FEDERAL WEALTH TRANSFER TAX ANTHOLOGY

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income of, or rights in, the enterprise." Section 2036(c) had no effect on the timing or valuation of the initial transfer; however, when the owner ultimately disposed of the retained interest during life or at death, the previously transferred interest was revalued and drawn back into the transfer tax base. For a critical analysis of § 2036(c), see Karen C. Burke, *Valuation Freezes After the 1988 Act: The Impact of Section 2036(c) on Closely Held Businesses*, 31 WM. & MARY L. REV. 67 (1989). The new provision provoked vehement opposition from business owners and estate planners, and was repealed in 1990 simultaneously with the enactment of Chapter 14.

3. Estate Freezes Under Current Law

James R. Repetti examines the special valuation rules of §§ 2701 and 2704, and compares the detailed statutory treatment of equity freezes with the absence of specific rules for minority discounts. Another view is offered by Louis S. Harrison, who concludes that these provisions effectively eliminate valuation abuses associated with business estate freezing techniques. Finally, Grayson M.P. McCouch discusses the impact of § 2702 on split-interest trusts.

James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995)*

* * *

* * * Congress has adopted rules to prevent shareholders or partners from transferring the opportunity to participate in future appreciation of corporations or partnerships in transactions commonly referred to as "estate freezes." In the typical estate freeze, an older generation transfers ownership rights to a younger generation that are likely to appreciate in value while retaining interests that are unlikely to appreciate.[114] Because the value of the retained interest is not likely to appreciate, the older generation has "frozen" the value of property that will be includable in its estate. Any future appreciation in the transferred interest will escape taxation.

For example, in a classic estate freeze, an older generation transfers common stock to the younger generation and retains preferred stock with a fixed dividend right. Even if the company becomes more profitable, the preferred stock will not appreciate because of its fixed dividend right. The future appreciation in common stock will not be subject to the estate or gift tax.

Congress first sought to address this problem in 1987 by adopting 2036(c). Because 2036(c) was deemed too vague, Congress repealed it in 1990 and replaced it with 2701. In general, 2701 deals with abuses in calculating the value of the transferred interests, the common stock in the above example.[120] It assumes that the value of the common stock equals the value of all stock interests, common and preferred, minus the value of the preferred stock. The pre-

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[114] STAFF OF JOINT COMM. ON TAX'N, 101ST CONG., 2D SESS., FEDERAL TRANSFER TAX CONSEQUENCES OF ESTATE FREEZES at 9 (Comm. Print 1990).

[120] *See* Louis S. Harrison, *The Real Implications of the New Transfer Tax Valuation Rules—Success Or Failure?*, 47 TAX LAW. 885, 892-94, 903-07 (1994) * * * .

ferred stock generally is treated as having a zero value if the corporation is a "controlled entity" unless the preferred stock has a cumulative right to receive dividends. A "controlled entity" is defined as a corporation or partnership in which at least 50% of the total voting power or fair market value of the equity interests are owned immediately before the transfer "by the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse."

Note that 2701 assumes that, where the transferees have voting control and are family members, they will maximize the transferred value. The requirement that dividends be cumulative in the context of a family-controlled entity, in effect, creates an irrebuttable presumption that the family members will work together to increase the value of the transferred interest after the taxable transfer by causing the company not to pay dividends. Congress apparently has not been willing to assume, however, that family members will work together with respect to other management matters. Section 2701 does not affect the availability of minority discounts. The regulations under 2701 continue to allow a minority discount in calculating the value of the transferred interests that would have been allowed prior to the adoption of 2701.

* * *

Estate planners also have used the concept of disappearing value by employing formal legal rights that lapse upon the death of the holder. Frequently, a taxpayer would hold stock in a family owned corporation or an interest in a family owned partnership that would include the right to liquidate. If the corporation or partnership had valuable assets, that right may cause the stock or partnership interest to be more valuable than it would have been without a liquidation right. In order to minimize the value of the partnership interest or stock in the taxpayer's estate, the liquidation right would lapse upon the taxpayer's death.

The lapse of the liquidation right could result in a substantial diminution in the value of assets held by the estate and, therefore, a significant decrease in estate tax. Note, however, that the lapse would have no adverse economic impact on the legatees or other family members because the family's control of the partnership or corporation would allow the family to liquidate the business at will. For example, in *Estate of Harrison v. Commissioner*,[124] the taxpayer and the Service stipulated that a limited partnership interest in a partnership that held valuable real estate, oil and gas interests and marketable securities would have a value of more than $59 million if accompanied by a liquidation right but only $33 million without a liquidation right. The court held that because the taxpayer's liquidation right lapsed upon death, the limited partnership interest should be valued at the lower amount even though the taxpayer's family continued to control the partnership.[126]

The legislative response to *Estate of Harrison* was 2704(a), adopted as part of a major revision of the estate and gift taxes in 1990. Section 2704(a) provides that, in certain situations, the lapse of a voting or liquidation right with respect to an interest in an entity is a transfer for estate and gift tax purposes. The amount of the transfer is the reduction in value attributable to the lapse.

Section 2704(a) applies where the holder of the lapsed voting or liquidation right and the holder's family control the entity immediately before and after the lapse. The holder and holder's family must be able to liquidate an interest that the holder held and could have liquidated prior to the lapse. In determining whether the interest could be liquidated after the lapse, restrictions on liquidation that may be removed by the holder or holder's family are disregarded.

[124] 52 T.C.M. (CCH) 1306 (1987).

[126] The court rejected the Service's argument that the lapse of the liquidation right had transferred "something of value" to the taxpayer's two sons who were the only other partners because the Service had stipulated the value of the son's partnership interests had remained the same after the lapse. *Id.* at 1309 * * * .

In effect, 2704 assumes that there has been no diminution in value when a liquidation right lapses, because the family, viewed as a whole, still has the power to liquidate the entity.

* * *

Section 2704(a) also applies to a lapse of any "voting right." Voting right is defined as "a right to vote with respect to any matter of the entity," for example, the right of a general partner to participate in partnership management. The holder of a lapsed voting right in a family controlled entity is treated as having made a taxable transfer. Again, the value of the transfer is the difference between the value of all interests in the entity held by the taxpayer before the lapse and the value of such interests after the lapse. Where the lapse of voting rights results in the holder losing control of the entity, the amount transferred should include the value of the control premium.

One remarkable aspect of 2704(a) is that it, in effect, creates an irrebuttable presumption that family members will cooperate. It assumes that the transferor's voting or liquidation right has not disappeared but rather has been transferred to family members. Thus, in the narrow context of voting and liquidation rights, Congress has done what it refused to do in the broader context of minority discounts for assets held by family members. Indeed, Congress was very careful to point out that it did not intend to change the treatment of minority discounts or other discounts under present law.

* * *

NOTE

Is the treatment of voting and liquidation rights under § 2704(a) consistent with Repetti's recommendation, reproduced *supra* in Subpart A, concerning minority discounts? Why did Congress avoid addressing the valuation of minority discounts in § 2704? Compare Repetti's view of §§ 2701 and 2704 with the somewhat more enthusiastic appraisal in the following excerpt.

Louis S. Harrison, *The Real Implications of the New Transfer Tax Valuation Rules—Success or Failure?*, 47 Tax Law. 885 (1994)*

* * *

III. VALUING RETAINED RIGHTS IN THE CORPORATE OR PARTNERSHIP SETTING UNDER CHAPTER 14

* * *

B. Application of the Valuation Mandate

* * *

The following example illustrates [the operation of § 2701]. *P*, an individual, holds all 1,000 shares of corporation *X*'s stock, which is voting common. The fair market value of *P*'s family-held interest in *X* is $1,500,000 * * * . *P* decides to engage in an estate freeze under section 2701 and causes *X* to issue, in a tax-free transaction, 1,000 shares of 8%, $1,000 par value

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cumulative preferred stock, which bears an annual cumulative dividend of $80 per share. The preferred stock also allows the holder to put all of the stock to *X* at any time for $1,500,000. *P* transfers all of the common stock to *P*'s children and retains only the preferred stock. Under section 2701, the gift tax value of the common is determined by subtracting from the value of the family-held interests, $1,500,000, the value of *P*'s retained preferred stock * * * . The preferred stock consists of two applicable retained interests, the dividend right and the put right; accordingly, the stock is valued pursuant to the special valuation rules set forth in section 2701 * * * . The put right is valued at zero because it is an extraordinary payment right. In contrast, because the dividend right under the preferred stock is cumulative, the preferred stock is ascribed a value for these purposes. The value of the dividend right, and therefore the retained preferred stock, could approximate $800,000. The gift tax value of the transferred common is thus $1,500,000 less $800,000, or $700,000 * * * . Because all of the common has been transferred, no minority discount is applicable * * * , and the value of the common is not further reduced.

C. Elimination of Corporate and Partnership Valuation Abuses

Section 2701 eliminates the two common valuation abuses of pre-Chapter 14 business estate freezes. First, section 2701 assumes that discretionary rights will go unexercised. To the extent that these rights are attached to preferred stock, they are given no value for gift tax purposes.

Second, section 2701 prevents the estate freeze accomplished by ascribing a value to an asset held by a donor, allowing that donor to retain that value, and thereafter allowing all increases in value in the asset to pass to one or more donees. Prior to section 2701, one method used to achieve this type of freeze in the corporate setting was for a donor to create two classes of stock: a preferred class retained by the donor, which had discretionary nonlapsing put, liquidation preference, or other rights that could be valued in such a way as to equal the current fair market value of the corporation; and a common class of stock transferred to the donees.

Section 2701 mandates that if the rights under the preferred class of stock can be exercised (or not exercised) at the donor's discretion, then the value of the transferred common stock carries with it the full value of the corporation. In essence, for gift tax purposes the donor will be treated as having retained no equity interest in the company. Accordingly, there is no retained interest that can be frozen.[133]

A freeze could also be obtainable prior to section 2701 when a donor retains only the right to receive a stream of annual payments from the transferred property. Theoretically, a freeze occurs if the donor receives aggregate payments equal to the fair market value of the donor's retained interest (at the time the freeze was undertaken). But if the donor receives, in total, aggregate payments in excess of that amount, then the donor has in actuality received a portion of the increase in the value of the partnership or corporation (i.e., a portion of the net profits). In that instance, not all growth in the value of the entity will pass to the nonfrozen interest and, at best, the donor will have only partially frozen the donor's retained interest.

[133] Not only will a freeze be unachievable in this situation, but it could result in * * * double taxation because the full value of the corporation has been transferred for gift tax purposes during life, but the transferor is confronted with an estate tax on the value of the retained preferred stock at her death. * * *

* * *

To account for this type of inequity, Congress in section 2701(e)(6) provided that regulations are to make appropriate adjustments for the subsequent transfers, or inclusions in the gross estate, of any applicable retained interest valued under section 2701(a). * * *

Prior to section 2701, [a] freeze could have been achieved when the donor retained noncumulative preferred dividends. Through donor-exercised control of the corporation, the corporation could be certain to issue aggregate dividends less than or equal to the initial calculated value of the donor's retained preferred dividend right.

Section 2701 eliminates this type of freeze. First, noncumulative preferred stock is valued at zero. Accordingly, the retention of noncumulative preferred stock cannot form the basis of a freeze because that retained interest is valued at zero for gift tax purposes.

Second, in order to be ascribed a value for gift tax purposes, the preferred stock must result in a qualified payment right, or such a right must be electively presumed to exist. But even though the preferred stock in this instance will be given a value for gift tax purposes, a full freeze will still not be obtainable. This is because the holder of the preferred stock will receive aggregate payments in excess of the initial value of the retained interest.

The starting point for this analysis is with the methodology used in valuing the qualified payment right. That right is no more than an infinitesimal string of constant payments. Although the Code and regulations provide no express guidance on how to value these payments, the regulations implicitly contemplate that the payments will be valued like an annuity, at an assumed discount rate. * * *

Generally, the lower the discount rate, the greater the value of the retained interest, and therefore the lower the value of the gift of the transferred interest. Hence, a discount rate related to existing market rates, such as the prime rate, is more beneficial from a transfer tax perspective than, say, one based on a junk bond rate.

The Code and regulations provide no guidance as to what discount rate to use in valuing the retained qualified payment right. The section 7520 rate, used in other gift and estate tax contexts, is not necessarily the most realistic discount rate. Nor is a discount rate tied to a market rate; dividend rights in a closely held business context are more uncertain than those in a publicly traded corporation. * * *

* * *

To the extent the corporation's rate of earnings exceeds the discount rate used in valuing the retained preferred stock, that excess rate will inure to the benefit of the holders of the transferred common stock. Hence, as to that excess, there is a minimal freeze created but that is not abusive because the reverse could also occur. If the corporation's earnings are at a rate less than the discount rate used in valuing the retained preferred stock, then there will actually be a reverse freeze, or a transfer tax loss. That is, the retained interest will increase at a rate in excess of the rate of increase of the transferred interest.

* * *

V. CONCLUSION

* * *

Through the enactment of a complicated system of rules and procedures, Chapter 14 has effectively addressed [estate freezing] abuses. For valuation purposes, gifts made in the business context * * * are now the functional equivalent of outright, lifetime gifts of full interests in property. Although there are limited exceptions to that conclusion, those windows of opportunity are narrow and not abusive. The valuation rules set forth in Chapter 14 are fair and accomplish their mission to further consolidate the unification of the estate and gift tax system.

NOTE

The legislative history of Chapter 14 indicates that Congress intended to curb abusive estate freezing techniques without hindering nonabusive "standard intrafamily transactions." Does § 2701 achieve its announced goal of ensuring "more accurate gift tax valuation of the initial transfer" through "well defined and administrable" rules? Does § 2701 avoid the problems of complexity, overbreadth and vagueness that plagued former § 2036(c)? The following excerpt explores the impact of Chapter 14 on estate freezing techniques involving split-interest trusts.

Grayson M.P. McCouch, *Rethinking Section 2702*, 2 FLA. TAX REV. 99 (1994)*

* * *

II. VALUATION UNDER GENERAL PRINCIPLES

Section 2702 is aimed primarily at a few tax-driven techniques involving transfers with retained interests. A classic example is the so-called grantor retained income trust (a "GRIT"), by which the donor makes a gift of property subject to a retained income interest for a limited term. * * *

* * *

* * * When beneficial enjoyment of property is split into a term interest and a remainder, the property's value is apportioned among the interests. Since the combined interests represent complete ownership of the property, the value of each interest generally is derived by subtracting the value of the other interests from the value of the entire property. Thus, the values of the respective interests are interdependent, and any uncertainty or inaccuracy in the valuation of one interest indirectly affects the valuation of the other.

If the limitations and conditions affecting possession or enjoyment of the underlying property can be estimated reasonably, the gift tax value of a term interest or remainder is determined by discounting the future payments to present value under Treasury tables based on prescribed discount rates and mortality assumptions. * * *

A simple GRIT illustrates the impact of the tables on the gift tax value of split interests. Assume that *A*, age 70, transfers property worth $100,000 in trust to pay income to herself for a term of 15 years with remainder at the end of the term to her nephew *B* or *B*'s estate.[18] If the applicable discount rate is 10%, the value under the tables of *A*'s retained interest is $76,061 (the present value of 15 annual payments of $10,000 each), and *A* has made a gift of $23,939, the value of the trust property less the value of *A*'s retained income interest. *A* can reduce further the amount of the gift by retaining the right to receive the trust property at the end of the 15-year term in the event she is not then living.[20] * * *

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[18] The special valuation rules of § 2702 do not apply because *B* is not a "member of [*A*]'s family" within the meaning of that section. * * *

[20] *A* might retain this additional interest because the trust corpus will be included in her gross estate for estate tax purposes in the event she dies before her retained income interest expires. Retention of the conditional interest in trust corpus therefore reduces the gift tax without significantly increasing the potential estate tax. * * *