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Current Issues in Estate Planning Featuring the Replacement of Section 2036(c)

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CURRENT ISSUES IN ESTATE PLANNING
FEATURING THE REPLACEMENT OF SECTION 2036(c)

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Prepared for the
THIRTY-SIXTH WILLIAM AND MARY TAX CONFERENCE
November 30, 1990
(Outline updated through October 29, 1990)

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- I. Selected recent judicial and administrative developments.
 - A. Marital deduction.
 1. QTIP requirements: "stub period income."
 - a. The Court of Appeals for the Ninth Circuit has held that a trust qualifies for QTIP treatment even if the income accumulated between the last regular installment payment of income to the spouse and the spouse's death is not paid under the trust instrument to the spouse's estate or pursuant to the spouse's power of appointment. Estate of Howard v. Commissioner, 910 F.2d 633 (9th Cir. 1990), rev'g 91 T.C. 329 (1988).
 - b. Taxpayers outside the Ninth Circuit may use a closing agreement procedure which the Service has extended to December 31, 1990. Notice 90-46, 1990-28 I.R.B. 11. Additional extensions will probably be provided if needed.
 - c. Ultimately, a legislative solution might be provided.
 2. QTIP qualification: "right to occupy": The Court of Appeals for the Eleventh Circuit has allowed QTIP treatment for a devise of a personal residence

"subject . . . to the right of [the decedent's] husband . . . to occupy said property for as long as he desires," reasoning that the right "to occupy" entails the right to rents for life and that the limitation "for as long as he desires" is not distinguishable from the right of any life tenant to renounce or give away the life estate before death. Estate of Peacock v. United States, No. 89-7771 (11th Cir. Oct. 11, 1990).

3. QTIP election: "check the box."
 - a. The Court of Appeals for the Sixth Circuit has affirmed the disallowance of a marital deduction in a case where the estate tax return woefully lacked evidence consistent with a QTIP election. Estate of Higgins v. Commissioner, 897 F.2d 856 (6th Cir. 1990), aff'g 91 T.C. 61 (1988).
 - b. To the same effect is Technical Advice Memorandum 9037003 (June 4, 1990).
 - c. Despite occasional expressions of a conciliatory attitude by the National Office of the Service, estate tax examiners and appeals officers continue to have great difficulty allowing a marital deduction in cases of defective QTIP elections.
 - d. Even the National Office's attitude has now apparently hardened with respect to post-1985 versions of the federal estate tax return (Form 706).
4. Funding a marital bequest: The funding of a pecuniary pre-residuary credit shelter bequest with assets valued on the dates of their distribution will not disqualify the residuary marital bequest under the principles of Rev. Proc. 64-19, 1964-1 C.B. 682, even though such an arrangement puts the risk of post-death declines in value

on the marital bequest. Rev. Rul. 90-3,
1990-1 C.B. 174.

B. Gifts from trusts.

1. The Service continues to view gifts made from a revocable trust pursuant to the trust instrument within three years before the grantor's death as includible in the grantor's gross estate under section 2035(d)(2), even if the gifts qualify for the annual gift tax exclusion. Technical Advice Memoranda 9015001 and 9016002 (Dec. 29, 1989). The Service has been upheld in Estate of Perkins v. United States, No. 1:89CV1937 (N.D. Ohio Sept. 20, 1990).
2. The Service does not view such gifts as includible if they are not authorized by the trust instrument, in which case the trustee is treated as having made them, in effect, as the agent of the grantor. Technical Advice Memoranda 9010004 and 9010005 (Nov. 17, 1989).

C. Power to remove trustees.

1. The Service has indicated a disposition to broadly apply the holding of Rev. Rul. 79-353, 1979-2 C.B. 325, that a power retained by a grantor to remove and replace an otherwise independent trustee causes the trust to be included in the grantor's gross estate.
 - a. To the decedent's incidents of ownership in a life insurance policy. Technical Advice Memorandum 8922003 (Feb. 24, 1989).
 - b. To powers of appointment conferred on beneficiaries. Letter Ruling 8916032 (Jan. 19, 1989).
2. Both Rev. Rul. 79-353 itself and its possible extension to conferred powers continue to be controversial issues, frequently discussed with the Service.

D. Revaluation of gifts.

1. In an 10-8 decision, the Tax Court has now stated its view that the value of a decedent's gifts may be adjusted for purposes of determining adjusted taxable gifts under section 2001(b), even if a gift tax had been paid and such revaluation for gift tax purposes would have been barred by section 2504(c). Estate of Smith v. Commissioner, 94 T.C. No. 55 (1990) (reviewed by the Court). Thus, the Tax Court disagrees with the decision of the District Court in Boatmen's First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988).
2. The Tax Court went on, however, to hold that the estate was entitled to calculate the credit for gift taxes payable under section 2001(b)(2) with reference to the gift tax that would have been payable if the gifts had originally been valued correctly. As a result, the only effect of the decision will be to determine the starting estate tax bracket, and the decision will have no effect at all where the amount of gifts have been very large, so that the donor's estate is in the top bracket anyway.

E. Partitioning a GST-grandfathered trust.

1. The Service first asserted in September 1988 that the partitioning of a pre-September 25, 1985 generation-skipping trust causes the trust to lose its grandfathered status for GST tax purposes if it results in a change in the quality, value, or timing of the interests of lower generation beneficiaries. Letter Rulings 8851017 (Sept. 22, 1988) and 8927026 (Apr. 6, 1989).
2. Grandfathered status is not lost, however, when the partition preserves the quality, value, and timing of the respective interests. Letter Rulings 8951068 (no date)

given), 9004007 (Oct. 19, 1989), 9005019 (Nov. 3, 1989), 9020017 (Feb. 16, 1990), 9028032 (Apr. 6, 1990), 9033016 (May 18, 1990), 9033047 (May 22, 1990), and 9038037 (June 26, 1990).

F. Disclaimers.

1. GST tax: A disclaimer can be effective for GST tax purposes. Letter Ruling 9038051 June 28, 1990).
2. Remainders.
 - a. In cases involving the same trust, two federal district courts have held that the rule of Jewett v. Commissioner, 455 U.S. 305 (1982) -- that a disclaimer of a remainder interest in a trust is untimely if not made until after the life beneficiary's death -- does not apply to trusts created before the enactment of the gift tax in 1932. Ordway v. United States, 89-1 USTC ¶ 13,802 (1989); Estate of Irvine v. United States, 89-2 USTC ¶ 13,818 (D. Minn. 1989).
 - b. The Court of Appeals for the Eleventh Circuit has reversed this holding. Ordway v. United States, 908 F.2d 890 (11th Cir. 1990).
 - c. The Government's appeal has been briefed and argued and is pending in the Court of Appeals for the Eighth Circuit.
3. Joint tenancies.
 - a. In connection with its acquiescence in McDonald v. Commissioner, T.C. Memo 1989-140 (1989), the Service's Chief Counsel's office stated, in AOD CC-1990-06:

"Where a joint tenant has the right to sever the joint tenancy or

cause the property to be partitioned under state law, the Service will no longer litigate that the transfer relative to which the timeliness of the disclaimer of a survivorship interest is measured refers to the transfer creating the joint tenancy. The Service will also no longer contend that a joint tenant cannot make a qualified disclaimer of any portion of the joint interest attributable to consideration furnished by that joint tenant. Treas. Reg. § 25.2518-2(c)(4)(i) will be revised accordingly."

- b. An illustration is Letter Ruling 9038031 (June 25, 1990).
 - c. This may increase the convenience and attractiveness of joint tenancies, which avoid probate everywhere, can save inheritance tax in some jurisdictions (such as Maryland), and (in Virginia) can save probate tax.
4. Illustrations of disclaimers of other interests.
- a. Pension plan benefits. Letter Ruling 9016026 (Jan. 18, 1990).
 - b. An IRA account. Letter Ruling 9037048 (June 20, 1990).
- G. Estate tax apportionment: The Court of Appeals for the Fourth Circuit has held that Virginia law, in effect, permits a testator's will to apportion estate taxes on probate property against property held as a tenancy by the entireties. Estate of Reno v. Commissioner, No. 89-2078 (4th Cir. Oct. 19, 1990).
- H. Commissions and fees deducted on the estate tax return but reduced after the estate tax statute of limitations has expired constitute taxable income to the estate under the

estate's "duty of consistency." Letter Ruling 9033034 (May 22, 1990).

- II. Section 2036(c) repeal and new "estate freeze" provisions of chapter 14: Sections 11601 and 11602 of the Omnibus Budget Reconciliation Act of 1990 (H.R. 5835).

The following is based on a draft of the conference report (which is reprinted in the Appendix, together with the relevant portions of the draft statement of managers). The draft reflects the decisions made by House-Senate negotiators, but technical drafting changes may be made in the enrolled Act which becomes law.

- A. Repeal of section 2036(c), retroactively to December 18, 1987.
- B. New valuation rules.
 - 1. Preconditions.
 - a. A transfer of stock in a corporation or an interest in a partnership to or for the benefit of a member of the transferor's family. Section 2701(a)(1) (page 2). [Page numbers refer to the pages of the statutory language in the Appendix.]
 - i. For this purpose, "family" is limited to the transferor's spouse, descendants, descendants of spouse, and the spouses of any of the foregoing. Section 2701(e)(1) (pages 14-15).
 - ii. This is the same as in section 2036(c) except for parents, grandparents, and the spouses of parents and grandparents.
 - b. A distribution, liquidation, put, call, or conversion right in the entity retained, directly or indirectly,

by the transferor, by the transferor's spouse, by any ancestor of the transferor or the transferor's spouse, or by the spouse of any such ancestor. Section 2701(a)(1)(B), (b)(1), and (e)(2) (pages 2, 5, and 15).

- i. A distribution right is not treated as so retained, however, unless immediately after the transfer the transferor and the transferor's spouse, their ancestors, and the spouses of those ancestors in the aggregate "control" the entity. Section 2701(b)(1)(A) (page 5).
 - (A) "Control" means the holding of at least half of the vote or value of the stock of a corporation, the holding of at least half of the capital or profits interests in a partnership, or the holding of any general partner interest in a limited partnership. Section 2701(b)(2) (pages 5-6).
 - (B) For this purpose, an individual is treated as holding any interest held by that person's brothers, sisters, and descendants. Section 2701(e)(3)(B) (page 15).
- ii. A distribution right is not treated as so retained if it is embodied in an equity interest that is junior in all respects to the transferred interest. Section 2701(c)(1)(B)(i) (pages 6-7).
- iii. A right to receive guaranteed payments described in section 707(c) is not treated as a retained distribution right.

Section 2701(c)(1)(B)(iii)
(page 7).

- iv. A liquidation, put, call, or conversion right is not treated as so retained if it must be exercised at a specified time and at a specified amount or if its exercise or nonexercise would not affect the value of the transferred stock or partnership interest. Section 2701(c)(2)(A) and (B)(i) (page 7).
 - v. A conversion right is not treated as so retained if it is a non-lapsing right to convert into a fixed share of the equity of the entity. Section 2701(c)(2)(C) (pages 7-8).
2. Operation: It is assumed that the value of the transferred interest will be determined by a "subtraction" or "residual" method, under which the value of certain other interests in the corporation or partnership will, in effect, be subtracted from the total value of the entity. In determining those amounts to be subtracted, special valuation rules are prescribed for determining the value of rights retained by the transferor, by the transferor's spouse, by any ancestor of the transferor or the transferor's spouse, and by the spouse of any such ancestor.
- a. A retained distribution right -- that is, a right to distributions with respect to stock of a corporation or with respect to a partner's interest in a partnership. Section 2701(c)(1) (page 6).
 - i. Valued according to its terms if the distributions are "qualified payments" -- i.e., determined at a fixed rate or with reference to a specified market interest rate.

Section 2701(a)(3)(A), (c)(3)(A),
and (c)(3)(B) (pages 3-4 and
8-9).

- ii. Otherwise valued at zero. Section 2701(a)(3)(A) (pages 3-4).
- iii. Elections available to the holder of a distribution right -- i.e., the transferor, the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.
 - (A) To irrevocably waive "qualified payment" treatment. Section 2701(c)(3)(C)(i) (page 9).
 - (B) To irrevocably elect "qualified payment" treatment not otherwise available, assuming payments in such amounts and at such times as are specified in the election. Section 2701(c)(3)(C)(ii) (page 9).
- b. A retained liquidation, put, call, or conversion right: Valued at zero. Section 2701(a)(3)(A) (pages 3-4).
- c. A retained liquidation, put, call, or conversion right that is associated with a retained distribution right.
 - i. Valued as if such liquidation, put, call, or conversion right were exercised in a manner resulting in the lowest value for all such rights. Section 2701(a)(3)(B) (page 4).
 - ii. May by regulations be treated as a separate interest. Section 2701(e)(7) (page 17).

3. Thin capitalization floor: In applying these rules, the common stock of a corporation or non-preferential interest in a partnership must be given a value equal to at least 10 percent of the total value of all the equity interests in the entity plus the total indebtedness of the entity to the transferor, the transferor's spouse, any ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor. Section 2701(a)(4) (pages 4-5).
4. Exceptions.
 - a. If market quotations for the transferred interest are readily available as of the date of the transfer on an established securities market. Section 2701(a)(1) (page 2).
 - b. If market quotations for the retained interest are readily available as of the date of the transfer on an established securities market. Section 2701(a)(2)(A) (page 3).
 - c. If the retained interest is "of the same class" as the transferred interest. Section 2701(a)(2)(B) (page 3).
 - d. If the retained interest is "proportionally the same" as the transferred interest. Section 2701(a)(2)(C) (page 3). For this purpose, nonlapsing differences in voting power (not merely differences in voting rights), and nonlapsing differences with respect to management and liability in the case of a partnership, are disregarded, and lapses caused only by federal or state law are disregarded (except as provided in regulations to prevent abuse).
5. A new "in effect" rule: A capital contribution, redemption, recapitalization, or other change in the capital structure of a

corporation or partnership is treated as a transfer by anyone who receives in the transaction a right that would trigger the statute (or, as provided in regulations, holds such a right immediately after the transaction). Section 2701(e)(5) (page 16).

- C. Post-transfer treatment of retained interests: In one of the most significant compromises between the original House and Senate versions of this legislation, if an interest in a corporation or partnership retained by the transferor, the transferor's spouse, an ancestor of either of them, or the spouse of any such ancestor is given value because it is (or is elected to be) a right to "qualified payments," that interest is given special valuation treatment in subsequent transfers, if any such payments have ever been more than four years in arrears. Section 2701(d)(1) and (d)(2)(C) (pages 10 and 12).
1. Upward adjustments: The estate or gift tax value of that retained interest is increased to reflect the value of the distributions in arrears (and the time-value of distributions that were more than four years late) on the assumption that all such distributions were timely made and invested at the discount rate originally used to value the retained interest. Section 2701(d)(2)(A) (pages 10-11).
 2. Limitation: This increase in value is limited to the proportional increase in value (from the date of the original transfer to the date of the subsequent transfer) in the interests in the entity junior to the retained interest being valued. Section 2701(d)(2)(B) (pages 11-12). See Example 5 on page 155 of the draft of the statement of managers (reprinted in the Appendix); assume that in that example dividends are not paid on the class B stock.

3. Elective application of these rules: Although the ordinary occasion for application of these rules is the death of the holder of the retained interest or a gift or sale of the retained interest by that holder, the holder may elect to apply these rules, to bring the transfer tax treatment of the retained interest current, at any time a distribution is paid more than four years late. Section 2701(d)(3)(A)(iii) (page 13).
 4. Transfers to family members.
 - a. If a transfer of a retained interest that would otherwise be subject to these rules is a transfer to the holder's spouse for which the spouse pays consideration or for which a gift tax marital deduction is allowed, these rules are not applied at that time, but are applied upon the death of the spouse or transfer by the spouse. Section 2701(d)(3)(B) (pages 13-14).
 - b. If an inter vivos transfer of a retained interest is made to another family member other than the holder's spouse, these rules are applied at that time and again upon the death of that transferee or transfer by that transferee. Section 2701(d)(4)(B) (page 14).
 5. Downward adjustments: May be provided by regulations. Section 2701(e)(6) (pages 16-17).
- D. Buy-sell agreements, options, restrictions, and similar arrangements: Disregarded in determining transfer tax value unless they meet certain tests.
1. Codification of Reg. § 20.2031-2(h).
 - a. Bona fide business arrangement. Section 2703(b)(1) (page 21).

b. Not a device to transfer such property to members of the transferor's family for less than adequate and full consideration. Section 2703(b)(2) (page 21).

2. Clarification that both these tests must be met, not just one. Section 2703(b) (page 21). This would prevent a recurrence of the District Court's conclusion in Roth v. United States, 511 F. Supp. 653, 654-55 (E.D. Mo. 1981), rev'd sub nom. St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982), that a business purpose necessarily excludes the possibility that an arrangement is a tax-avoidance device.
3. Addition of a third express requirement that the terms must be "comparable to similar arrangements entered into by persons in an arms' length transaction." Section 2703(b)(3) (page 21).

E. Lapsing rights and restrictions.

1. A lapse of voting or liquidation rights that transfers value is treated as a taxable gift. Section 2704(a) (pages 21-22).
2. Certain lapsing restrictions on liquidation are disregarded for transfer tax valuation purposes. Section 2704(b) (pages 22-24).
3. Section 2704 is aimed at the result in Estate of Harrison v. Commissioner, 52 TCM 1306 (1987).
4. Section 2704 was a relatively late addition to the statute, did not receive the public review or comment that most of the other elements of the statute received, and, perhaps as a consequence, is written very broadly. A clear understanding of section 2704 may have to await further development of this legislative theme.

F. Trusts and term interests.

1. Special valuation rules, for gift tax purposes, for valuing any interest in a trust retained by the transferor, the transferor's spouse, any ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor, in the case of a transfer in trust to or for the benefit of any of the foregoing or a descendant of the transferor or the transferor's spouse, the spouse of any such descendant, a brother or sister of the transferor, or the spouse of any such brother or sister. Section 2702(a)(1) and (e) (pages 17 and 20).
 - a. Normal valuation rules (under section 7520) (section 2702(a)(2)(B) (pages 17-18)) will be used to value a "qualified interest," which is the right to receive --
 - i. a fixed amount payable at least annually -- i.e., an annuity interest (section 2702(b)(1) (page 18));
 - ii. an amount payable at least annually equal to a fixed percentage of the fair market value of the trust property, determined annually -- i.e., a unitrust interest (section 2702(b)(2) (pages 18-19)); or
 - iii. a noncontingent remainder following one or more of the above (section 2702(b)(3) (page 19)).
 - b. The value of any retained interest other than a qualified interest will be treated as being zero. Section 2702(a)(2)(A) (page 17).
2. Term interests.

- a. In general, for purposes of these rules, term interests -- for life or for a term of years -- are treated as trust interests. Section 2702(c)(1) (page 19).
 - b. A joint purchase by family members is treated as a purchase by the person acquiring the term interest followed by that person's transfer of the remainder. Section 2702(c)(2) (page 19).
3. Tangible property.
- a. A trust interest or term interest involving non-wasting tangible property (such as art) will be valued at what the holder of the interest establishes as the amount an unrelated third party would pay for it. Section 2702(c)(4) (page 20).
 - b. The theory underlying this rule is not clear.
 - i. One possibility is that the gift upon the creation of a trust with artwork would have to be valued at the full value of the art, less a single-payment rent that the grantor establishes an unrelated museum would pay to display the art for the trust term. Because museums are presumably interested in preserving art, not in short-term use, such a hypothetical single-payment rent would not reduce the value of the gift by very much. In contrast, if the gift were valued at what a museum would pay for the remainder, there would be a substantial time-value-of-money discount, just as if the current valuation tables were used.

- ii. Another, more cynical, view is that this rule has been made so esoteric that the taxpayer's burden of proof will be so great that such transactions will simply be discouraged.
4. Exceptions: These valuation rules will not apply in the case of a transfer in trust that is not a completed gift (such as creation of a revocable trust) or a trust holding only a personal residence of the holder of the term interest in the trust. Section 2702(a)(3) (page 18).
- G. Statute of limitations: If a transfer results in a gift under these new valuation rules, the statutory period of limitations for gift tax purposes does not begin to run with respect to any such transfer unless the transfer is adequately disclosed on a gift tax return. Section 6501(c)(9) (page 25). It will not be enough to file a gift tax return reporting other gifts.
- H. Commission of a Treasury study into options, agreements, and other methods used to distort value for transfer tax purposes, to be completed by December 31, 1992 (pages 25-26).
- I. Effective date: October 9, 1990 (pages 26-27).
- 1. Exception for buy-sell and similar agreements in effect before October 9, 1990, and not substantially modified on or after that date.
 - 2. Exception with respect to the anti-Harrison rule for restrictions or rights created before October 9, 1990.
 - 3. Exception for failure to exercise a right of conversion, failure to pay dividends, or failure to exercise any other rights specified in regulations with respect to property transferred before October 9, 1990.

III. What's left of basic estate planning techniques?

- A. Ordinary recapitalizations, with a transfer of common stock (by gift or sale) to younger generations.
 - 1. The disastrous estate tax suspense of section 2036(c) is avoided under chapter 14.
 - 2. Under chapter 14, the preferred stock dividends could be "qualified payments." If not, an election might be made to treat them as such.
- B. Various debt or lease transactions.
 - 1. Examples.
 - a. A "recapitalization," using debt instead of preferred stock. This could be a redemption accompanied by a section 302(c)(2) waiver. See section 302(c)(2)(A)(i).
 - b. An installment sale (e.g., to children).
 - c. A "bootstrap" gift to younger generations, while the entity owes debt to the transferor.
 - d. A redemption for property which is leased back to the entity.
 - 2. Analysis.
 - a. Any debt issued in the transaction will have to be amortized, with resulting capital gain, whereas preferred stock could have been held until death to receive a stepped-up basis. But the corporation will receive an income tax deduction for the payment of interest, which would not have been available for the payment of dividends.

- b. Section 5076 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) amended section 453A to require payment to the Service of an interest charge each year with respect to the income tax deferred in the case of installment obligations with a face amount over \$5,000,000. This could have a dramatic adverse effect on an installment sale.
- c. Chapter 14 is not concerned with debt, except in applying the 10-percent minimum equity rule, nor with leases.
- C. Transactions involving employment and reasonable compensation for services.
- D. Continued operation under a buy-sell agreement established before October 9, 1990.
- E. Grantor retained income trusts (GRITs).
 - 1. Circumstance in which a GRIT might be helpful, even though the requirement that it be in the form of an annuity trust or unitrust limits its transfer tax leverage:
 - a. To make a transfer of appreciating property at a time when the transferor is cash-poor and desires to reduce the gift tax burden by any means available.
 - b. To reduce the transferor's holdings in an entity to a minority, to qualify subsequently for a minority discount.
 - 2. Limitations of a GRIT in any event.
 - a. Obviously survival for the necessary period can never be assured. If the grantor dies during the GRIT term, the entire value of the GRIT property at that time is included in the grantor's gross estate under section 2036(a).

- b. If the grantor does survive the GRIT term, the income from the GRIT to the grantor will stop, and the grantor must have sufficient other assets to absorb this loss of income.

F. Life insurance.

1. Removed from section 2036(c) by Notice 89-99, 1989-2 C.B. 422, 425.
2. Not affected by chapter 14.
3. See also Estate of Leder v. Commissioner, 89 T.C. 235 (1987), aff'd, 893 F.2d 237 (10th Cir. 1989), Estate of Chapman v. Commissioner, 56 TCM 1461 (1989), and Estate of Headrick v. Commissioner, 93 T.C. 171 (1989) (reviewed by the Court without dissent) (avoiding the three-year rule of section 2035(d)(3) with respect to a life insurance trust).

G. All transactions involving the transferor's personal residence.

H. Other classic "freeze" techniques that are not obviously affected (favorably or adversely) by the enactment of chapter 14.

1. A testamentary freeze -- bequest of common stock to descendants and preferred stock to spouse.
2. A post mortem freeze.
 - a. Possibly a recapitalization freeze (by executor before distribution).
 - i. Marital trust (or spouse) ultimately receives preferred stock.
 - ii. Credit shelter trust (or descendants) receive common stock.

- b. Funding freeze.
 - i. Marital trust (or spouse) receives assets not as likely to appreciate.
 - ii. Credit shelter trust receives "hot assets" most likely to appreciate.
- c. Tax payment freeze.
 - i. Pay estate tax on death of first spouse to die (perhaps by using the spouse's disclaimer or a partial QTIP election followed by division of the trust).
 - ii. This could also maximize the benefit from the credit for tax on prior transfers under section 2013.
- 3. Gift or bequest of preferred stock to children and common stock to grandchildren.
 - a. Freezes children's estates.
 - b. May minimize the generation-skipping transfer tax on the direct skip to the grandchildren, if a low value for the common stock can be supported.
- 4. Proportional transfer of all classes of stock or similar interests, or maintenance of a single class of ownership, or use of only voting and nonvoting interests.
- 5. Depletion of the value of the business through payment of salaries or dividends or other distributions to the younger generation. Within limits, some depletion will almost certainly be allowed.
- 6. Creative (or realistic, depending on one's point of view) valuations, including minority discounts.

7. Transfers, including annual exclusion gifts, of common stock (or equivalent partnership interests) resulting from a freeze recapitalization. The special valuation rules of section 2701 must be used, but will not prevent such a transfer or deny its effectiveness in removing property from the transferor's gross estate.

APPENDIX

Sections 11601 and 11602 of the Omnibus Budget
Reconciliation Act of 1990 (H.R. 5835)

The following is a draft of the conference report and the relevant portions of the draft statement of managers. The draft reflects the decisions made by House-Senate negotiators, but technical drafting changes may be made in the enrolled Act which becomes law.

1 Subtitle F--Small Business Incentives

2 PART I--TREATMENT OF ESTATE TAX FREEZES

3 SEC. 11601. REPEAL OF SECTION 2036(c).

4 (a) IN GENERAL.--Section 2036 (relating to transfers with
5 retained life estate) is amended by striking subsection (c)
6 and by redesignating subsection (d) as subsection (c).

7 (b) CONFORMING AMENDMENTS.--

8 (1) Section 2207B is amended--

9 (A) by striking subsection (b) and redesignating
10 subsections (c), (d), and (e) as subsections (b),
11 (c), and (d), respectively,

12 (B) by striking ``subsections (a) and (b)'' in
13 subsection (c) (as so redesignated) and inserting
14 ``subsection (a)'', and

15 (C) by striking ``subsections (a), (b), and (c)''
16 in subsection (c) (as so redesignated) and inserting
17 ``subsections (a) and (b)''.

18 (2) Section 2501(d) is amended by striking paragraph
19 (3).

20 (c) EFFECTIVE DATE.--The amendments made by this section
21 shall apply in the case of property transferred after
22 December 17, 1987.

23 SEC. 11602. SPECIAL VALUATION RULES.

24 (a) IN GENERAL.--Subtitle B is amended by adding at the
25 end thereof the following new chapter:

1

``CHAPTER 14--SPECIAL VALUATION RULES

``Sec. 2701. Special valuation rules in case of transfers of certain interests in corporations or partnerships.

``Sec. 2702. Special valuation rules in case of transfers of interests in trusts.

``Sec. 2703. Certain rights and restrictions disregarded.

``Sec. 2704. Treatment of certain lapsing rights and restrictions.

2

``SEC. 2701. SPECIAL VALUATION RULES IN CASE OF TRANSFERS OF

3

CERTAIN INTERESTS IN CORPORATIONS OR

4

PARTNERSHIPS.

5

``(a) VALUATION RULES.--

6

``(1) IN GENERAL.--Solely for purposes of determining

7

whether a transfer of an interest in a corporation or

8

partnership to (or for the benefit of) a member of the

9

transferor's family is a gift (and the value of such

10

transfer), the value of any right--

11

``(A) which is described in subparagraph (A) or

12

(B) of subsection (b)(1), and

13

``(B) which is with respect to any applicable

14

retained interest that is held by the transferor or

15

an applicable family member immediately after the

16

transfer,

17

shall be determined under paragraph (3). This paragraph

18

shall not apply to the transfer of any interest for which

19

market quotations are readily available (as of the date

20

of transfer) on an established securities market.

1 ``(2) EXCEPTIONS FOR MARKETABLE RETAINED INTERESTS,
2 ETC.--Paragraph (1) shall not apply to any right with
3 respect to an applicable retained interest if--

4 ``(A) market quotations are readily available (as
5 of the date of the transfer) for such interest on an
6 established securities market,

7 ``(B) such interest is of the same class as the
8 transferred interest, or

9 ``(C) such interest is proportionally the same as
10 the transferred interest, without regard to
11 nonlapsing differences in voting power (or, for a
12 partnership, nonlapsing differences with respect to
13 management and limitations on liability).

14 Subparagraph (C) shall not apply to any interest in a
15 partnership if the transferor or an applicable family
16 member has the right to alter the liability of the
17 transferee of the transferred property. Except as
18 provided by the Secretary, any difference described in
19 subparagraph (C) which lapses by reason of any Federal or
20 State law shall be treated as a nonlapsing difference for
21 purposes of such subparagraph.

22 ``(3) VALUATION OF RIGHTS TO WHICH PARAGRAPH (1)
23 APPLIES.--

24 ``(A) IN GENERAL.--The value of any right
25 described in paragraph (1), other than a distribution

1 right which consists of a right to receive a
2 qualified payment, shall be treated as being zero.

3 `` (B) VALUATION OF QUALIFIED PAYMENTS.--If--

4 `` (i) any applicable retained interest
5 confers a distribution right which consists of
6 the right to a qualified payment, and

7 `` (ii) there are 1 or more liquidation, put,
8 call, or conversion rights with respect to such
9 interest,

10 the value of all such rights shall be determined as
11 if each liquidation, put, call, or conversion right
12 were exercised in the manner resulting in the lowest
13 value being determined for all such rights.

14 `` (4) MINIMUM VALUATION OF JUNIOR EQUITY.--

15 `` (A) IN GENERAL.--In the case of a transfer
16 described in paragraph (1) of a junior equity
17 interest in a corporation or partnership, such
18 interest shall in no event be valued at an amount
19 less than the value which would be determined if the
20 total value of all of the junior equity interests in
21 the entity were equal to 10 percent of the sum of--

22 `` (i) the total value of all of the equity
23 interests in such entity, plus

24 `` (ii) the total amount of indebtedness of
25 such entity to the transferor (or an applicable

1 family member).

2 `` (B) DEFINITIONS.--For purposes of this
3 paragraph--

4 `` (i) JUNIOR EQUITY INTEREST.--The term
5 `junior equity interest' means common stock or,
6 in the case of a partnership, any partnership
7 interest under which the rights as to income and
8 capital are junior to the rights of all other
9 classes of equity interests.

10 `` (ii) EQUITY INTEREST.--The term `equity
11 interest' means stock or any interest as a
12 partner, as the case may be.

13 `` (b) APPLICABLE RETAINED INTERESTS.--For purposes of
14 this section--

15 `` (1) IN GENERAL.--The term `applicable retained
16 interest' means any interest in an entity with respect to
17 which there is--

18 `` (A) a distribution right, but only if,
19 immediately before the transfer described in
20 subsection (a)(1), the transferor and applicable
21 family members hold (after application of subsection
22 (e)(3)) control of the entity, or

23 `` (B) a liquidation, put, call, or conversion
24 right.

25 `` (2) CONTROL.--For purposes of paragraph (1)--

1 ``(A) CORPORATIONS.--In the case of a
 2 corporation, the term `control` means the holding of
 3 at least 50 percent (by vote or value) of the stock
 4 of the corporation.

5 ``(B) PARTNERSHIPS.--In the case of a
 6 partnership, the term `control` means--

7 ``(i) the holding of at least 50 percent of
 8 the capital or profits interests in the
 9 partnership, or

10 ``(ii) in the case of a limited partnership,
 11 the holding of any interest as a general partner.

12 ``(C) DISTRIBUTION AND OTHER RIGHTS; QUALIFIED
 13 PAYMENTS.--For purposes of this section--

14 ``(1) DISTRIBUTION RIGHT.--

15 ``(A) IN GENERAL.--The term `distribution right`
 16 means--

17 ``(i) a right to distributions from a
 18 corporation with respect to its stock, and

19 ``(ii) a right to distributions from a
 20 partnership with respect to a partner's interest
 21 in the partnership.

22 ``(B) EXCEPTIONS.--The term `distribution right`
 23 does not include--

24 ``(i) a right to distributions with respect
 25 to any junior equity interest (as defined in

1 subsection (a)(4)(B)(i)),
 2 (ii) any liquidation, put, call, or
 3 conversion right, or
 4 (iii) any right to receive any guaranteed
 5 payment described in section 707(c) of a fixed
 6 amount.

7 (2) LIQUIDATION, ETC. RIGHTS.--

8 (A) IN GENERAL.--The term 'liquidation, put,
 9 call, or conversion right' means any liquidation,
 10 put, call, or conversion right, or any similar right,
 11 the exercise or nonexercise of which affects the
 12 value of the transferred interest.

13 (B) EXCEPTION FOR FIXED RIGHTS.--

14 (i) IN GENERAL.--The term 'liquidation,
 15 put, call, or conversion right' does not include
 16 any right which must be exercised at a specific
 17 time and at a specific amount.

18 (ii) TREATMENT OF CERTAIN RIGHTS.--If a
 19 right is assumed to be exercised in a particular
 20 manner under subsection (a)(3)(B), such right
 21 shall be treated as so exercised for purposes of
 22 clause (i).

23 (C) EXCEPTION FOR CERTAIN RIGHTS TO

24 CONVERT.--The term 'liquidation, put, call, or
 25 conversion right' does not include any right which--

1 “(i) is a right to convert into a fixed
 2 number (or a fixed percentage) of shares of the
 3 same class of stock in a corporation as the
 4 transferred stock in such corporation under
 5 subsection (a)(1) (or stock which would be of the
 6 same class but for nonlapsing differences in
 7 voting power),

8 “(ii) is nonlapsing,

9 “(iii) is subject to proportionate
 10 adjustments for splits, combinations,
 11 reclassifications, and similar changes in the
 12 capital stock, and

13 “(iv) is subject to adjustments similar to
 14 the adjustments under subsection (d) for
 15 accumulated but unpaid distributions.

16 A rule similar to the rule of the preceding sentence
 17 shall apply for partnerships.

18 “(3) QUALIFIED PAYMENT.--

19 “(A) [IN GENERAL.--Except as otherwise provided
 20 in this paragraph, the term ‘qualified payment’ means
 21 any dividend payable on a periodic basis under any
 22 cumulative preferred stock (or a comparable payment
 23 under any partnership interest) to the extent that
 24 such dividend (or comparable payment) is determined
 25 at a fixed rate.

1 ``(B) TREATMENT OF VARIABLE RATE PAYMENTS.--For
 2 purposes of subparagraph (A), a payment shall be
 3 treated as fixed as to rate if such payment is
 4 determined at a rate which bears a fixed relationship
 5 to a specified market interest rate.

6 ``(C) ELECTIONS.--

7 ``(i) WAIVER OF QUALIFIED PAYMENT
 8 TREATMENT.--A transferor or applicable family
 9 member may elect with respect to payments under
 10 any interest specified in such election to treat
 11 such payments as payments which are not qualified
 12 payments.

13 ``(ii) ELECTION TO HAVE INTEREST TREATED AS
 14 QUALIFIED PAYMENT.--A transferor or any
 15 applicable family member may elect to treat any
 16 distribution right as a qualified payment, to be
 17 paid in the amounts and at the times specified in
 18 such election. The preceding sentence shall apply
 19 only to the extent that the amounts and times so
 20 specified are not inconsistent with the
 21 underlying legal instrument giving rise to such
 22 right.

23 ``(iii) ELECTIONS IRREVOCABLE.--Any election
 24 under this subparagraph with respect to an
 25 interest shall, once made, be irrevocable.

1 “(d) TRANSFER TAX TREATMENT OF CUMULATIVE BUT UNPAID
2 DISTRIBUTIONS.--

3 “(1) IN GENERAL.--If a taxable event occurs with
4 respect to any distribution right to which subsection
5 (a)(3)(B) applied, the following shall be increased by
6 the amount determined under paragraph (2):

7 “(A) The taxable estate of the transferor in the
8 case of a taxable event described in paragraph
9 (3)(A)(i).

10 “(B) The taxable gifts of the transferor for the
11 calendar year in which the taxable event occurs in
12 the case of a taxable event described in paragraph
13 (3)(A) (ii) or (iii).

14 “(2) AMOUNT OF INCREASE.--

15 “(A) IN GENERAL.--The amount of the increase
16 determined under this paragraph shall be the excess
17 (if any) of--

18 “(i) the value of the qualified payments
19 payable during the period beginning on the date
20 of the transfer under subsection (a)(1) and
21 ending on the date of the taxable event
22 determined as if--

23 “(I) all such payments were paid on the
24 date payment was due, and

25 “(II) all such payments were reinvested

1 by the transferor as of the date of payment
2 at a yield equal to the discount rate used in
3 determining the value of the applicable
4 retained interest described in subsection
5 (a)(1), over

6 `` (ii) the value of such payments paid during
7 such period computed under clause (i) on the
8 basis of the time when such payments were
9 actually paid.

10 `` (B) LIMITATION ON AMOUNT OF INCREASE.--

11 `` (i) IN GENERAL.--The amount of the increase
12 under subparagraph (A) shall not exceed the
13 applicable percentage of the excess (if any) of--

14 `` (I) the value (determined as of the
15 date of the taxable event) of all equity
16 interests in the entity which are junior to
17 the applicable retained interest, over

18 `` (II) the value of such interests
19 (determined as of the date of the transfer to
20 which subsection (a)(1) applied).

21 `` (ii) APPLICABLE PERCENTAGE.--For purposes
22 of clause (i), the applicable percentage is the
23 percentage determined by dividing--

24 `` (I) the number of shares in the
25 corporation held (as of the date of the

1 taxable event) by the transferor which are
2 applicable retained interests of the same
3 class, by

4 `` (II) the total number of shares in such
5 corporation (as of such date) which are of
6 the same class as the class described in
7 subclause (I).

8 A similar percentage shall be determined in the
9 case of interests in a partnership.

10 `` (iii) DEFINITION.--For purposes of this
11 subparagraph, the term `equity interest' has the
12 meaning given such term by subsection (a)(4)(B). ---

13 `` (C) GRACE PERIOD.--For purposes of subparagraph
14 (A), any payment of any distribution during the
15 4-year period beginning on its due date shall be
16 treated as having been made on such due date.

17 `` (3) TAXABLE EVENTS.--For purposes of this
18 subsection--

19 `` (A) IN GENERAL.--The term `taxable event' means
20 any of the following:

21 `` (i) The death of the transferor if the
22 applicable retained interest conferring the
23 distribution right is includible in the estate of
24 the transferor.

25 `` (ii) The transfer of such applicable

1 retained interest.

2 (iii) At the election of the taxpayer, the
 3 payment of any qualified payment after the period
 4 described in paragraph (2)(C), but only with
 5 respect to the period ending on the date of such
 6 payment.

7 (B) EXCEPTION WHERE SPOUSE IS TRANSFEREE.--

8 (i) DEATHTIME TRANSFERS.--Subparagraph
 9 (A)(i) shall not apply to any interest includible
 10 in the gross estate of the transferor if a
 11 deduction with respect to such interest is
 12 allowable under section 2056 or 2106(a)(3).

13 (ii) LIFETIME TRANSFERS.--A transfer to the
 14 spouse of the transferor shall not be treated as
 15 a taxable event under subparagraph (A)(ii) if
 16 such transfer does not result in a taxable gift
 17 by reason of--

18 (I) any deduction allowed under section
 19 2523, or

20 (II) consideration for the transfer
 21 provided by the spouse.

22 (iii) SPOUSE SUCCEEDS TO TREATMENT OF
 23 TRANSFEROR.--If an event is not treated as a
 24 taxable event by reason of this subparagraph, the
 25 transferee spouse or surviving spouse (as the

1 case may be) shall be treated in the same manner
 2 as the transferor in applying this subsection
 3 with respect to the interest involved.

4 ``(4) SPECIAL RULES FOR APPLICABLE FAMILY MEMBERS.--

5 ``(A) FAMILY MEMBER TREATED IN SAME MANNER AS
 6 TRANSFEROR.--For purposes of this subsection, an
 7 applicable family member shall be treated in the same
 8 manner as the transferor with respect to any
 9 distribution right retained by such family member to
 10 which subsection (a)(3)(B) applied.

11 ``(B) TRANSFER TO APPLICABLE FAMILY MEMBER.--In
 12 the case of a taxable event described in paragraph
 13 (3)(A)(ii) involving the transfer of an applicable
 14 retained interest to an applicable family member
 15 (other than the spouse of the transferor), the
 16 applicable family member shall be treated in the same
 17 manner as the transferor in applying this subsection
 18 to distributions accumulating with respect to such
 19 interest after such taxable event.

20 ``(5) TRANSFER TO INCLUDE TERMINATION.--For purposes
 21 of this subsection, any termination of an interest shall
 22 be treated as a transfer.

23 ``(e) OTHER DEFINITIONS AND RULES.--For purposes of this
 24 section--

25 ``(1) MEMBER OF THE FAMILY.--The term `member of the

1 family' means, with respect to any transferor--

2 `` (A) the transferor's spouse,

3 `` (B) a lineal descendant of the transferor or
4 the transferor's spouse, and

5 `` (C) the spouse of any such descendant.

6 `` (2) APPLICABLE FAMILY MEMBER.--The term 'applicable
7 family member' means, with respect to any transferor--

8 `` (A) the transferor's spouse,

9 `` (B) an ancestor of the transferor or the
10 transferor's spouse, and

11 `` (C) the spouse of any such ancestor.

12 `` (3) ATTRIBUTION RULES.--

13 `` (A) INDIRECT HOLDINGS AND TRANSFERS.--An
14 individual shall be treated as holding any interest
15 to the extent such interest is held indirectly by
16 such individual through a corporation, partnership,
17 trust, or other entity. If any individual is treated
18 as holding any interest by reason of the preceding
19 sentence, any transfer which results in such interest
20 being treated as no longer held by such individual
21 shall be treated as a transfer of such interest.

22 `` (B) CONTROL.--For purposes of subsections
23 (b)(1), an individual shall be treated as holding any
24 interest held by the individual's brothers, sisters,
25 or lineal descendants.

1 ``(4) EFFECT OF ADOPTION.--A relationship by legal
2 adoption shall be treated as a relationship by blood.

3 ``(5) CERTAIN CHANGES TREATED AS TRANSFERS.--Except
4 as provided in regulations, a contribution to capital or
5 a redemption, recapitalization, or other change in the
6 capital structure of a corporation or partnership shall
7 be treated as a transfer of an interest in such entity to
8 which this section applies if the taxpayer or an
9 applicable family member--

10 ``(A) receives an applicable retained interest in
11 such entity pursuant to such contribution to capital
12 or such redemption, recapitalization, or other
13 change, or

14 ``(B) under regulations, otherwise holds,
15 immediately after the transfer, an applicable
16 retained interest in such entity.

17 This paragraph shall not apply to any transaction (other
18 than a contribution to capital) if the interests in the
19 entity held by the transferor, applicable family members,
20 and members of the transferor's family before and after
21 the transaction are substantially identical.

22 ``(6) ADJUSTMENTS.--Under regulations prescribed by
23 the Secretary, if there is any subsequent transfer, or
24 inclusion in the gross estate, of any applicable retained
25 interest which was valued under the rules of subsection

1 (a), appropriate adjustments shall be made for purposes
2 of chapter 11, 12, or 13 to reflect the increase in the
3 amount of any prior taxable gift made by the transferor
4 or decedent by reason of such valuation.

5 (7) TREATMENT AS SEPARATE INTERESTS.--The Secretary
6 may by regulation provide that any applicable retained
7 interest shall be treated as 2 or more separate interests
8 for purposes of this section.

9 SEC. 2702. SPECIAL VALUATION RULES IN CASE OF TRANSFERS OF
10 INTERESTS IN TRUSTS.

11 (a) VALUATION RULES.--

12 (1) IN GENERAL.--Solely for purposes of determining
13 whether a transfer of an interest in trust to (or for the
14 benefit of) a member of the transferor's family is a gift
15 (and the value of such transfer), the value of any
16 interest in such trust retained by the transferor or any
17 applicable family member (as defined in section
18 2701(e)(2)) shall be determined as provided in paragraph
19 (2).

20 (2) VALUATION OF RETAINED INTERESTS.--

21 (A) IN GENERAL.--The value of any retained
22 interest which is not a qualified interest shall be
23 treated as being zero.

24 (B) VALUATION OF QUALIFIED INTEREST.--The value
25 of any retained interest which is a qualified

1 interest shall be determined under section 7520.

2 `` (3) EXCEPTIONS.--

3 `` (A) IN GENERAL.--This subsection shall not
4 apply to any transfer--

5 `` (i) to the extent such transfer is an
6 incomplete transfer, or

7 `` (ii) if such transfer involves the transfer
8 of an interest in trust all the property in which
9 consists of a residence to be used as a personal
10 residence by persons holding term interests in
11 such trust.

12 `` (B) INCOMPLETE TRANSFER.--For purposes of
13 subparagraph (A), the term 'incomplete transfer'
14 means any transfer which would not be treated as a
15 gift whether or not consideration was received for
16 such transfer.

17 `` (b) QUALIFIED INTEREST.--For purposes of this section,
18 the term 'qualified interest' means--

19 `` (1) any interest which consists of the right to
20 receive fixed amounts payable not less frequently than
21 annually,

22 `` (2) any interest which consists of the right to
23 receive amounts which are payable not less frequently
24 than annually and are a fixed percentage of the fair
25 market value of the property in the trust (determined

1 annually), and

2 “(3) any noncontingent remainder interest if all of
3 the other interests in the trust consist of interests
4 described in paragraph (1) or (2).

5 “(c) CERTAIN PROPERTY TREATED AS HELD IN TRUST.--For
6 purposes of this section--

7 “(1) IN GENERAL.--The transfer of an interest in
8 property with respect to which there is 1 or more term
9 interests shall be treated as a transfer of an interest
10 in a trust.

11 “(2) JOINT PURCHASES.--If 2 or more members of the
12 same family acquire interests in any property described
13 in paragraph (1) in the same transaction (or a series of
14 related transactions), the person (or persons) acquiring
15 the term interests in such property shall be treated as
16 having acquired the entire property and then transferred
17 to the other persons the interests acquired by such other
18 persons in the transaction (or series of transactions).
19 Such transfer shall be treated as made in exchange for
20 the consideration (if any) provided by such other persons
21 for the acquisition of their interests in such property.

22 “(3) TERM INTEREST.--The term ‘term interest’
23 means--

24 “(A) a life interest in property, or

25 “(B) an interest in property for a term of

1 years.

2 ``(4) VALUATION RULE FOR CERTAIN TERM INTERESTS.--If
3 the nonexercise of rights under a term interest in
4 tangible property would not have a substantial effect on
5 the valuation of the remainder interest in such
6 property--

7 ``(A) subparagraph (A) of subsection (a)(2) shall
8 not apply to such term interest, and

9 ``(B) the value of such term interest for
10 purposes of applying subsection (a)(1) shall be the
11 amount which the holder of the term interest
12 establishes as the amount for which such interest
13 could be sold to an unrelated third party.

14 ``(d) TREATMENT OF TRANSFERS OF INTERESTS IN PORTION OF
15 TRUST.--In the case of a transfer of an income or remainder
16 interest with respect to a specified portion of the property
17 in a trust, only such portion shall be taken into account in
18 applying this section to such transfer.

19 ``(e) MEMBER OF THE FAMILY.--For purposes of this
20 section, the term 'member of the family' shall have the
21 meaning given such term by section 2704(c)(2).

22 ``SEC. 2703. CERTAIN RIGHTS AND RESTRICTIONS DISREGARDED.

23 ``(a) GENERAL RULE.--For purposes of this subtitle, the
24 value of any property shall be determined without regard to--

25 ``(1) any option, agreement, or other right to

1 acquire or use the property at a price less than the fair
2 market value of the property (without regard to such
3 option, agreement, or right), or

4 `` (2) any restriction on the right to sell or use
5 such property.

6 `` (b) EXCEPTIONS.--Subsection (a) shall not apply to any
7 option, agreement, right, or restriction which meets each of
8 the following requirements:

9 `` (1) It is a bona fide business arrangement.

10 `` (2) It is not a device to transfer such property to
11 members of the decedent's family for less than full and
12 adequate consideration in money or money's worth.

13 `` (3) Its terms are comparable to similar
14 arrangements entered into by persons in an arms' length
15 transaction.

16 `` SEC. 2704. TREATMENT OF CERTAIN LAPSING RIGHTS AND
17 RESTRICTIONS.

18 `` (a) TREATMENT OF LAPSED VOTING OR LIQUIDATION RIGHTS.--

19 `` (1) IN GENERAL.--For purposes of this subtitle,
20 if--

21 `` (A) there is a lapse of any voting or
22 liquidation right in a corporation or partnership,
23 and

24 `` (B) the individual holding such right
25 immediately before the lapse and members of such

1 individual's family hold, both before and after the
 2 lapse, control of the entity,
 3 such lapse shall be treated as a transfer by such
 4 individual by gift, or a transfer which is includible in
 5 the gross estate of the decedent, whichever is
 6 applicable, in the amount determined under paragraph (2).

7 `` (2) AMOUNT OF TRANSFER.--For purposes of paragraph
 8 (1), the amount determined under this paragraph is the
 9 excess (if any) of--

10 `` (A) the value of all interests in the entity
 11 held by the individual described in paragraph (1)
 12 immediately before the lapse (determined as if the
 13 voting and liquidation rights were nonlapsing), over

14 `` (B) the value of such interests immediately
 15 after the lapse.

16 `` (3) SIMILAR RIGHTS.--The Secretary may by
 17 regulations apply this subsection to rights similar to
 18 voting and liquidation rights.

19 `` (b) CERTAIN RESTRICTIONS ON LIQUIDATION DISREGARDED.--

20 `` (1) IN GENERAL.--For purposes of this subtitle,
 21 if--

22 `` (A) there is a transfer of an interest in a
 23 corporation or partnership to (or for the benefit of)
 24 a member of the transferor's family, and

25 `` (B) the transferor and members of the

1 transferor's family hold, immediately before the
 2 transfer, control of the entity,
 3 any applicable restriction shall be disregarded in
 4 determining the value of the transferred interest.

5 `` (2) APPLICABLE RESTRICTION.--For purposes of this
 6 subsection, the term `applicable restriction' means any
 7 restriction--

8 `` (A) which effectively limits the ability of the
 9 corporation or partnership to liquidate, and

10 `` (B) with respect to which either of the
 11 following applies:

12 `` (i) The restriction lapses, in whole or in
 13 part, after the transfer referred to in paragraph
 14 (1).

15 `` (ii) The transferor or any member of the
 16 transferor's family, either alone or
 17 collectively, has the right after such transfer
 18 to remove, in whole or in part, the restriction.

19 `` (3) EXCEPTIONS.--The term `applicable restriction'
 20 shall not include--

21 `` (A) any commercially reasonable restriction
 22 which arises as part of any financing by the
 23 corporation or partnership with a person who is not
 24 related to the transferor or transferee, or a member
 25 of the family of either, or

1 ``(B) any restriction imposed, or required to be
2 imposed, by any Federal or State law.

3 ``(4) OTHER RESTRICTIONS.--The Secretary may by
4 regulations provide that other restrictions shall be
5 disregarded in determining the value of the transfer of
6 any interest in a corporation or partnership to a member
7 of the transferor's family if such restriction has the
8 effect of reducing the value of the transferred interest
9 for purposes of this subtitle but does not ultimately
10 reduce the value of such interest to the transferee.

11 ``(c) DEFINITIONS AND SPECIAL RULES.--For purposes of
12 this section--

13 ``(1) CONTROL.--The term 'control' has the meaning
14 given such term by section 2701(b)(2).

15 ``(2) MEMBER OF THE FAMILY.--The term 'member of the
16 family' means, with respect to any individual--

17 ``(A) such individual's spouse,

18 ``(B) any ancestor or lineal descendant of such
19 individual or such individual's spouse,

20 ``(C) any brother or sister of the individual,

21 and

22 ``(D) any spouse of any individual described in
23 subparagraph (B) or (C).

24 ``(3) CONTRIBUTION.--The rule of section 2701(e)(3)(A)
25 shall apply for purposes of determining the interests

1 held by any individual."

2 (b) EXTENSION OF STATUTE OF LIMITATIONS.--Subsection (c)
 3 of section 6501 (relating to limitations on assessment and
 4 collection) is amended by adding at the end thereof the
 5 following new paragraph:

6 "(9) GIFT TAX ON CERTAIN GIFTS NOT SHOWN ON
 7 RETURN.--If any gift of property the value of which is
 8 determined under section 2701 or 2702 (or any increase in
 9 taxable gifts required under section 2701(d)) is required
 10 to be shown on a return of tax imposed by chapter 12
 11 (without regard to section 2503(b)), and is not shown on
 12 such return, any tax imposed by chapter 12 on such gift
 13 may be assessed, or a proceeding in court for the
 14 collection of such tax may be begun without assessment,
 15 at any time. The preceding sentence shall not apply to
 16 any item not shown as a gift on such return if such item
 17 is disclosed in such return, or in a statement attached
 18 to the return, in a manner adequate to apprise the
 19 Secretary of the nature of such item."

20 (c) CONFORMING AMENDMENT.--The table of chapters for
 21 subtitle B is amended by adding at the end thereof the
 22 following item:

"CHAPTER 14. Special Valuation Rules."

23 (d) STUDY.--The Secretary of the Treasury shall conduct a

1 study of--

2 (1) the prevalence and types of options and
3 agreements used to distort the valuation of property for
4 purposes of subtitle B of the Internal Revenue Code of
5 1986, and

6 (2) other methods using discretionary rights to
7 distort the value of property for such purposes.

8 The Secretary shall, not later than December 31, 1992, report
9 the results of such study, together with such legislative
10 recommendations as the Secretary considers necessary, to the
11 Committee on Finance of the Senate and the Committee on Ways
12 and Means of the House of Representatives.

13 (e) EFFECTIVE DATES.--

14 (1) SUBSECTION (a).--

15 (A) IN GENERAL.--The amendments made by
16 subsection (a)--

17 (i) to the extent such amendments relate to
18 sections 2701 and 2702 of the Internal Revenue
19 Code of 1986 (as added by such amendments), shall
20 apply to transfers after October 8, 1990,

21 (ii) to the extent such amendments relate to
22 section 2703 of such Code (as so added), shall
23 apply to--

24 (I) agreements, options, rights, or
25 restrictions entered into or granted after

1 October 8, 1990, and

2 (II) agreements, options, rights, or
3 restrictions which are substantially modified
4 after October 8, 1990, and

5 (iii) to the extent such amendments relate to
6 section 2704 of such Code (as so added), shall
7 apply to restrictions or rights (or limitations
8 on rights) created after October 8, 1990.

9 (B) EXCEPTION.--For purposes of subparagraph
10 (A)(i), with respect to property transferred before
11 October 9, 1990--

12 (i) any failure to exercise a right of
13 conversion,

14 (ii) any failure to pay dividends, and

15 (iii) any failure to exercise other rights
16 specified in regulations,

17 shall not be treated as a subsequent transfer.

18 (2) SUBSECTION (b).--The amendment made by subsection
19 (b) shall apply to gifts after October 8, 1990.

2. Small Business Incentives

a. Revision of estate freeze rules

Present Law

Estate tax inclusion relating to estate freezes

If a person, in effect, transfers property having a disproportionately large share of the potential appreciation in such person's interest in an enterprise while retaining an interest, or right in, the enterprise, then the transferred property is includible in his gross estate (Code sec. 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 in the gross estate had the transferor died at the time of the transfer.

Preferred interests in corporations and partnerships

The transfer of a residual interest in a corporation or partnership for less than full and adequate consideration is a gift. The value of a residual interest in a corporation or partnership often is determined by subtracting the value of the preferred interest from the value of all interests in the corporation or partnership.

Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Under the "willing buyer, willing seller" valuation standard, it is assumed that rights will be exercised so as to maximize the value of the owner's interests. The failure to exercise rights in an arm's-length manner may give rise to a taxable gift.

Gift tax statute of limitations

Generally, no proceeding in a court for the collection of gift tax can begin without an assessment within 3 years after the filing of the return. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time.

Trusts and term interests in property

The transfer of a remainder interest in property results in a taxable gift if the value of the remainder interest exceeds the value of any consideration received for such interest. The value of the remainder interest is the value of the entire property less the value of rights in the property retained by the transferor. Income interests

retained by the transferor generally 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 interest rate.

Options and buy-sell agreements

Some courts have held that the price contained in a buy-sell agreement limits 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.

Lapsing rights

Some courts have held that the fair market value of property is determined the moment after death. Under this theory, the value attributable to a right that lapses upon death is not subject to estate tax.

House Bill

No provision.

Senate Amendment

Estate tax inclusion relating to estate freezes

The Senate amendment repeals section 2036(c) retroactively.

Preferred interests in corporations and partnerships

The Senate amendment provides rules for valuing certain rights held by the transferor or certain family members immediately after the transfer of a residual interest in a corporation or partnership. The rules rely on present law principles that value residual interests by subtracting the value of preferred interests from the value of the entire corporation or partnership, with an adjustment to reflect the actual fragmented ownership. The rules apply in determining the value of a residual interest that is transferred to, or for the benefit of, a family member.

The Senate amendment establishes specific valuation rules for three types of retained rights. First, a retained liquidation, put, call, conversion or similar right is valued at zero, unless such right must be exercised at a specific time and amount. Second, a retained distribution right that is noncumulative or lacks a preference upon liquidation is valued at zero if the transferor and applicable family members control the corporation or partnership. Third, a cumulative distribution right having a preference upon

liquidation in a corporation or partnership in which the transferor and applicable family members retain control is valued under a special standard: the determination of whether a dividend can reasonably be expected to be timely paid is made without regard to the transferor's control. The amendment exempts from these rules a retained interest that is publicly traded, that is of the same class as the transferred interest, that is of the same class but for nonlapsing differences in voting power, or that possesses proportionally the same rights as the transferred interest.

The Senate amendment values a redemption or liquidation right without a fixed date at zero even if such right is held in conjunction with a cumulative distribution right. The Senate amendment does not specify the treatment of a distribution right with no fixed termination date.

The Senate amendment increases the amount of estate or gift tax on a subsequent transfer of the retained preferred interest by the time value of accumulated distributions. The amount of accumulated distributions and interest thereon that is subject to gift or estate tax is capped at an amount equal to (1) the excess of the fair market value of the residual interests in the corporation or partnership at the date of the subsequent transfer over the fair market value of such interests at the date of the initial transfer multiplied by (2) a fraction the numerator of which is the value of the preferred interests in the corporation or partnership held by the transferor and the denominator of which is the value of all such interests.

The Senate amendment also provides that the aggregate value of the junior equity interests in a corporation or partnership can be no less than 10 percent of the sum of the total equity in the corporation or partnership plus any debt which the corporation or partnership owes to the transferor or members of his family.

Except as provided in Treasury regulations, any redemption, recapitalization, contribution to capital, or other change in the capital structure of a corporation or partnership is treated as a transfer of an interest in such entity if an individual or applicable family member thereby receives a retained right affected by the bill. Regulations also may provide that such an event results in a transfer if the individual or applicable family member thereafter holds such an interest.

Statute of limitations

The Senate amendment provides that the gift tax statute of limitations runs for transfers subject to the rules governing preferred interests in corporations and partnerships and to increases in taxable gifts with respect

to cumulative preferred stock only if the transfer is disclosed on a gift tax return with sufficient detail to apprise the Secretary of the Treasury of the nature of the transferred and retained interests.

Trusts and term interests in property

Under the Senate amendment, retained interests in trusts or term interests in property generally are valued at zero for gift tax purposes unless they take the form of an annuity or unitrust interest.

Buy-sell agreements

The Senate amendment provides that the value of property is determined without regard to any option, agreement, right or restriction, unless (1) the option, agreement, right or restriction is a bona fide business arrangement, (2) the option, agreement, right or restriction is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration, and (3) the terms of the option, agreement, right or restriction are comparable to those obtained in similar arrangements entered into by persons in an arm's length transaction.

Lapsing rights

Under the Senate amendment, the value of property is determined without regard to any restriction other than a restriction which by its terms will never lapse.

In addition, any right held by the decedent with respect to property includible in the gross estate which effectively lapses on the death of the decedent would, in valuing such property in the estate, be deemed exercisable by the estate.

Treasury study

The Senate amendment requires that the Secretary of the Treasury study buy-sell agreements and discretionary rights that have the potential for distorting transfer tax value and report the results of the study no later than December 31, 1992.

Effective date

The Senate amendment generally applies to transfers made and agreements entered into (or substantially modified) after October 8, 1990.

Conference Agreement

The conference agreement follows the Senate amendment, with the following modifications.

Preferred interests in corporations and partnerships

Valuation of distribution rights

The conferees are concerned that by ignoring liquidation, put, call and conversion rights held in conjunction with a distribution right, the Senate amendment undervalues certain applicable retained rights. By valuing at zero a liquidation right associated with a distribution right, the Senate amendment permits the possibility that the distribution right also would receive little value, particularly when such liquidation right is likely to be exercised at the earliest possible date.

Accordingly, the conference agreement modifies the rules applicable to the valuation of distribution rights. Under the conference agreement, a retained interest that confers (1) a liquidation, put, call or conversion right and (2) a distribution right that consists of the right to receive a qualified payment (as defined below) is valued on the assumption that each right is exercised in a manner resulting in the lowest value for all such rights. Each right receives a value consistent with that assumption.

Example 1.--Father retains cumulative preferred stock in a transaction to which the provision applies. The cumulative dividend is \$100 per year and the stock may be redeemed at any time after two years for \$1,000. Under the conference agreement, the value of the cumulative preferred stock is the lesser of (1) the present value of two years of \$100 dividends plus the present value of the redemption for \$1,000 in year two, or (2) the present value of \$100 paid every year in perpetuity. If the present values are substantially identical, the stock receives such value.

A qualified payment is a dividend payable on a periodic basis and at a fixed rate¹ under cumulative preferred stock (or a comparable payment under a partnership agreement).² A transferor or applicable family member may elect to treat any other distribution right as a qualified payment to be paid in the amounts and at the times specified in the election.

The election to treat distribution rights as qualified

¹ For this purpose, a fixed rate includes one bearing a fixed relationship to a specified market rate.

² A transferor or applicable family member may elect not to treat such a dividend (or comparable payment) as a qualified payment. If the transferor made such an election, unpaid amounts on cumulative preferred interests would not be subject to the compounding rules.

payments cannot be inconsistent with the legal instrument underlying the right. Accordingly, the transferor cannot elect to treat a distribution right as a right to receive a qualified payment in excess of amounts that could actually be received under the instrument. For example, a transferor cannot elect to value a noncumulative right to \$100 per year on the assumption that it would pay \$110 per year.

Example 2.--Father and Daughter are partners in a partnership to which Father contributes an existing business. Father is entitled to 80 percent of the net cash receipts of the partnership until he receives \$1 million, after which time he and Daughter both receive 50 percent of the partnership's cash flow. Father's liquidation preference equals \$1 million. Under the conference agreement, the retained right to \$1 million is valued at zero, unless Father elects to treat it as a right to receive qualified payments in the amounts, and at the times, specified in the election. If Father elects such treatment, amounts not paid at the times specified in the election become subject to the compounding rules.

Regulatory authority

The conference agreement also grants the Secretary of the Treasury regulatory authority to treat a retained interest as two or more separate interests under the provision. Such treatment would allow value to be accorded to the participating feature of a participating preferred interest pursuant to the exception for retained interests that are of the same class as the transferred interest.

Example 3.--Mother owns all the stock in a corporation. One class is entitled to the first \$100 in dividends each year plus half the dividends paid in excess of \$100 that year; the second class is entitled to one half of the dividends paid above \$100. The preferred right under the first class is cumulative. Mother retains the first class and gives the second class to Child. Under the conference agreement, Treasury regulations may treat an instrument of the first class as two instruments under the provision: one, an instrument bearing a preferred right to dividends of \$100; the other, an instrument bearing the right to half the annual dividends in excess of \$100, which would fall within the exception for retained interests of the same class as the transferred interest.

Example 4.-- Father and Daughter enter into a partnership agreement under which Father is to receive the first \$1 million in net cash receipts and is thereafter to share equally in distributions with Daughter. Under the conference agreement, Treasury regulations may treat Father's retained interests as consisting of two interests: (1) a distribution right to \$1 million and (2) a 50 percent

partnership interest. Father could elect to treat the first interest as a right to receive qualified payments at specified amounts and times; the second interest would fall within the exception for retained interests of the same class as the transferred interest.

Limitation on transfer tax inclusion

Under the conference agreement, the limitation on the amount of unpaid dividends and interest subject to subsequent transfer tax equals (1) the excess of the fair market values of equity interests that are junior to any retained preferred interests at the date of the later transfer over such values as of the date of the prior transfer of the junior interest, multiplied by (2) a fraction (determined immediately before the later transfer), the numerator of which is the number of shares of preferred interests held by the transferor and the denominator of which is the number of all shares of the same class of preferred interest. This limitation applies with respect to each class of preferred held by the transferor or applicable family member.

Example 5.--A corporation has four classes of stock. Class A is entitled to the first \$10 of dividends each year; Class B is entitled to the second \$10 of dividends each year; Class C is entitled to the third \$10 of dividends each year; and Class D is entitled to all dividends in excess of those paid to classes A, B and C. Classes A, B and C all have cumulative rights to dividends. In a transaction to which the provision applies, Father gives Daughter stock in classes A and C while retaining stock in class B. Class D is owned by an unrelated party. Dividends are not paid on the class C stock and several years later Father dies holding the class B stock. The cap on future amounts subject to transfer tax equals the excess of the fair market value of stock in classes C and D at the date of Father's death over such value at the date of the gift multiplied by a fraction equal to the percentage of class B stock held by Father.

Exceptions

Under the conference agreement, a retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability). This exception would apply, for instance, if the retained and transferred interests consisted of two classes of common stock, which shared in all distributions, liquidation and other rights in a two-to-one ratio. It would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions.

Except as provided in Treasury regulations, a right that lapses by reason of Federal or State law generally would be treated as nonlapsing under this exception. The conferees intend, however, that Treasury regulations may give zero value to rights which lapse by reason of Federal or State law that effectively transfer wealth that would not pass in the absence of a specific agreement. Such regulations could, for example, give zero value to a management right that lapses by reason of the death of a partner under the Uniform Partnership Act as adopted in a State if the decedent had waived in the partnership agreement the right to be redeemed at fair market value under that Act.

Definitions

The conference agreement modifies two definitions in the Senate amendment.

Junior equity interest.--In the case of a partnership, a junior equity interest is any partnership interest under which the rights to income and capital are junior to the rights of all other classes of equity interests in the partnership.

Transfer.--Except as provided in Treasury regulations, a contribution to capital, or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership is treated as a transfer of an interest in such entity if an individual or applicable family member thereby receives a retained right whose value would be affected by the provision. Regulations also may provide that such an event results in a transfer if the individual or applicable family member thereafter holds such an interest.

The conferees understand that such regulations would apply the provision to a contribution to capital, or a redemption, recapitalization, or other change in capital structure of a corporation or partnership that effects a transfer (determined under the above valuation rules). Thus, for example, the regulations might provide that a contribution to capital, or a redemption, recapitalization or other change in capital structure is subject to these rules if such event would result in a gift if all applicable retained interests were valued at zero.

The conference agreement provides, however, that the provision would not apply to a change in capital structure other than a contribution to capital if the interests held by the transferor, applicable family members, and family members are substantially identical before and after the change. The provision would not apply, for example, to a recapitalization not involving a contribution to capital if all shareholders held substantially identical interests both before and after the recapitalization. Nor would it apply to a change in

corporate name. In addition, the conferees intend that the addition of capital to an existing partnership or corporation would result in the application of these rules only to the extent of such contribution.

Buy-sell agreements and options

The conferees do not intend the provision governing buy-sell agreements to disregard such an agreement merely because its terms differ from those used by another similarly situated company. The conferees recognize that general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard contained in the conference agreement.

Treatment of certain restrictions and lapsing rights

In general

The conference agreement modifies the provision in the Senate amendment regarding the effect of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. These rules are intended to prevent results similar to that of Estate of Harrison v. Commissioner, 52 T.C.M. (CCH) 1306 (1987). These rules do not affect minority discounts or other discounts available under present law. The conferees intend that no inference be drawn regarding the transfer tax effect of restrictions and lapsing rights under present law.

Lapsing rights

The conference agreement provides that the lapse of a voting or liquidation right in a family-controlled corporation or partnership results in a transfer by gift or an inclusion in the gross estate. The amount of the transfer is the value of all interests in the entity held by the transferor immediately before the lapse (assuming the right was nonlapsing) over the value of the interests immediately after the lapse. The conference agreement grants the Secretary of the Treasury regulatory authority to apply these rules to rights similar to voting and liquidation rights.

Example 6.--Parent and Child control a corporation. Parent's stock has a voting right that lapses on Parent's death. Under the conference agreement, Parent's stock is valued for Federal estate tax purposes as if the voting right of the parent's stock were nonlapsing.

Example 7.-- Father and Child each own general and limited interests in a partnership. The general partnership interest carries with it the right to liquidate the

partnership; the limited partnership interest has no such right. The liquidation right associated with the general partnership interest lapses after ten years. Under the conference agreement, there is a gift at the time of the lapse equal to the excess of (1) the value of Father's partnership interests determined as if he held the right to liquidate over (2) the value of such interests determined as if he did not hold such right.

Restrictions

Under the conference agreement, any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored in valuing a transfer among family members if (1) the transferor and family members control the corporation or partnership, and (2) the restriction either lapses after the transfer or can be removed by the transferor or members of his family, either alone or collectively.

Example 8.--Mother and Son are partners in a two-person partnership. The partnership agreement provides that the partnership cannot be terminated. Mother dies and leaves her partnership interest to Daughter. As the sole partners, Daughter and Son acting together could remove the restriction on partnership termination. Under the conference agreement, the value of Mother's partnership interest in her estate is determined without regard to the restriction. Such value would be adjusted to reflect any appropriate fragmentation discount.

This rule does not apply to a commercially reasonable restriction which arises as part of a financing with an unrelated party or a restriction required under State or Federal law. The provision also grants to the Treasury Secretary regulatory authority to disregard other restrictions which reduce the value of the transferred interest for transfer tax purposes but which do not ultimately reduce the value of the interest to the transferee.