LTR 8610011 (Nov. 1, 1985) (finding a gift on the failure to redeem stock).

[25] *See, e.g.*, W. Nelson at 1009 (arguing that *Dickman* does not apply to unexercised freeze rights).

ferred interest estate freeze, however, it has been held that the preferred and residual interests may be considered separate property and therefore that a decedent's gross estate did not include the full value of a corporation in which the decedent gave his children common stock but in which he retained voting preferred stock.[26]

The IRS has privately ruled that the value of a voting right that lapses on the decedent's death is includible in the gross estate under section 2031.[27] In *Estate of Harrison v. Commissioner*,[28] however, a court held to the contrary. In that case, a father retained both a limited and general partnership interest after forming a partnership in which his sons received limited partnership interests. Held in conjunction with the general partnership interest, the father's limited partnership interest was worth $59 million (because the general partnership interest carried with it the right to liquidate the partnership); held alone, the limited partnership interest was worth $33 million. The father died owning both interests, but the general partnership interest was immediately sold to the sons for $700,000 pursuant to a buy-sell agreement taking effect at death. The United States Tax Court held that the limited partnership interest was includible in the father's gross estate at a value of $33 million. Thus, $26 million in wealth was passed without incurring either gift or estate tax. Several commentators agree with the Tax Court and argue that the retention of lapsing rights reduce the value of the transferred interest but are not includible in the gross estate.[29]

### 2. Grantor retained income trusts

#### *Description*

The grantor retained income trust ("GRIT") is an irrevocable trust to which the grantor transfers property or money while retaining an income interest for a term of years.[30] This transaction has the effect of transferring a contingent or vested remainder interest to another person. The grantor also may retain a contingent reversion or power of appointment that takes effect only if the grantor dies within the term.

#### *Gift tax consequences*

The transfer into the trust is treated as a taxable gift for transfer tax purposes. The amount of the gift is the value of the entire property less the value of rights in the property retained by the grantor. Rights retained by the grantor are valued pursuant to Treasury tables that assume a rate of return on the underlying property equal to 120 percent of the applicable Federal midterm rates (sec. 7520, Treas. Reg. sec. 20.2512-5(f)). Use of the Treasury tables is allowed even when they do not accurately predict the actual rate of return from the trust. For example, in 1977, the Internal Revenue Service ruled that the application of tables based

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[26] *See Estate of John G. Boykin*, 53 T.C.M. (CCH) 345 (1987).
[27] *See* LTR 8510002.
[28] 52 T.C.M. (CCH) 1306 (1987).
[29] *See* W. Nelson at 1010; D. Freeman at 2-50.
[30] *See, e.g.*, S. Leimberg and R. Doyle, "GRITS and SuperGRITS," 45 *Tax Notes* 1503 (1989); J. Mahon, "Grantor Lead Trusts: New Tax Savings Under the 10 Percent Tables," 128 *Trusts and Estates* 26 (August 1984).

on an interest rate of 6 percent per year was appropriate in valuing a trust whose corpus consisted of stock that had paid an average dividend of 3 percent for the preceding ten years.[31] According to the ruling, "departure from strict application of the tables is permissible in exceptional cases where use of the tables would violate reason and fact; for example, where transferred property may yield no income at all or the income is definitely determinable by other means." [32]

The IRS has ruled privately that the failure of an income beneficiary to exercise a State law right to force the trustee to invest in income-producing property results in a gift to the remainderman.[33]

*Estate tax consequences*

If the grantor dies during the term of the trust, the value of the trust property is includible in his gross estate (sec. 2036(a)), with an adjustment for gift tax previously paid. The property is included regardless of whether the decedent retained a contingent reversion or power of appointment. If the grantor dies after the term of the trust, none of the trust property is included in his gross estate.

### 3. Options and buy-sell agreements

*Description*

Under another common freeze device, a member of an older generation grants a member of a younger generation an option to purchase property at a fixed or formula price. Such an option may be part of a buy-sell agreement among family members under which the survivor (or the corporation) has the right to purchase stock from the estate of the first to die. An option may freeze the value of property at the strike price if the strike price is below the fair market value of the property at the date of death.[34]

*Gift tax consequences*

The transfer of a binding and enforceable unilateral option results in a gift equal to the excess of the fair market value of the option over the consideration received in exchange for the option.[35] Receipt of services in exchange for the option can provide adequate consideration.[36] Little judicial authority discusses the gift tax consequences of an agreement creating bilateral options. Such an agreement might give rise to a gift if the values of the options are not equal, for example, when the life expectancies of the two par-

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[31] *See* Rev. Rul. 77-195, 1977-1 C.B. 295.

[32] *Id.* at 297.

[33] *See* LTR 8805029 (Nov. 9, 1987), LTR 8806082 (Nov. 18, 1987).

[34] *See, e.g.*, T. Solberg, "Buy-Sell Agreements Can Freeze Asset Values and in Some Cases Make Them Disappear," 59 *Taxes* 437 (July 1981); S. Tobisman, "Estate and Gift Tax Considerations in Buy-Sell Agreements," 35 *U.S. California Tax Institute*, para. 2700 (1983).

[35] *See Hoffman v. Commissioner*, 2 T.C. 1160, 1187-88 (1943), *acq.* 1944 C.B. 13, *aff'd on other issue*, 148 F.2d 285 (9th Cir. 1945), *cert. denied*, 326 U.S. 730 (1945); Rev. Rul. 80-186, 1980-2 C.B. 280.

[36] *See Bensel v. Commissioner*, 36 B.T.A. 246 (1937) *aff'd*, 100 F.2d 639 (3d Cir. 1938) (continued services by son constituted adequate consideration for option given by father); *Cobb v. Commissioner*, 49 T.C.M. (CCH) 1364 (1985) (exchange of option for agreement to act as farm manager did not result in gift).

ties holding the options differ although the exercise price is the same.[37]

### *Estate tax consequences*

A restriction upon the sale or transfer of property reduces its fair market value. For example, a right of first refusal depresses value, since it reduces the attractiveness of the stock to other potential buyers.[38] Treasury regulations issued in 1958 acknowledge that the existence of an option or contract to purchase may affect the estate tax value of stock. Those regulations provide that the restriction is to be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass the decedent's stock to natural objects of his bounty for less than full and adequate consideration.[39] IRS rulings of that period give substantial weight to a price contained in a buy-sell agreement for purposes of determining value.[40]

Courts have gone beyond the published position of the Internal Revenue Service and generally have held that the price contained in a buy-sell agreement will limit fair market value for estate tax purposes if the price is fixed or determinable, the estate is obligated to sell, the agreement contains restrictions on lifetime transfers, and there is a valid business purpose for the agreement.[41] One court has held that, in addition to having a business purpose, the agreement cannot also be a testamentary device.[42]

The precise effect of an agreement meeting these requirements depends upon the extent of the buyer's obligation. If the buyer is obligated to purchase the property under the agreement, the agreement determines fair market value because, knowing of the approaching sale, a willing buyer would pay no more, and a willing seller would accept no less, than the strike price.[43] If the buyer merely possesses an option to purchase property, the option price creates a ceiling on fair market value because no willing buyer would pay more than the option price knowing that he would be obligated to sell the stock at the option strike price.[44]

Authorities generally consider continuation of family ownership and control to be a business purpose. It has been found sufficient even when the "control" being preserved is merely a right to par-

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[37] Some judicial authority suggests that the creation of the agreement does not result in a "transfer." *See Littick v. Commissioner*, 31 T.C. 181, 186 (1958). The Internal Revenue Service disagrees with this conclusion. *See* AOD CC-1985-008 (Dec. 24, 1984).

[38] *See Reynolds v. Commissioner*, 55 T.C. 172 (1970), *acq.*, 1971-2 C.B. 3.

[39] *See* Treas. Reg. sec. 20.2031-2(h). Nonetheless, in a subsequent memorandum, the Internal Revenue Service has stated: "The difficulty [with the regulation] is that there may be a legitimate business purpose in restricting shares to the decedent's descendants and yet the option price may be so low as not to fairly reflect value. The primary inquiry should be the correct estate tax value, and the motives or purposes behind the restriction should be of concern to the Internal Revenue Service only as they bear on the valuation question. . . . What is important should be, . . . not so much the legitimate purpose of the decedent in imposing the restriction, but whether the purchase price was an arm's length price that fairly represented value both at the time the restriction was imposed and at the time of death." G.C.M. 37958 (1978).

[40] *See* Rev. Rul. 59-60, 1959-1 C.B. 237, 243 (option price "usually accepted as fair market value for estate tax purposes").

[41] *See Seltzer v. Commissioner*, T.C. Memo 1987-568, 54 T.C.M. (P-H) para. 85,515 at 2345. *See also Weil v. Commissioner*, 22 T.C. 1267, 1273-74 (1954), *acq.*, 1955-2 C.B. 10;

[42] *See Saint Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982).

[43] *See, e.g., Broderick v. Gore*, 224 F.2d 892, 896 (10th Cir. 1955).

[44] *See Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932) (buy-sell agreement that binds the estate caps the value of corporate stock even if the holder of the option does not exercise the option and instead obtains the interest under the will).

ticipate as a limited partner,[45] or when a party to the agreement has already contracted a terminal illness.[46]

Although some courts suggest that the business purpose requirement necessitates that the option price be reasonable when the agreement was made,[47] others do not.[48] In either case, the strike price need not approximate fair market value at the date of death, even when such value is stipulated.[49] Thus, courts have found a fixed price contained in a buy-sell agreement to be determinative of estate tax value even though the stock was not in fact sold until many years later.[50] Similarly, formulas based on book value or capital accounts have fixed value.[51] A formula has been upheld even when it has the effect of creating an estate tax value of zero.[52]

### 4. Sales of remainder interests and joint purchases of interests in property

#### *Description*

Other common freeze transactions involve terms of years, life estates and remainder interests in property. For example, an owner of property may sell a remainder interest in the property to a child. Alternatively, older and younger generations may jointly purchase term and remainder interests in property from a third party. Both these transactions effect freezes because all the future

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[45] *See Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977).

[46] In *Littick v. Commissioner*, 31 T.C. 181, (1958), *acq.*, 1959-2 C.B. 5, acq., 1984-2 C.B. 1 (in result),

the decedent, who had contracted a terminal illness entered into a fixed-price buy-sell agreement with his brothers one year prior to death. Finding "nothing in the record to indicate that the [fixed price] was not fairly arrived at by arm's-length negotiation or that any tax avoidance scheme was involved," the U.S. Tax Court valued the stock at its fixed price, rather than its stipulated fair market value. 31 T.C. at 187.

[47] *See Bischoff*, 69 T.C. at 41 n.9.

[48] *See Davis v. United States*, 5 AFTR 2d 1902 (D. Utah 1960) (finding that a formula price of 25 percent of the "appraised value" of a partnership determined the value of a one-half interest in the partnership; low price necessary to ensure continued family control); *Seltzer*, T.C.M. (P-H) at 2346 (formula based on book value found determinative notwithstanding exclusion of goodwill from purchase price). *See also Reynolds v. Commissioner*, 55 T.C. 172, 194 (1970), *acq.*, 1971-2 C.B. 3 (holding that a voting trust agreement containing formula price equivalent to $100 per share was not a device to pass wealth for less than full and adequate consideration even though, when the agreement was made, the over-the-counter market price for the stock was $250 per share).

[49] *See, e.g., Commissioner v. Childs' Estate*, 147 F.2d 368 (3d Cir. 1945) (estate tax value of $10 per share upheld when market price was $100 per share); *Novak v. United States*, 1987-2 T.C.M. (CCH) para. 13728 (D. Neb.) (estate tax value at $1,000,750 upheld rather than fair market value of $1,657,465); *Littick*, 31 T.C. at 187 (1958) (estate tax value almost $60,000 below stipulated fair market value); *Weil v. Commissioner*, 22 T.C. 1267, 1272 (1954), *acq.*, 1955-2 C.B. 10 (estate tax value of $172,000 upheld by court that conceded that fair market value was $538,000 higher).

[50] In *Slocum v. United States*, 256 F. Supp. 753 (S.D.N.Y. 1956), a fixed price ($100) contained in an agreement entered into in 1915 fixed the estate tax value of stock of a decedent dying some 40 years later. In *Wilson v. Bowers*, 57 F.2d 682 (2d Cir. 1932), a fixed price contract entered into in 1909 determined the estate tax value of stock passed by the decedent some ten years later. *See also Novak*, 1987-2 T.C.M. (CCH) para. 13728 (fixed price option determined estate tax value).

[51] *See Bischoff*, 69 T.C. at 41 n.9 (formula based on capital account found determinative); *Fiorito v. Commissioner*, 33 T.C. 440 (formula based on capital account found determinative). *See also Hall v. Commissioner*, 92 T.C. 312 (1989) (transfer restrictions considered in determining fair market value; fair market value held to be adjusted book value).

[52] In *May v. McGowan*, 194 F.2d 396 (2d Cir. 1952), father and son entered into a buy-sell agreement for a fixed price less a percentage of debt guaranteed by the son. Application of this formula resulted in an estate tax valuation of zero. The Second Circuit concluded: "It seems clear that with the option outstanding, no one would purchase the stock of the decedent when it was subject to call by [the son] at zero. . . . [citing cases]. . . . Such a loophole, if important, should be closed by legislative action rather than by disregarding the cases we have cited." 194 F.2d at 397.

appreciation potential in the property inures to the younger generation.

*Gift tax consequences*

The gift tax consequence of a sale of a remainder interest or a joint purchase are similar to those of a GRIT. If the younger generation pays less than fair market value for the remainder interest, there is a gift from the older generation. The value of the remainder interest is determined pursuant to IRS tables.

*Estate tax consequences*

If the decedent dies after the term, the property is not included in his gross estate. If the decedent dies within the term or has a life estate, the property is includible unless the decedent received full and adequate consideration for the remainder interest during his life (in the case of a sale of a remainder interest) or paid no more than the value of his interest (in the case of a joint purchase). The amount includible is reduced by consideration received. In *Gradow v. United States*,[53] the Federal Circuit held in one situation that full and adequate consideration is the value of the entire property, not merely the value of the remainder interest.[54]

**5. Installment sales and private annuities**

*Description*

A freeze also may be achieved through sale of the property in return for an installment note or annuity.[55] The note may cancel upon the transferor's death.[56] In conjunction with the sale, the transferor may lease back the property and pay rent or make annual gifts that are used to make the installment payment.[57]

*Gift tax consequences*

A private annuity is valued pursuant to Treasury tables. The failure to pay an amount owed under a note generally is treated as a gift.

*Estate tax consequences*

Sale of property for a private annuity or installment note generally does not result in such property being included in the estate unless the annuity effectively results in the decedent's retention of an interest in the sold property (sec. 2036(a)). The U.S. Supreme Court has suggested that the transaction will not be treated as a transfer with a retained interest if "the promise is a personal obligation of the transferor, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made." [58]

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[53] No. 89-1377 (Fed. Cir. March 1, 1990), *aff'g.* 11 Cl. Ct. 808 (1987).

[54] The decision in *Gradow* has been criticized. *See* P. Weinbaum, "Are Sales of Remainder Interests Still Available in Light of a New Decision," 14 Estate Planning 258 (Sept./Oct 1987).

[55] A sale would result in recognition of gain that might be deferred as an installment sale (sec. 453). Once sold, the property does not receive the step-up in basis that would have occurred had such property been retained until death (sec. 1014).

[56] *See* D. Freeman at sec. 4.11; W. Blum, "Self-Cancelling Installment Notes," 60 *Taxes* 183 (1982).

[57] *See* D. Freeman at sec. 5.06.

[58] *Fidelity-Phila. Trust Co. v. Smith*, 356 U.S. 274, 280 n. 8 (1958). *See also Lazarus v. Commissioner* 513 F.2d 824 (9th Cir. 1975); *Lane v. Commissioner* 37 T.C. 188 (1961).

## IV. TRANSFER TAX CONCERNS RAISED BY ESTATE FREEZES

Estate freezes raise three basic transfer tax concerns. First, because frozen interests are inherently difficult to value, they can be used as a means of undervaluing gifts. Second, such interests entail the creation of rights that, if not exercised in an arm's-length manner, may subsequently be used to transfer wealth free of transfer tax. Third, "frozen" interests may be used to retain substantial ownership of the entire property while nominally transferring an interest in the property to another person.

### A. Undervaluation of Initial Transfer

Estate freezes provide an opportunity for undervaluation of the initial gift. Because gift tax adjustments do not generally result in additional tax (due to the unified credit) and because the Internal Revenue Service has limited audit resources, such undervaluation may go unchallenged.

Undervaluation may occur because the transferor claims a value for the transferred property lower than the amount a willing buyer would pay for the interest.[59] This undervaluation is difficult to detect because of the inherent difficulty in valuing interests created in a freeze.

The discounted cash flow method depends upon proper valuation of the preferred interest.[60] Such interests pose substantial valuation difficulties. Even if the features of the closely held preferred interest are identical to those found in public markets, differences between the two types of securities make comparison difficult. Much publicly traded preferred stock is held by corporations, which, because of the dividend received deduction (sec. 243), are willing to accept a dividend yield lower than individual investors. Also, the need of publicly traded companies to have continued access to the capital markets creates an incentive to pay dividends on preferred stock that may be absent for the closely held company. Further, publicly traded preferred stock is inherently more liquid than is comparable stock of a closely held company. Finally, publicly traded companies are more likely to be in more than one line of business, which may effect the variability of the firm's earnings (or cash flows).

Moreover, the features of a preferred stock issued in a freeze often vary substantially from features contained in publicly traded

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[59] Indeed, the very application of the willing buyer, willing seller standard to certain property rights held by related parties may be problematic. In most families, family relationships rather than contractual rights determine how and when property will pass.

[60] Since the option and the discounted cash flow methods are both sound, they theoretically reach substantially the same result. The existence of a substantial difference in the values determined by each method may suggest inaccurate application of one or both methods.

stocks. Stock issued in a freeze may lack features common to publicly traded comparables (such as a cumulative right to dividends) or contain features missing from such comparables (such as discretionary capital call rights).

These valuation difficulties create the possibility that inconsistent valuation assumptions will be used to value a preferred interest. Taxpayers may use favorable assumptions in valuing the retained preferred stock at the time of the freeze and unfavorable assumptions in valuing such stock at death.

Undervaluation also may result from the failure to value correctly restrictions or options to buy property. Fixed price and book formula options may be used without considering the likely appreciation in the property. Options granted in exchange for services may be valued on a mistaken assumption that the parties are dealing at arm's length. Bilateral options exercisable at death may be valued without regard to the different life expectancies of the parties.

Further, undervaluation may result from the use of Treasury tables valuing annuities, life estates, terms for years, remainders and reversions. Those tables are based on assumptions regarding rates of return and life expectancy that are seldom accurate in a particular case, and therefore, may be the subject of adverse selection. Because the taxpayer decides what property to give and when to give it, use of tables, in the aggregate, more often results in undervaluation than in overvaluation.

### B. Subsequent Transfers

Creation of a frozen interest in property also permits the transfer of wealth free of transfer tax through the subsequent exercise or nonexercise of rights with respect to the enterprise. Even if the transferred property is properly valued at the time of the initial transfer under the willing buyer, willing seller standard, wealth may be transferred thereafter if the rights are not exercised in an arm's-length manner. This may occur if, after the transfer, either transferor or transferee acts or fails to act or causes the enterprise to act or fail to act. It is unclear under present law whether such exercise or nonexercise results in a gift. Even if it does, it is virtually impossible for the IRS to monitor all post-transfer action or inaction with respect to such rights.

Closely held businesses provide many opportunities for subsequent transfers of wealth. Such transfers may occur through legal rights created at the time of the freeze transaction. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends to the preferred shareholder. Even if the preferred stock is cumulative, such failure results in a transfer equal to the value of the use of the money until the dividend is paid. Or, by exercising conversion, liquidation, put or voting rights in other than an arm's-length fashion (or by not exercising such rights before they lapse), the transferor may transfer part or all of the value of such rights.

Subsequent action or inaction may transfer wealth even in the absence of a preferred interest in a closely held company. For example, failure to revise a dated sales price contained in a buy-sell agreement can transfer wealth from the party who would benefit

from such revision. Similarly, the failure of a life tenant to exercise his rights to use the property can have the effect of transferring wealth to the remainderman. Conversely, improvements by a life tenant can enrich the remainderman.

### C. Disguised Testamentary Transfers

Third, the retention of a frozen interest may be used in order to retain enjoyment of the entire property. Enjoyment may be retained through a voting right, a preferred interest in a partnership or corporation, an income interest in a trust, a life estate in property, or a right to use property. In such cases, the transfer is, in reality, incomplete at the time of the initial transfer and, if the frozen interest is retained until death, the transfer is testamentary in nature.

Failure to treat a testamentary transfer as such gives the donor the advantage of favorable rules applicable only to gifts—such as the annual exclusion and tax-exclusive gift tax base. In addition, early utilization of the unified credit increases its present value. These benefits are appropriate only when the transferor has parted with substantial ownership of the transferred property.

## V. PRESENT LAW: CODE SECTION 2036(c)

In the Omnibus Budget Reconciliation Act of 1987 (1987 Act), the Congress addressed the estate freeze transaction by including the value of the appreciating interest in the decedent's gross estate and crediting any gift tax previously paid (Code sec. 2036(c)). Such inclusion effectively treats the transfer as incomplete for transfer tax purposes during the period of the freeze. Thus, section 2036(c) addresses the possibilities of initial undervaluation, subsequent transfer of wealth, and retention of substantial ownership by postponing a final determination of transfer tax until the frozen interest passes.

Since its enactment, section 2036(c) has been amended and interpreted. In the Technical and Miscellaneous Revenue Act of 1988 (1988 Act), the Congress enacted safe harbors for the retention of debt and agreements to provide goods and services for fair market value. The Internal Revenue Service provided additional guidance in Notice 89-99, issued on August 31, 1989.

### A. General Description of Section 2036(c)

Section 2036(c) generally provides that if a person in effect transfers property having a disproportionately large share of the potential appreciation in an enterprise while retaining an interest, or right in, the enterprise, then the transferred property is includible in his gross estate. For example, if a person who owns all the preferred and common stock in a corporation transfers the common stock while retaining the preferred stock, the common stock is includible in his gross estate.

Section 2036(c) does not apply if the sale is to an unrelated person for full and adequate consideration or the transferor and his family own less than 10 percent of the income or voting power of the enterprise. If the family member provides consideration not originally received from the transferor, a portion of the enterprise is excluded from the estate under section 2036(c). Dispositions of either the transferred or retained property prior to the transferor's death result in a deemed gift equal to the amount that would have been includible had the transferor died at the time of the transfer.

Section 2036(c) applies only if an interest is retained in an enterprise. The legislative history of section 2036(c) describes an enterprise as including a business or other property which may produce income or gain.[61] In its notice, the Internal Revenue Service stated that an enterprise is an arrangement that has significant business aspects. The notice excluded from the definition of enterprise personal use property, such as a principal residence or a life insurance contract.[62]

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[61] *See* H. R. Rept. No. 100-495 at 996 (100th Cong., 1st Sess).
[62] *See* Notice 89-99, 1989-38 I.R.B. 4 at 7.

The statute and notice contain safe harbors for common business transactions that pose only limited possibility for the transfer of wealth outside the transfer tax system and do not resemble retained life estates. Failure to comply with the precise requirements of these safe harbors does not necessarily cause section 2036(c) to apply to a transaction.[63] The IRS also has solicited comments on the desirability of a safe harbor for transactions in which a significant number of unrelated parties participate.[64]

## B. The Effect of Section 2036(c) on Specific Estate Freeze Transactions

### 1. Preferred interests in corporations and partnerships

Section 2036(c) generally applies to freezes involving the transfer of common stock coupled with the retention of preferred stock in a corporation. The provision also may apply if the parent exchanges common stock for preferred stock in a corporation in which the child also owns common stock,[65] or if the parent loans or contributes capital to a corporation in which the child owns a disproportionate share of the appreciation.[66] Creation of a holding company can cause section 2036(c) to apply even if the underlying property consists of stock in an enterprise in which the parties lack a 10 percent interest. The provision also applies to similar transactions using partnership interests.

Section 2036(c) applies only to transfers of a disproportionately large share of appreciation. The provision does not apply if the transferred and retained interests have the same rights, or if the only difference between the two interests is with respect to voting or managerial powers.[67]

Several safe harbors may apply to transactions involving preferred interests in corporations or partnerships. These safe harbors provide that section 2036(c) will not apply simply by reason of the retention or receipt of certain interests. One safe harbor exists for "qualified debt" held by the decedent. Qualified debt generally is debt that requires the payment of a sum certain in money at a fixed time and lacks equity features.[68] Such debt is excepted because it is easily valued, presents limited opportunity for the subsequent transfer of wealth and does not constitute retained enjoyment of the enterprise.[69]

In addition, there is a safe harbor for certain debt or preferred stock received in exchange for a cash loan to an enterprise engaged in an active trade or business so long as the holder of the debt or preferred stock did not, within three years, transfer property (including goodwill) or other business opportunities to the enter-

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[63] *See id* at 11.
[64] *See id.* at 8.
[65] *See id.* at 9, Example 13.
[66] *See id.* at 10, Example 15.
[67] *See id.* at 10.
[68] *See* sec. 2036(c)(7)(c). An unconditional debt to pay a sum certain on demand incurred in return for cash used to meet normal business needs of the enterprise need not have a fixed maturity date or be payable on one or more specified dates. *Id.*
[69] See H.R. Rept. No. 100-795 at 424.

prise.[70] This safe harbor relaxes the requirements generally imposed upon qualified debt because of the increased likelihood that appreciation in start-up enterprises is attributable to the transferee's labor and not to disguised transfers of wealth from the transferor.[71]

Another safe harbor provides that section 2036(c) generally will not apply solely because of the existence of an agreement for the sale or lease of goods or other property to be used in the enterprise or the providing of services if the agreement (1) is an arm's-length agreement for fair market value and (2) does not otherwise involve any change in interests in the enterprise.[72] This exception is provided because such agreements do not present an opportunity for transferring wealth free of transfer tax and do not involve the retention of enjoyment of the enterprise.[73]

These safe harbors do not exhaust the transactions excluded from section 2036(c). For example, the provision does not apply simply because a person provides *de minimis* amounts of property or services to be used in the child's business or because such person, in the ordinary course of business, provides goods or other property for use in the business.[74]

### 2. Grantor retained income trusts

Section 2036(c) generally applies to a grantor retained income trust (GRIT).[75] An exception exists for transfers to a trust in which the transferor retains a right to receive amounts determined solely by reference to income from the trust property if the term of the income interest does not exceed 10 years and the transferor is not a trustee of the trust (sec. 2036(c)(6)). This exception does not apply if the transferor retains an interest that is not determined solely by reference to income from the trust. Thus, it does not apply if the transferor retains an annuity interest.[76] In addition, the exception does not apply if the grantor retains a contingent reversion or power of appointment with a value in excess of 25 percent of the retained income interest.[77]

### 3. Options and buy-sell agreements

Section 2036(c) applies to an option or buy-sell agreement because such an arrangement creates two classes of interests, with differing rights to appreciation.[78] The effect of section 2036(c) is to

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[70] In addition, the retained interest cannot be voting or convertible to another interest. If the interest is debt, it must unconditionally require the payment of a sum certain in money. If the interest is preferred equity, it must have a cumulative dividend preference with a fixed rate of return, a nonlapsing liquidation preference for capital plus accrued dividends and not be redeemable for less than such preference. *See* sec. 2036(c)(7)(D); Notice 89-99 at 12-13.

[71] *See* H. R. Rept. No. 100-795 at 426.

[72] Sec. 2036(c)(7)(A)(ii). The safe harbor does not apply to any amount determined in whole or in part by reference to gross receipts, income, profits, or similar items of the enterprise or to agreements to provide services over a period greater than three years after the transfer. *See* sec. 2036(c)(7)(B).

[73] *See* H. R. Rept. No. 100-795 at 426.

[74] *See* Notice 89-99, at 7.

[75] *See id.* at 5. An irrevocable trust is an enterprise even if the property held in trust would not constitute an enterprise if held directly. *See id.* at 6.

[76] *See* H.R. Rept. No. 160-1104 at 74 n. 1.

[77] *See* Notice 89-99, at 11-12.

[78] *See id.*

include the value of the option or restriction in the transferor's gross estate.

Section 2036(c) does not generally apply to an arm's-length buy-sell agreement between unrelated persons.[79] There is a statutory safe harbor for an option or other agreement to buy or sell property at fair market value determined as of the time the option is (or rights under the agreement are) exercised. In recognition of the expense and administrative difficulty involved in determining fair market value, the IRS considers an agreement as falling within the safe harbor if the sale price is determined by application of a formula that reasonably can be expected to produce a result that approximates the fair market value of the property when the sale is consummated.[80]

**4. Sales of remainder interests and joint purchases of interests in property**

Section 2036(c) applies to the sale of a remainder interest and the joint purchase of an income and remainder interest in property.[81] The value of the entire property is included in the term-holder's estate, with an adjustment for the consideration provided by the term-holder.

**5. Installment sales and private annuities**

Section 2036(c) may apply to an installment note or private annuity if the installment note or annuity constitutes a retained interest in the enterprise.[82]

Even if it constitutes a retained interest in an enterprise, an installment note or private annuity may qualify for the safe harbor for qualified debt. Because such safe harbor requires an unconditional obligation to pay a sum certain in money, a note or annuity for which the payments are contingent on future events, such as the survival of the transferor, does not qualify.[83]

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[79] *See id.*
[80] See *id.*
[81] *See id.* at 5, 10 (Example 16).
[82] *See id.* at 5, 10-11.
[83] *See* H. R. Rept. No. 100-795 at 425; Notice 89-99, at 12.

## VI. GENERAL CRITICISMS OF SECTION 2036(c)

### A. The Merits of an Incomplete Gift Approach

One criticism of section 2036(c) regards the merits of using an incomplete gift rule for estate freezes. Critics of such an approach argue that regardless of the possibilities for initial undervaluation and subsequent transfer, the gift tax assessed when the transfer is made should finalize the transfer tax consequences of the transaction. They also argue that frozen interests should be regarded as separate property rather than the retention of substantial ownership of the enterprise. Further, they argue that section 2036(c) does not adequately implement an incomplete gift rule because it only credits the gift tax on the initial transfer rather than eliminating such tax entirely. Thus, the donor has in effect prepaid his estate tax without interest.

Proponents of an incomplete gift approach argue that estate tax inclusion is the surest means of providing a proper valuation and avoiding problems attendant to subsequent transfers. They note that such a rule achieves roughly the same effect as treating the transaction as a gift initially—taxation of appreciation is offset by the benefit derived from deferral of tax. They stress that an incomplete gift rule is the only means of addressing the problem of inherently testamentary transfers. Some suggest modifying section 2036(c) to eliminate the initial gift tax while others justify the initial tax on administrative grounds.

### B. The Breadth of Section 2036(c)

Critics of section 2036(c) note that the section extends far beyond the preferred stock freeze to a wide variety of family transactions. They argue that such breadth creates uncertainty and hampers planning by family members. They note that section 2036(c) can trap unwary taxpayers undertaking common business transactions such as the lending of money or the provision of services. They believe that further modification of the statute would create undue complexity.

Others counter that freezes may be performed through a wide variety of devices—partnerships, trusts, options and interests in property—and argue that a broad scope is necessary to reach these devices. They note that in the family context many common business transactions operate to transfer wealth. They assert that present-law safe harbors protect most common business transactions with limited transfer tax avoidance potential and that additional safe harbors could be enacted if necessary.

### C. Effect on Small Business

Critics of section 2036(c) observe that the provision makes it more difficult to transfer a closely held business between generations. They note that a family is sometimes forced to sell the business in order to pay estate tax. They argue that the creation of special rules for family transfers is unfair and that entrepreneurs play an important role in our society.

Supporters of section 2036(c) note that the provision does not discriminate against small businesses, but in fact treats all transfers of assets alike. They also argue that the donative character of many intrafamily transactions justifies the application of a special standard to them. They argue that all types of wealth should be subject to the same transfer tax.

Supporters of section 2036(c) also note that the unified credit exempts estates of up to $600,000 (potentially $1,200,000 for a married couple) and that small business owners already receive estate tax relief through the unified credit, special valuation rules for real property, sales treatment of redemptions to pay death taxes, and rules allowing deferred payment of estate taxes. They argue that additional relief for family businesses is better granted to small business generally through modification of these provisions rather than limiting relief to persons engaging in estate freeze transactions.

## VII. ALTERNATIVES TO SECTION 2036(c)

Generally, there are three points of time for subjecting property to transfer tax. Alternatives to section 2036(c) might modify the law with respect to any of them.

First, gift tax can be imposed on the initial transfer. This approach predominated under pre-1987 law. Valuation at the time of the initial transfer might be improved by requiring notice and information reporting to the IRS, expanding the use of qualified appraisals, creating valuation assumptions for discretionary rights, and extending the statute of limitations.

Second, gift tax can be imposed on subsequent transfers. This approach is similar to the Dickman case and section 7872. This approach might be bolstered by clarifying the gift tax consequences of the failure to convert stock, declare a dividend, or exercise other rights with respect to property.

Third, gift or estate tax can be imposed on the transferred interest when the transferor disposes of the frozen interest. This hard to complete approach was implicit in sections 2036 through 2042 of pre-1987 law and was extended by section 2036(c). Even if section 2036(c) were replaced, the hard to complete approach could be retained for certain transactions such as transfers to trusts, or retentions of rights that lapse on death.

Five proposed alternatives to section 2036(c) are described below.

### A. Repeal of Section 2036(c) Without Replacement

During March and April of 1989, Senators Boren, Daschle, Heflin and Symms introduced bills proposing repeal of section 2036(c) without replacement.[84] Repeal without replacement would reinstate pre-1987 law.

### B. Proposal of the Task Force of the American Bar Association and American College of Probate Counsel

#### 1. General description of Task Force Proposal

In 1989, an ad hoc Task Force of the American Bar Association and the American College of Probate Counsel formulated a two-part replacement for section 2036(c) ("Task Force Proposal").[85] The first part is a valuation assumption made for gift tax purposes. Under that assumption, nonpublic stock and partnership interests are valued in order to maximize the value of the gift by assuming that any discretionary liquidation, conversion, dividend or put

[84] *See* S. 659 (Senator Symms) (March 17, 1989), S. 838 (Senator Heflin) (April 18, 1989), and S. 849 (Senators Daschle, Heflin, Boren, and Symms) (April 19, 1989). *See also* H.R. 60 (Mr. Archer) (January 3, 1989).

[85] *See* letter of Irwin L. Treiger, L. Henry Gissel, Jr. and Geraldine S. Hemmerling to Ronald A. Pearlman (July 27, 1989) (enclosure).

rights retained by the donor or the donor's spouse will not be exercised in a manner adverse to the interest of a member of the donor's family. The effect of the first part is to value the transfer without regard to discretionary rights retained by the transferor. Accordingly, the value of the transferred interest is increased.

The second part is a safe harbor, which would, in valuing a gift of a residual equity interest, value certain retained preferred interests at their liquidation preference. The safe harbor applies only if (1) the preferred interest carries a cumulative return equal to the applicable Federal rate, compounded semiannually; (2) the failure to pay income for 36 months results in the preferred interest having voting control of the corporation or partnership; and (3) the sum of all preferred interests does not exceed 80% of all equity interests in the corporation or partnership.

### 2. Application of Task Force Proposal to specific transactions

#### a. Preferred interests in corporations and partnerships

The Task Force Proposal affects gift tax valuation by placing rights retained by the transferor into one of three categories. First, certain preferred interests bearing a cumulative compounded return equal to AFR are valued at par. Second, discretionary liquidation, conversion, dividend or put rights retained by the donor or donor's spouse are assumed not to be exercised in a manner adverse to the interest of a family member. Third, all other rights are valued under present law. A cumulative preferred stock lacking discretionary rights that is not within the safe harbor continues to be valued under present law.

The Task Force Proposal does not affect estate tax valuation.

#### b. Other transactions

The Task Force Proposal is limited to preferred interests in corporations and partnerships. Thus, under the Task Force Proposal grantor retained income trusts, options and buy-sell agreements, sales of remainder interests, joint purchases, installment sales, and private annuity transactions would be governed by pre-1987 law.

## C. Discussion Draft Released March 22, 1990

### 1. General description of Discussion Draft

*Overview*

In a Ways and Means Committee press release dated March 22, 1990, Ways and Means Committee Chairman Dan Rostenkowski announced the release of a Discussion Draft relating to estate freezes ("Discussion Draft"). The Discussion Draft would repeal section 2036(c) and enact in its place a set of rules generally intended to modify the gift tax valuation rules so as to more accurately value the initial transfer. Such rules operate by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's-length manner.

The Discussion Draft would repeal section 2036(c), under which the transfer is incomplete until the freeze ceases. Rejecting the characterization of freeze transactions as testamentary, the Discussion Draft generally substitutes for section 2036(c) a set of rules in-

tended to modify the gift tax valuation rules in such a way as to more accurately value the initial transfer. Such rules operate by adopting valuation assumptions that take into account the likelihood that related parties will not exercise rights in an arm's-length manner.

*Assumptions in valuing gifts*

The Discussion Draft assumes that the value of a residual interest in an entity is determined by reducing the value of the whole by the value of retained preferred interests. In determining whether a gift has been made, and the amount of the gift, the Discussion Draft provides rules for valuing rights retained by the transferor and members of his family (other than the transferee). Such rights fall into one of three categories.

The first category consists of qualified fixed payments (QFPs), which are generally rights to payment that are fixed both as to time and amount. Such payments are assumed to be made as provided in the instrument. Payments under instruments lacking a fixed termination date are assumed made in perpetuity.

The second category consists of voting rights and retained rights in the same or a junior class. Such rights continue to be valued as under present law.

The third category of retained rights consists of all other rights. Such rights are valued at zero in recognition of the uncertainty that they will be exercised in an arm's-length manner. Certain rights which would otherwise fall into this category may, under certain circumstances, be valued as though they were qualified fixed payment rights.

These categories can be illustrated by considering the following example: a person holding cumulative preferred stock that can be put to the corporation for its par value and common stock gives one half of the common stock to a family member. In valuing the gift, dividends are assumed to be paid as provided in the preferred stock, the put right is valued at zero, and the retained rights under the common stock are valued as under present law.

*Rules governing late payment of QFP or transfer of retained rights*

The failure to make a QFP within a specified period of time, generally 3 years, results in a gift. This consequence is a corollary of the favorable assumption made in valuing QFPs at the time of the gift. If the QFP is made after the deemed gift, the Discussion Draft would refund the gift tax paid on the deemed gift.

The Discussion Draft adopts special rules for the transfer of retained rights previously valued under these rules. In order to avoid double taxation, the Discussion Draft reduces the value of any right previously valued at zero by the amount of the increase in the original gift resulting from valuing such right at zero. To ensure consistent use of the favorable valuation assumption, the later transfer of a QFP is treated as giving rise to an additional transfer equal to the excess of the value of the QFP determined with the statutorily mandated assumption that QFPs would be paid over the value determined without regard to that assumption. Additional transfer tax is not imposed on a transfer of a retained in-

terest to a spouse; however, the spouse is treated as the transferor in the future for purposes of these rules.

*Scope*

The valuation rules apply to transfers of an interest in a corporation, partnership or trust of which the transferor and his family own more than 10 percent. A debt instrument or lease is treated as an interest in an entity. The rules apply in valuing donative transfers and all transfers to a spouse, to lineal descendents and descendents of the spouse, to parents or grandparents, to parents and grandparents of the spouse, and to spouses of the foregoing. The rules also apply to a recapitalization, redemption or contribution to capital that has the effect of a transfer.

*Statute of limitations*

The gift tax statute of limitations is extended from three years to six years for transfers subject to the Discussion Draft. In addition, the statute of limitations is unlimited for transfers subject to the Discussion Draft which are not reported, regardless of whether a gift tax return was filed, or required to be filed, for the year in which the transfer occurred.

*Effective date*

The Discussion Draft would repeal section 2036(c) retroactively to the date of its enactment. The Discussion Draft does not contain an effective date for the substitute valuation rules.

**2. The effect of the Discussion Draft on specific estate freeze transactions**

**a. Preferred interests in corporations and partnerships**

*Valuation of initial transfer*

*QFPs*

QFPs from a corporation or partnership include a cumulative preferred dividend (payable on a periodic basis and at a fixed rate), or any other payment or distribution which is fixed both as to time and amount.[86] The transferor may elect to treat non-cumulative preferred stock dividends and partnership distributions which are contingent on cash flow or income as QFPs.

As under present law, QFPs from corporations or partnerships are valued by determining the value of the fixed payments, using appropriate market discount rates. Taxpayers are free to set the rate of the QFP at whatever rate they wish. For example, if preferred stock with a par value of $1,000 carried an 8 percent cumulative dividend, and 8 percent was the appropriate market rate, the value of the stock would be approximately $1,000 (its par value). On the other hand, if the taxpayer chose a 4 percent dividend rate, but the appropriate market rate were 8 percent, the value of the stock would be less than par value.

[86] QFPs could have a variable interest rate if the rate were tied to a specified market rate. Payments subject to a life contingency would not be QFPs.

These special rates could not reduce the value of the common stock of a corporation or the non-preferred interests of a partnership below a minimum value. Thus, the total value of the common stock or non-preferred partnership interests could not be less than 20 percent of the sum of the total equity in the corporation or partnership and any debt which the corporation or partnership owed to the transferor or members of his family. This minimum value is intended to reflect the "option value" of the right of the common stock or non-preferred interest to future appreciation.

*Other rights*

The Discussion Draft does not apply where the transferor transfers preferred stock and retains common stock or where he transfers and retains only stock of the same class (even if the transferred and retained stock differs with respect to voting rights). Such transfers are valued without regard to the valuation rules of the Discussion Draft. Conversion, liquidation, redemption and other capital call rights lacking a fixed payment date are valued at zero.

*Example*

Assume a holder of a partnership interest gives to a family member a partnership interest that has income rights that are junior to those of the retained interest. Unless the donor elects otherwise, the retained income rights are valued at zero. If the donor elects to treat the income right as a QFP, such right is valued on the assumption that the payment will be made as scheduled.

***Subsequent treatment of retained rights***

To make allowance for natural changes in the business cycle, no gift is deemed for failure to make a QFP from a corporation or partnership until three years after the year in which the QFP is due. In addition, there is no deemed gift if the instrument under which the payment is to be made provides that the unpaid QFP will bear compound interest at the discount rate used to determine the value of the initial gift.

A transfer of a retained QFP right results in a transfer equal to the excess of (1) the value of the gift determined with the statutorily mandated assumption that QFPs would be paid over (2) the value determined without such assumption.

***Bankruptcy or insolvency***

Special rules apply to corporations and partnerships in bankruptcy or insolvency. Under these special rules, the three-year grace period for deemed gifts is extended by the period of insolvency or bankruptcy; QFPs which are discharged in bankruptcy are not treated as deemed gifts; and no deemed gift occurs if the transferor transfers his retained interest during insolvency or bankruptcy. The bankruptcy exception does not apply if one purpose for commencing the bankruptcy suit was to avoid these rules. Insolvency is defined as the excess of liabilities over the fair market value of the assets. For this purpose, liabilities owed to the transferor or a member of the transferor's family are not taken into account.

### b. Grantor retained income trusts

*Valuation of initial transfers*

For trusts, a QFP would either be (1) a fixed amount payable at least annually, (2) an amount payable at least annually which is a fixed percentage of the trust's assets (valued annually), or (3) a non-contingent remainder interest if all the other interests in the trust are QFPs. These interests are similar to those permitted in charitable split interest trusts. Such interests would be valued under the appropriate Treasury tables.

Other interests in trusts are disregarded. Thus, a person who makes a completed transfer of an interest in property in trust and retains an interest determined by reference to the income of the trust (or a contingent reversionary right to trust corpus) is treated as making a transfer equal to the value of the whole property.

*Subsequent treatment of retained right*

Failure by a trust to make a QFP within 65 days of the end of its taxable year results in a deemed gift by the transferor.

*Personal residences*

The Discussion Draft does not apply to transfers of interests in a personal residence to be used by the holder of the term interest.

### c. Options and buy-sell agreements

Under the Discussion Draft, the value of property is determined without regard to options, rights of first refusal and leasehold rights held by family members. An exception to the rule is provided for property that lacks a readily ascertainable fair market value and is sold pursuant to a price determined under a formula which was reviewed within three years of the sale and which, at the time of the review, was reasonably expected to produce a price approximating fair market value at the time of exercise. The effect of an option falling within this exception on estate tax value would be determined under pre-section 2036(c) law.

### d. Sale of remainder interest and joint purchase of interests in property

Under the Discussion Draft, the retention of a term interest (including a life estate) in property is treated like the retention of an interest in trust. Moreover, a joint purchase of property is treated as an acquisition of the entire property by the holder of the term interest, followed by a transfer of the remainder interest. Thus, the Discussion Draft effectively treats the purchaser of a life estate pursuant to a joint purchase as making a gift of the entire property less the amount of any consideration paid by the purchaser of the remainder.

A special rule applies to a term interest in tangible property where the non-exercise of the term-holder's rights does not substantially affect the value of the property passing to the holder of the remainder interest. In that case, the value of the term interest is not zero, but the amount for which the term interest could be sold to an unrelated third party (not determined under the Treasury tables). For example, the rule could apply to the joint purchase of a

painting or undeveloped real estate (the value of which primaril reflects future development potential). On the other hand, the rul would not apply to a joint purchase of depletable property.

#### e. Installment sales and private annuities

The Discussion Draft only applies in valuing an interest in a co poration, partnership, or trust. Thus, the Discussion Draft genera ly does not apply to an installment note or private annuity fo which an individual is the obligor. In the case of a note or annuit which is an interest in an entity, the note or annuity would b treated as a QFP, so long as payments on it were fixed as to tim and amount and not subject to a life contingency.

### D. Proposal of the Section of Taxation of the District of Columbia Bar Association

#### 1. General description of D.C. Bar Proposal

On April 17, 1990, the section of taxation of the District of Columbia Bar Association issued a report containing a proposed alternative to section 2036(c) ("D. C. Bar Proposal").[87] The Proposal contained two sets of rules governing transactions that generally would be subject to section 2036(c), i.e., those involving an enterprise in which the transferor owns more than 10% before the transfer and in which he retains an interest after the transfer.

The first set of rules relates to valuation. Under one rule, the value of property transferred to a family member is determined as if it were associated with property retained by the transferor. The effect of this rule is to permit a discount for lack of control only if the retained and transferred property together constitute a minority interest.

Another valuation rule permits departure from the Treasury tables if the income or mortality assumption of those tables is likely to be substantially different from that actually experienced. Failure of the tables to reflect the subsequent experience of the transferred property would be evidence that their use at the time of the initial transfer was inappropriate, unless the deviation is due to circumstances not foreseeable at the time of the transfer and is attributable to factors beyond the reasonable control of the parties.

The second set of rules in the D.C. Bar Proposal concerns disclosure and the statute of limitations. The Proposal requires reporting of all section 2036(c) transactions regardless of whether the transaction gives rise to a taxable gift. In addition, the gift tax statute of limitations generally is extended to six years. Failure to adequately disclose the transaction tolls the gift tax statute of limitations. Even if the transfer is adequately disclosed, the Internal Revenue Service could, at donor's death, prove that the gift was undervalued and collect additional transfer tax attributable to the gift.

The D.C. Bar Proposal also gives the taxpayer the right to petition for an audit. Such audit permanently forecloses the Internal Revenue Service from subsequently revaluing the property. Failure of the IRS to audit within the later of (1) six years of the disclosure

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[87] *See* letter of Jane E. Bergner to Ronald A. Pearlman (April 19, 1990) (enclosure).

or (2) two years after filing the request for audit results in the taxpayer's value being treated as conclusive. Upon the donor's death, the Commissioner could not challenge the value for purposes of determining either the tax due on the gift or the appropriate estate tax bracket and credit.

**2. The effect of the D.C. Bar Proposal upon specific estate freeze transactions**

The disclosure and statute of limitations component of the D.C. Bar Proposal applies to the specific estate freeze transactions described below. In addition it makes the following substantive changes.

**a. Preferred interests in corporations and partnerships**

Under the D.C. Bar Proposal, the gift and estate tax consequences of the transfer of common stock, coupled with the retention of preferred stock is governed by pre-1987 law except that a discount for lack of control is permitted only if the retained and transferred property together would be entitled to such a discount. Subsequent events have potential transfer tax consequences. The failure to pay dividends or exercise other rights with respect to the retained preferred stock would be evidence of undervaluation of the transferred interest at the time of initial transfer. In addition, the D.C. Bar Proposal would retain present law gift tax treatment for the failure to exercise retained rights.

**b. Grantor retained income trusts**

The D.C. Bar Proposal modifies the valuation of a retained income interest in a GRIT to permit valuation without regard to the Treasury tables if either the Internal Revenue Service or the taxpayer establish that the actual income or mortality experience is likely to be different from those contained in the tables. The failure of the tables to predict the actual experience may be used to establish the inaccuracy of the original valuation unless the deviation is due to circumstances not foreseeable at the time of the transfer and is attributable to factors outside the reasonable control of the transferor or transferee.

**c. Options and buy-sell agreements**

Under the D.C. Bar Proposal, the estate or gift tax treatment of options and buy-sell agreements is governed by pre-1987 law.

**d. Sale of remainder interest and joint purchase of interests in property**

The D.C. Bar Proposal treats a sale of a remainder interest and a joint purchase in property the same as a GRIT. Thus, departure from Treasury tables is permitted if the Internal Revenue Service or the taxpayer establishes that the actual income or mortality experience is likely to be different from that assumed in the tables.

**e. Installment sales and private annuities**

The D.C. Bar Proposal treats a private annuity the same as a retained income interest in a GRIT. Thus, departure from Treasury tables is permitted if the Internal Revenue Service or the taxpayer

establishes that the actual income mortality experience is likely to be different from that assumed in the tables. Under the D.C. Bar Proposal, an installment sale is governed by pre-1987 law.

## E. Proposal of the U.S. Chamber of Commerce

### 1. General description of Chamber of Commerce Proposal

In its testimony before the House Ways and Means Committee on April 24, 1990, the U.S. Chamber of Commerce supported the "core concept" of the Discussion Draft and offered a modified draft ("Chamber of Commerce Proposal).[88]

*Assumptions in valuing gifts*

Like the Discussion Draft, the Chamber of Commerce Proposal divides retained rights into three categories.

One category consists of qualified non-discretionary payments, which are generally payments that are non-discretionary both as to time and amount. It also includes any dividend payable on a preferred stock to the extent that the dividend is determined at a non-discretionary rate. Such payments are assumed to be made as provided in the instrument. Payments under instruments lacking a non-discretionary termination date are assumed made in perpetuity.

A second category consists of rights valued under present law. These include: any interest of the same class as the transferred interest; any discount for minority interest or lack of marketability with respect to the transferred junior interest; any rights with respect to the retained preferred interest which have no preference over any rights under the transferred interest; any option, buy-sell, cross-purchase, redemption or other agreement to buy or sell property interests; employment agreements, debt, leases and other non-equity interests; rights of first refusal agreements and other transfer restrictions; and a payment or right which is (i) a function of any published index, (ii) directly related to sales or production, or (iii) otherwise not subject to the discretion of the transferor, his or her spouse or the 50 percent owned entity.

The third category consists of discretionary rights, defined as any liquidation, conversion, put, call or other right to a payment or distribution the payment of which is at the discretion of the transferor or entity. Such rights are valued at zero.

*Rules governing late payment of qualified non-discretionary payment or transfer of retained rights*

As under the Discussion Draft, the failure to make a qualified non-discretionary payment within three years generally results in a gift. The gift tax paid is refunded if the payment is subsequently made.

The later transfer of a qualified non-discretionary right is valued under the same assumptions made in the initial transfer. The value of any discretionary right previously valued at zero is reduced by the amount of the increase in the original gift resulting from valuing such right at zero.

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[88] *See* statement of David R. Burton to House Ways and Means Committee (April 24, 1990).

*Scope*

The Chamber of Commerce Proposal is limited to preferred interests retained in a partnership or corporation. It applies only to rights retained by the transferor or a spouse in a corporation or partnership in which the transferor directly or indirectly owns 50 percent or more. The definition of family is the same as the Discussion Draft except it excludes donees who are not otherwise related to the transferor.

*Statute of limitations*

The Chamber of Commerce Proposal does not change the gift tax statute of limitations.

**2. The effect of the Chamber of Commerce Proposal upon specific freeze transactions**

**a. Preferred interests in corporations and partnerships**

*Valuation of initial transfer*

*Qualified non-discretionary payments*

A qualified non-discretionary payment includes cumulative and noncumulative dividends. Such payments are valued by appropriately discounting future payments. Under the Chamber of Commerce Proposal, the value of all preferred interests determined under the special valuation rules is limited to the value of the entire business, and the value of the retained preferred stock is limited to its proportionate share of such value. Unlike the Discussion Draft, the Chamber of Commerce Proposal attaches no minimum value to the common interests.

*Other rights*

The Chamber of Commerce Proposal does not affect any nonequity interest; any right in the same or junior class; a minority discount or lack of marketability discount; or any payment or right that is (1) the function of a published index, (2) directly related to sales or production, or (3) otherwise not subject to the discretion of the transferor, his or her spouse, or the 50-percent or more owned entity. Discretionary liquidation, conversion, put and call rights are valued at zero.

*Subsequent treatment of retained rights*

Failure to make a qualified nondiscretionary payment within three years of its due date does not result in a gift if the instrument provides for compounding of interest. In addition, no gift occurs if the failure occurs when the company is bankrupt or insolvent (determined by taking into account liabilities owed the transferor). Finally, failure to make a qualified non-discretionary payment does not result in a gift if the sum of the entity's annual earnings and profits plus compensation to family members allocable to the retained interest is less than the qualified non-discretionary payment payable under the instrument. This exception applies only if, for the three years prior to the initial transfer, such sum

exceeded 150 percent of the average qualified non-discretionar payment payable.

**b. Other transactions**

The Chamber of Commerce Proposal is limited to preferred inter ests in corporations and partnerships. Thus, grantor retaine income trusts, options and buy-sell agreements, sales of remainde trusts, joint purchases, installment sales, and private annuit transactions would be governed by pre-1987 law.

## APPENDIX: DATA ON FEDERAL ESTATE AND GIFT TAXES

### *Federal estate and gift taxes compared to total Federal revenues*

Federal estate and gift taxes raised $8.7 billion towards total Federal receipts in fiscal year 1989. As indicated in Table 1, estate and gift taxes generally have provided increasing revenues over the past 50 years. Throughout the postwar period, the United States has experienced substantial growth of real per capita income and wealth. In the absence of changes in Federal transfer taxes, increasing wealth would generate increases in the real value of revenues generated by estate and gift taxes. In addition, the exemption levels and tax rate brackets of the estate and gift taxes have not been indexed for inflation. Consequently, inflation also would lead to increased revenues from the estate and gift taxes. The reduction in transfer tax revenues experienced after 1977 and again after 1982 primarily results from the increase in the exclusion amount (phased in), expanded marital deduction, and reduction in the highest marginal tax rates enacted by the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981.

Adjusting for inflation, the revenue collected from Federal transfer taxes in 1988 is more than 80 percent greater than the revenue collected from Federal transfer taxes in 1955. However, adjusting for inflation, the revenue collected from Federal transfer taxes in 1988 is less than 80 percent of the value of the revenue collected from transfer taxes in either 1965 or 1975.

While the more than $8 billion collected from the transfer taxes is significant, Federal transfer taxes in percentage terms provide only a small fraction of total Federal revenues. In the postwar era, Federal transfer taxes have only rarely provided revenues in excess of two percent of total Federal receipts. As Table 1 documents, revenues from the transfer taxes as a percentage of total Federal receipts have declined since the mid-1970s. Since 1982, transfer taxes have never accounted for more than one percent of total Federal receipts. The growth of other revenue sources accounts for at least some of the decline in the share of Federal receipts provided by the transfer taxes.

**Table 1.—Revenue from the Federal Estate and Gift Taxes, Selected Fiscal Years 1940–1989**

[Dollar amounts in millions]

| Fiscal year | Revenues | Percentage of total Federal receipts |
|---|---|---|
| 1940 | $357 | 6.9 |
| 1945 | 638 | 1.4 |
| 1950 | 698 | 1.9 |
| 1955 | 924 | 1.4 |
| 1960 | 1,606 | 1.7 |
| 1961 | 1,896 | 2.0 |
| 1965 | 2,716 | 2.3 |
| 1966 | 3,066 | 2.1 |
| 1970 | 3,644 | 1.9 |
| 1973 | 4,917 | 2.1 |
| 1975 | 4,611 | 1.7 |
| 1976 | 5,216 | 1.7 |
| 1977 | 7,327 | 2.1 |
| 1978 | 5,285 | 1.3 |
| 1979 | 5,411 | 1.2 |
| 1980 | 6,389 | 1.2 |
| 1981 | 6,787 | 1.1 |
| 1982 | 7,991 | 1.3 |
| 1983 | 6,053 | 1.0 |
| 1984 | 6,010 | 0.9 |
| 1985 | 6,422 | 0.9 |
| 1986 | 6,958 | 0.9 |
| 1987 | 7,493 | 0.9 |
| 1988 | 7,594 | 0.8 |
| 1989 | 8,745 | 0.9 |

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems,* 1964; Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 1987; and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 1991.*

### *Scope of the Federal estate tax*

Relatively few decedents incur a Federal estate tax liability. Since the revisions made to the estate tax as part of the Economic Recovery Tax Act of 1981, generally less than two percent of decedents incur an estate tax liability. In 1988, less than one percent of decedents incurred an estate tax liability. Never have as many as 10 percent of decedents incurred an estate tax liability. Table 2 presents data for selected years on the number of returns taxable under the estate tax compared to the number of adult deaths in the United States.

As discussed above, in the absence of changes in the estate tax, inflation and the growth in per capita wealth in the United States over the past 50 years would cause more decedents' estates to incur an estate tax liability. This was the case until 1977. The increase in

the estate tax exclusion enacted in the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981 removed a substantial number of estates from Federal estate taxation.

**Table 2.—Number of Taxable Federal Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years 1940–1988**

| Year | Deaths | Taxable estate tax return filed [1] | |
|---|---|---|---|
| | | Number | Percent of deaths |
| 1940 | 1,237,186 | 12,907 | 1.04 |
| 1945 | 1,239,713 | 13,869 | 1.12 |
| 1950 | 1,304,343 | 17,411 | 1.33 |
| 1955 | 1,379,826 | 25,143 | 1.82 |
| 1961 | 1,548,665 | 45,439 | 2.93 |
| 1966 | 1,727,240 | [2] 67,404 | 3.90 |
| 1970 | 1,796,940 | [2] 93,424 | 5.20 |
| 1973 | 1,867,689 | [2] 120,761 | 6.47 |
| 1977 | 1,819,107 | [2] 139,115 | 7.65 |
| 1982 | 1,897,820 | [2, 3] 41,620 | 2.19 |
| 1983 | 1,945,913 | [2, 3] 35,148 | 1.81 |
| 1984 | 1,968,128 | [2, 3] 31,507 | 1.60 |
| 1985 | 2,086,440 | [2, 3] 30,518 | 1.46 |
| 1988 | [4] 2,171,000 | [2] 18,948 | 0.87 |

[1] Estate tax returns are not necessarily filed in the year of the decedent's death. Consequently, the data for taxable returns may not correspond to the same year as the data for deaths.

[2] Not strictly comparable with pre-1966 data. For 1966 and later years, the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.

[4] Preliminary estimate.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington, Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income;* and U.S. National Center for Health Statistics.

### *Summary data from Federal estate tax returns*

Data from Federal estate tax returns filed in 1988 show that more than one quarter of the value of gross estates comes from corporate stock, both publicly traded and non-traded, held by the decedent. Real estate represents another fifth of the value of gross estates. Deductions exempt from tax nearly one half of the value of gross estates. However, one third of the value of estates is excluded from tax under the marital deduction, which generally only provides a deferral of tax until the death of the surviving spouse. Table 3 provides a more detailed presentation of summary data on the composition of estates for estate tax returns filed in 1988.

## Table 3.—Data on Federal Estate Tax Returns Filed in 1988

[Dollar amounts in millions]

| Item | Returns | Percent | Value | Percen |
|---|---|---|---|---|
| **Gross Estate** | **43,683** | **100.0** | **$70,625.4** | **100.** |
| Real estate | 35,077 | 80.3 | 13,564.8 | 19. |
| Corporate stock | 34,333 | 78.6 | 19,638.8 | 27. |
| Bonds (total) | 26,803 | 61.4 | 8,077.5 | 11. |
| Federal savings | 6,255 | 14.3 | 243.3 | . |
| Federal other | 9,239 | 21.2 | 1,539.2 | 2. |
| State and local | 19,521 | 44.7 | 5,823.1 | 8. |
| Corporate and foreign | 9,391 | 21.5 | 471.9 | . |
| Cash | 42,345 | 96.9 | 7,614.4 | 10. |
| Notes and mortgages | 12,568 | 28.8 | 1,708.7 | 2. |
| Life insurance | 23,741 | 54.3 | 2,150.0 | 3. |
| Annuities | 11,985 | 27.4 | 1,692.3 | 2. |
| Noncorporate business | 10,916 | 25.0 | 2,519.4 | 3. |
| Household assets | 39,374 | 90.1 | 2,547.4 | 3. |
| Lifetime transfers | 9,382 | 21.5 | 11,112.1 | 15. |
| **Deductions (total)** | **43,596** | **99.9** | **33,523.9** | **47.** |
| Funeral expenses | 40,274 | 92.2 | 197.5 | .3 |
| Admin. expenses (total) | 31,846 | 72.9 | 1,700.6 | 2.4 |
| Executors | 15,408 | 35.3 | 632.6 | .9 |
| Attorneys | 25,702 | 58.8 | 604.9 | .9 |
| Other | 30,762 | 70.4 | 463.1 | .7 |
| Debts and mortgages | 35,514 | 81.3 | 3,238.2 | 4.6 |
| Charity | 8,376 | 19.2 | 4,822.1 | 6.8 |
| Marital | 20,593 | 47.1 | 23,539.6 | 33.3 |
| ESOP | (1) | (1) | (1) | (1) |
| **Taxable estate** | **39,480** | **90.4** | **37,250.2** | **52.7** |
| Adjusted taxable gifts | 4,582 | 10.5 | 918.2 | 1.3 |
| Adjusted taxable estate | 39,551 | 90.5 | 38,168.4 | 54.0 |
| **Estate tax before credits** | **39,551** | **90.5** | **14,588.7** | **20.7** |
| **Credits (total)** | **39,550** | **90.5** | **8,187.3** | **11.6** |
| Unified | 39,550 | 90.5 | 6,559.5 | 9.3 |
| State death taxes | 21,900 | 50.1 | 1,567.5 | 2.2 |
| Other | 919 | 2.1 | 60.1 | .1 |
| **Estate tax** | **18,948** | **43.4** | **6,299.2** | **8.9** |

[1] Information not disclosed.

Source: Internal Revenue Service.

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