Prop. Regs. Address Adjustments and Lapsing Rights

The second set of Proposed Regulations on Chapter 14 focuses on adjustments relating to retained interests and on lapsing rights and restrictions. Although the Regs. clarify the rules, a number of issues remain unresolved.

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The second set of Proposed Regulations under Chapter 14 was issued on 9/10/91 (PS-30-91).[1] The Proposed Regulations provide guidance regarding two areas of Chapter 14: (1) adjustments under the special valuation rules to prevent double transfer taxation and (2) treatment of lapsing voting and liquidation rights, as well as restrictions on corporate and partnership interests.

Avoiding double taxation

A person who, intentionally or otherwise, makes a transfer (whether an estate freeze or a nonfreeze) that is subject to the special valuation rules of Section 2701 is subject to the risk of double transfer taxation. This could be the result, for instance, if the transferor retains an "applicable retained interest" (other than a qualified payment right) that is thereafter transferred during life or at the transferor's death.

The term "applicable retained interest" refers to an interest that confers a liquidation, put, call, conversion, or similar right if the exercise or nonexercise of that right would affect the value of the transferred interest (an "extraordinary payment right").[2] The term also refers to an interest as to which there is a distribution right in a "controlled" entity, *i.e.*, a corporation or partnership in which 50% of the total voting power or fair market value of equity interests was held before the transfer by the transferor, the transferor's spouse, an ancestor of either, a spouse of an ancestor, or by any lineal descendants of the parents of the transferor or the transferor's spouse.[3]

Applicable retained interests held by the transferor that consist of extraordinary payment rights are valued at zero. Also valued at zero is an applicable retained interest that is a distribution right in a controlled entity unless it is a "qualified payment right."[4] That zero valuation assumption would apply, for example, to

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retained noncumulative preferred stock in a corporation when the transferor gives common stock in the same corporation to a child, grandchild, spouse, or spouse of a child or grandchild. The transferor is treated for gift tax purposes as also having transferred the fair market value of that preferred stock (*i.e.*, the retained interest).

If the transferor holding the applicable retained interest thereafter transfers that interest during life or at death, the applicable retained interest will be valued for gift or estate tax purposes. The regular transfer tax provisions of the Code do not allow the applicable retained interest to be given the same value (zero) that it previously was given under Section 2701. The transferor is subject to transfer tax twice on the same interest—the applicable retained interest.

Example 1. P owns all the outstanding stock of corporation X, consisting of 100 shares of preferred stock, which pays a noncumulative preferred dividend, and 100 shares of common stock. The value of the corporation is $1 million. The 100 shares of common stock are appraised at $600,000, and the 100 shares of noncumulative preferred are appraised at $400,000. P gives the 100 shares of common stock to his children. Section 2701 treats P's retained preferred stock as an applicable retained interest to which the special valuation rules apply. For Chapter 14 gift tax purposes, P's retained noncumulative preferred is valued at zero, and the common stock carries with it the full value of the corporation, or $1 million. Thus, P is treated as also having transferred the value of the retained preferred stock, $400,000.

Nevertheless, if P dies while retaining the preferred stock interest, the value of this stock is computed under general fair market value principles, *i.e.*, $400,000, even though the $600,000 gift of the common stock to P's children was valued at $1 million as if the preferred stock had no value under the application of Section 2701. Accordingly, P would be taxed twice on this $400,000 amount—once for gift tax purposes and once for estate tax purposes.

Adjustments. To mitigate this effect, Congress in Section 2701(e)(6) provided that Regulations are to make appropriate adjustments for subsequent transfers, or inclusions in the gross estate, of any applicable retained interest valued under Section 2701(a). Proposed Regulation 25.2701-5 attempts to provide these adjustments in the form of a credit. Since these adjustments apply only if an applicable retained interest was valued pursuant to the special rules of Section 2701, excluded are applicable retained interests that represent "qualified payment rights" because these rights are valued pursuant to general valuation principles,[5] and not pursuant to Section 2701 principles.

Working with the credit

Under Prop. Reg. 25.2701-5(a), the credit will apply against the estate tax of a person who, during life, made a transfer where the amount of the taxable gift was calculated by reference to the special valuation rules under Section 2701. The Preamble to the Proposed Regulations explains that the credit is the increase in the gift tax payable on the transfer that results from the application of Section 2701. The Proposed Regulations, however, take a proportional approach similar to the reimbursement calculation in Section 2206, rather than the incremental approach hinted at in the explanation.

Proposed Regulation 25.2701-5(b) provides that the credit is the amount of the gift tax payable with respect to the initial transfer to which Section 2701 applied, prior to the application of the lifetime unified gift tax credit, multiplied by a fraction. To determine the fraction, two values are required: first, the taxable gift determined under Section 2701; and second, the amount the taxable gift would have been without application of Chapter 14 principles. The numerator of the fraction is the difference between these two values, and the denominator is the amount of the taxable gift determined under Section 2701.

Example 2. To calculate the credit applicable to the gift transfers in Example 1, first determine the amount by which P's taxable gifts were increased as a result of the special Section 2701 valuation rules. This amount is $400,000, the difference between P's taxable gift due to use of the special valuation rules and what P's

taxable gifts would have been without these valuation rules. The denominator is $1 million, P's initial taxable gift determined under Section 2701. The fraction is 400,000/1,000,000, or .4, and is multiplied by the gift tax payable with respect to P's initial transfer subject to Section 2701 (without application of the unified credit). This amount is $345,800; therefore, P's estate is entitled to a nonrefundable credit of $345,800 times .4, or $138,320.

The credit allowed by Prop. Reg. 25.2701-5 is nonrefundable and is reflected after the computation of the estate tax under Section 2001 but before the application of the unified credit under Section 2010. If the initial transfer is treated as a split gift made one-half by the initial transferor's spouse under Section 2513, Prop. Reg. 25.2701-5(b)(3) allows each spouse to be treated as the initial transferor as to one-half of the transfer.

Planning strategies. Practitioners should be aware of issues presented by this adjustment methodology before concluding that the adjustments will place the transferor in the same position as if no Section 2701 transfer had occurred. First, as noted, the adjustment allows a fractional credit, but the credit approach will not provide full relief from double taxation in all situations. The problem of double taxation could be avoided better by a reduction in adjusted taxable gifts, the approach used under Section 2702 (discussed *infra*). This point was noted at the hearings on the Proposed Regulations on 11/1/91.

In the above example, the equitable result would have been to value the preferred stock included in P's gross estate at zero because P had already paid gift tax on this stock. If P's highest marginal estate tax is 55%, then prior to the application of the adjustment, P would incur an additional $220,000 in estate tax as a result of the inclusion of the preferred stock in P's gross estate. After reducing this amount by the $138,320 credit, P incurs an additional $81,680 in estate tax. Had P died without making any transfer of the common stock, the full $1 million would have been included in P's gross estate, but the estate taxes incurred by this $1 million would have been less than the gift and estate taxes resulting from the Section 2701 transfer during lifetime.

Another concern with the proposed credit is that if the value of the applicable retained interest increases after the transfer, the appreciation is attributed completely to the individual holding the retained interest, and no adjustments are provided by the Proposed Regulations. Moreover, there is no adjustment for distributions received by the transferor from the partnership or corporation on account of the applicable retained interest.

The credit approach under Section 2701 will not provide full relief from double taxation in all cases.

A further problem with the credit is that there seem to be no adjustments in the Proposed Regulations for an applicable retained interest that is transferred during life by the holder of that interest. The Proposed Regulations allow an estate tax credit for an individual who made a Section 2701 transfer during lifetime, regardless of whether that individual holds the applicable retained interest at death. If there has been a transfer of the applicable retained interest during life, that interest is valued for gift tax purposes at then fair market value and no adjustment is made at that time. Instead, under the Proposed Regulations, the credit is applied against the estate tax even though that individual does not hold the applicable retained interest at death. It is hoped that the final Regulations will contain a relief provision specifically addressing inter vivos gifts of applicable retained interests that were initially valued under Section 2701.

As a result of these inequities with the credit approach, planners should generally avoid, for transfer tax purposes, transactions in which retained interests will be given a zero value under Section 2701 for gift tax purposes. To the extent these transactions are entered into for non-

transfer tax reasons, planners should be aware of the potential, additional transfer tax exposure resulting from the proposed transaction.

Application of deduction

The Proposed Regulations also address the situation in which an individual who retained a trust interest that was valued at zero under the special rules of Section 2702, later transfers that interest.[6] Chapter 14 contains no provision authorizing the adoption of Regulations to address this issue, and the issue itself may not be a practical concern. The adjustment will most often be required where a grantor creates a retained interest trust for a period of years, and the grantor retains an income interest. As a result of the new Section 2702 valuation rules, there is now no transfer tax purpose to this type of trust and there will not often be situations in which this type of trust is established.

Example 3. Grandmother M transfers $500,000 to a trust that she establishes for the benefit of her grandchildren. M retains an income interest in the trust for five years; the remainder interest continues to be held in trust after the expiration of her income interest. Under Section 2702, M is treated as having made a taxable gift of $500,000, the full amount transferred to the trust, and as not retaining any interest.

Assume that at the end of three years, M transfers her remaining income interest to her son, S. The value of this transfer, less the gift tax annual exclusion amount, under general gift tax principles is $72,232, using a discount rate of 9.4%. As a result, M would pay a gift tax twice on this same amount (*i.e.*, the $72,232 amount was included in the initial $500,000 gift).

To mitigate the possibility of double taxation, the Proposed Regulations permit a reduction in taxable gifts if an individual transfers an interest in trust that was previously valued under Section 2702, other than a qualified interest. The reduction in aggregate taxable gifts (or adjusted taxable gifts in the case of a remainder interest valued at zero under Section 2702 that is included in the individual's gross estate) is the lesser of the following:

1. The increase in the individual's taxable gifts resulting from the interest being valued at zero pursuant to the rules of Section 2702 (or being reduced in value pursuant to the rules applicable to tangible personal property under Section 2702).
2. The increase in the individual's taxable gifts (or gross estate) resulting from the subsequent transfer of the interest.[7]

Example 4. In Example 3, M makes a gift of $72,232 by transferring to S, at the end of three years, her right to income from the trust for the remainder of the five-year term. Under the Proposed Regulations, M can reduce her taxable gifts in that year by the lesser of (1) $180,932 (the increase in M's taxable gifts in year one due to the fact that the retained income interest was valued at zero), or (2) $72,232 (the amount of the taxable gift transfer). Hence, the transfer of the right to income to S does not result in a taxable gift ($72,232 − $72,232 = 0).

Planning issues with the proposed retained interest adjustment. Although the proposed

Citations

1 For background on the first set of Proposed Regulations under Chapter 14, see Harrison, *Proposed Regulations amplify new estate freeze rules*, 18 EP 259 (Sept/Oct 1991), and Harrison, *Prop. Regs. clarify planning for GRITs, buy-sell agreements*, 18 EP 323 (Nov/Dec 1991).
2 Section 2701(b)(1)(B); Prop. Reg. 25.2701-2(b)(1)(i).
3 Sections 2701(b)(1)(A), 2701(b)(2), 2701(c)(1)(A); Prop. Regs. 25.2701-2(b)(5), 25.2701-2(b)(3).
4 Section 2701(a)(3)(A); Prop. Regs. 25.2701-2(a)(1) and (2).
5 Prop. Reg. 25.2701-2(a)(4).
6 Prop. Reg. 25.2702-6(a).
7 Prop. Reg. 25.2702-6(b).
8 TCM 1987-8.
9 Prop. Reg. 25.2704-1(a). See also Prop. Reg. 25.2701-2(b)(5).
10 Prop. Reg. 25.2704-1(b).
11 Prop. Reg. 25.2704-1(h) (Example 9).
12 Prop. Reg. 25.2704-1(d). See also the Preamble to the Proposed Regulations.
13 Prop. Reg. 25.2704-1(h) (Example 8).
14 See also Prop. Reg. 25.2704-1(d).
15 Prop. Reg. 25.2704-1(d). See also Prop. Reg. 25.2704-1(h) (Example 7).
16 Prop. Reg. 25.2704-1(h) (Example 7).
17 *Cf. Estate of Hall*, 92 TC 19 (1989).
18 Section 2704(b)(1)(B); Prop. Regs. 25.2704-2(a), 25.2702-2(a)(1), 25.2701-2(b)(5).
19 Section 2704(b)(2); Prop. Reg. 25.2704-2(b).
20 Section 2704(b)(3); Prop. Reg. 25.2704-2(b).

Section 2702 deduction adjustment is preferable to the proposed Section 2701 credit adjustment, the deduction still does not return the transferor to a beneficial transfer tax position.

Example 5. In Example 3, the Section 2701 value of the retained interest is zero; but the initial value of the retained income interest under general valuation rules (assuming a 9.4% discount rate) is $180,932. At the time that M transfers the interest (at the end of year three), the taxable gift value of the transfer is $72,232, and under the Proposed Regulations, she would be entitled to a reduction in taxable gifts for that year of the transfer of $72,232. At first glance, this seems logical. Nevertheless, the amount of income that M has received prior to this transfer could be included in her gross estate. The Proposed Regulations do not provide an adjustment to account for this inequity—perhaps because of the difficulty of measuring the amount.

Lapse of rights

Section 2704(a) addresses the problem attacked by the Service in *Estate of Harrison*[8] and legislatively overrules the holding in that case. In *Harrison,* the decedent obtained during his life partnership interests with aggregate values of $59,476,523. This amount represented the decedent's share of the partnership if the partnership was liquidated, and the decedent had the right during life to dissolve and liquidate the partnership. At the decedent's death, the right to dissolve and liquidate the partnership effectively ceased as to the decedent's interest in the partnership. As a result, the value of the decedent's partnership interests decreased from approximately $60,312,136, the value immediately before death, to $33,757,116. In effect, the decedent's right to dissolve and liquidate the partnership increased the value of his other interests in the partnership by $26,555,020.

The Service attempted to include this additional $26,555,020 in the decedent's estate, arguing that the lapse of the liquidation right at death should be treated as a transfer and given a value for estate tax purposes. The Tax Court in *Harrison* refused to accept the Service's argument and held that for estate tax purposes, the value of the decedent's partnership interests was $33,757,116.

The problem identified by the Service—that $26,555,020 was transferred to the decedent's family without the payment of any gift tax or estate tax—was realistic. To address this problem, Congress in Section 2704 adopted the argument propounded by the Service—the same argument that was rejected by the *Harrison* court—that a right that lapses is given a value and treated as a taxable transfer at the time of the lapse.

Section 2704(a) provides that a lapse of any voting or liquidation right in a partnership or corporation is treated as a transfer by gift, or a transfer that is includable in the gross estate of the decedent, if the individual holding the right and members of his family control the partnership or corporation both before and after the lapse.[9] A "voting right" is any right to vote with respect to "any matter of the entity."[10] For example, the right of a general partner to participate in management is a voting right. A "liquidation right" is a right to "compel the entity to acquire all or a portion of the holder's equity interest in the entity." A right to put preferred stock to a corporation in exchange for its par value would qualify as a liquidation right under the Proposed Regulations.[11]

The amount of the transfer is the value that disappears because of the lapsing right. According to Prop. Reg. 25.2704-1(f), this amount is the excess of (1) the value of all interests the individual holds in a partnership or corporation immediately before the lapse (using the assumption that voting and liquidation rights do not lapse) over (2) the value of such interests after the lapse (increased by any consideration received on account of the lapse). Logically, if the lapse of voting rights results in the transferor losing voting control, the value of the control premium would be included in the value of the transfer.

Example 6. If the facts of *Harrison* had occurred after the enactment of Section 2704(a), the decedent's interest that lapsed at death (*i.e.*, the right to dissolve and liquidate the partnership) would be treated as a transfer and given a value for estate tax purposes. This value would

be the value of all interests held by the decedent immediately prior to death (approximately $60,312,136) over the value of such interests after the lapse (approximately $33,757,116). As a result, the lapse would be treated as a transfer of $26,555,020, and that additional amount would be included in the decedent's gross estate.

Narrowing the statute's reach

The language in Section 2704(a) is broad enough to cause concern that it would apply to situations other than the one in *Harrison*. For example, Section 2704(a) arguably could apply to the lapse of voting rights when a voting trust, an irrevocable proxy, or other stock voting agreement terminates, although these types of arrangements are not done for transfer tax purposes and should not be covered by the statute. Fortunately, the Proposed Regulations address this concern and provide that a transfer of stock to a voting trust or similar arrangement cannot result, by itself, in a lapse of a voting right subject to Section 2704(a).[12]

Example 7. D owns 45% and D's child, C, owns 20% of the voting common stock of corporation Y. C gives D an irrevocable proxy to vote C's stock for five years after which the right reverts to C. Section 2704(a) does not apply to C on the grant of the proxy or to D on its termination.[13]

Section 2704(a) could also apply to the inter vivos transfer of control. For example, a parent who owns 51% of the common stock and

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transfers 2% of his stock to his children, so that they became 51% owners, effectively has transferred control, an event that could invoke the statute. Arguably, this situation represents a lapse of a voting right in that "voting control" is eliminated by the transfer of the stock. The Preamble to the Proposed Regulations clarifies that this is not the case: "Generally, a transfer of an interest conferring a right is not a lapse of that right because the right is not reduced or eliminated. For example, the transfer of a minority interest by the controlling shareholder is not a lapse of voting rights even though the transfer results in a transferor's loss of voting control."[14]

As a result, the shift of a transferor from a voting control position to a minority position via the transfer of stock with voting rights to member of the transferor's family will not invoke the statute. A transfer that reduces an individual's aggregate voting power, however, is treated as a lapse of a liquidation right to the extent the transfer results in the elimination of the individual's right to compel liquidation of an interest other than the interest tied to the voting power.[15]

Example 8. D and his two children, A and B, are partners in partnership X. Each has a 3⅓% general partnership interest and a 30% limited partnership interest. The partnership agreement provides that when a general partner dies, the partnership must redeem the general partnership interest for its liquidation value. Under the agreement, only a general partner can liquidate the partnership. D transfers his general partnership interest prior to his death. Section 2704 does not apply to the transfer of D's voting rights attached to the general partnership interest because the voting rights are not reduced or eliminated. The transfer of the general partnership interest is also not a lapse of a liquidation right as to that interest because the liquidation right with respect to that general partnership interest has not been restricted or eliminated. In contrast, under the agreement, only a general partner (not a limited partner) can liquidate the partnership. Therefore, the transfer of the general partnership interest is a lapse of D's liquidation right with respect to his limited partnership interests since after the transfer D can no longer liquidate those interests.[16]

The Proposed Regulations explain the interplay between Sections 2701 and 2704(a). This

is important because although Section 2704 creates values for lapsing voting and liquidation rights, it does not apply when a lapsing voting right is created. The statute does not discuss the interplay between these two sections, which creates double taxation issues. Under Prop. Reg. 25.2704-1(e)(2), Section 2704(a) does not apply to the lapse of a voting or liquidation right previously valued in the hands of the holder under Section 2701(a).

Example 9. D owns all of the single class of stock of corporation Y and recapitalizes Y so that he retains nonvoting common and voting preferred stock. The preferred stock carries a right to put the stock for its par value at any time during the next ten years. D transfers the common stock to his grandchild for no consideration. In valuing D's gift, Section 2701 applies, and D's retained put right is valued at zero. If D owns the preferred stock at the time his put right lapses, the preferred stock could be revalued pursuant to Section 2704(a), and D would be treated as having made a transfer of the value of the unexercised put right. This would result in D being taxed twice on the put right. The Proposed Regulations prevent this result. Because the put right was previously valued in D's hands under Section 2701, Section 2704(a) does not apply to D when and if this put right lapses.

Certain restrictions disregarded

Section 2704(b) directs that for transfer tax purposes, certain restrictions placed on stock or partnership interests are to be ignored. The effect of disregarding a restriction is that the transferred interest is valued as if the restriction does not exist and as if the rights of the transferor are determined under applicable state law.[17]

A restriction ("applicable restriction") is disregarded in determining the value of a transferred interest provided the following conditions are met.

1. The interest transferred must be in a corporation or partnership and must be to, or for the benefit of, a member of the transferor's family.

2. The transferor and the members of his family must hold control of the corporation or partnership immediately before the transfer.[18]

3. The restriction must effectively limit the ability of the corporation or partnership to liquidate, it must be more restrictive than applicable state law, and it must either (1) lapse, in whole or in part, after the transfer of the interest, or (2) be subject to removal by the transferor or any member of the family immediately after the transfer.[19]

Example 10. P owns a 75% interest in a partnership and his children own the remaining 25%. Under state law, consent of 55% of the total ownership is required for liquidation, but under the partnership agreement, 100% is needed. On P's death, his partnership interest passes to his children. The requirement for 100% agreement to liquidate is an applicable restriction that will be disregarded under Section 2704(b) in valuing P's partnership interest. P's interest will be valued under state law.

The term "applicable restriction" does not include (1) any commercially reasonable restriction that arises as part of any financing by the partnership or corporation with an unrelated person or (2) any restriction imposed or acquired by Federal or state law.[20] Proposed Regulation 25.2704-2(b) clarifies that an unrelated person is one who is not listed in Section 267(b), the general attribution rules. For purposes of Section 267(b), the term "fiduciary of a trust" does not include a bank.

Prior to the Proposed Regulations, practitioners were concerned that Section 2704(b) restricted the application of the buy-sell rules under Section 2703. Importantly, Prop. Reg. 25.2704-2(b) makes clear that an option, right to use property, or agreement that is subject to Section 2703 is not an applicable restriction.

Conclusion

The latest Proposed Regulations under Chapter 14 answer many questions raised by the statute and provide needed guidance for practitioners. Nevertheless, a number of issues remain to be clarified. ◆