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SECTION 2036(c)

By

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I. The Basic Rule.

A. Typical Transaction.

1. Parent recapitalizes corporation which was a fair market value of \$2,000,000 with \$1,900,000 of noncumulative 10% preferred and common. Gives common to children valued at \$100,000.
 - a. In order to justify value in preferred it is given rights such as ability to convert into \$1,900,000 of common at any time, or ability to require liquidation.
 - b. Usually business had insufficient cash flow to justify actual payment of market rate preferred dividend.
 - c. Common usually valued at a small percentage of total in order to avoid gift tax.
2. Prior IRS potential attacks.
 - a. Common stock gift of over \$100,000.

- (1) Leverage of 19-1 gives it "option" value
 - (2) Company worth more than \$2,000,000
 - (3) Preferred not worth \$1,900,000
- b. Failure to pay dividend and not exercising other rights a gift.
3. Section 2036(c) requires entire value of common to be included in estate of donor as retention of preferred treated as retention of enjoyment of transferred property for Section 2036(a).

B. Required Elements To Trigger Application Of Section 2036(c).

1. Property dealt with is an enterprise. §2036(c)(1)(A)
 - a. Not a defined term.
 - b. May not be confined to an active business.
2. Person holds a substantial interest in an enterprise. §2036(c)(1)(A)
 - a. Defined to include direct or indirect interest of 10% or more of voting power or income stream. §2036(c)(3)(A)
 - b. Individual treated as owning an interest owned directly or indirectly by spouse, parent, grandparent, lineal descendent, lineal descendent of spouse or any spouse of foregoing.
 - c. Measured before transfer.
3. Person ineffect transfers after December 17, 1987.
 - a. Prior transfers grandfathered.
 - b. "Ineffect" transfers may require no actual transfer.
4. Transferred property having a disproportionately large share of potential appreciation in such person's interest in the enterprise. §2036(c)(1)(B)
 - a. Terms not defined in statute.

- b. Presumably a comparison of appreciation of interest given and retained.
5. Retain an interest in the income of or rights in the enterprise. §2036(c)(1)(B)
- a. Retention need not be disproportionate.
 - b. "Rights" not defined but may be quite broad. Exceptions are provided for certain compensation and debt arrangements.

C. Exceptions.

1. Bona fide sale for an adequate and full consideration to non-family member or between siblings. §2036(a)
2. If sale is to a family member for consideration that was never received directly or indirectly from transfer or, does not apply to "applicable fraction". §2036(c)(2)(B)(i)
 - a. "Applicable fraction" numerator is "amount of consideration referred to in paragraph (1)" denominator is "value of the portion referred to in clause (i) immediately after the transfer described in paragraph (1)" §2036(c) and (B)(ii).
 - b. Example from conference committee report. For example, a parent owns all the common and preferred stock in a corporation worth \$2 million. After December 17, 1987, the parent sells to his child the common stock for \$1 million not directly or indirectly received or acquired from the parent. If the parent continues to hold the preferred stock until his death, one half of the value of the corporation is includible in the parent's estate.
3. Retention of an interest in a qualified grantor retained interest trust. §2036(c)(6)(A)
 - a. Retained right may not exceed 10 years. §2036(c)(6)(B)(i)

- b. The person holding the income right transferred the property to the trust. §2036(c)(6)(B)(ii)
 - c. The person holding the income right is not trustee of the trust. §2036(c)(6)(B)(iii)
4. The section does not apply solely by reason of the receipt or retention of qualified debt. §2036(c)(7)(A)(i)
- a. Qualified debt means indebtedness meeting the following conditions: §2036(c)(7)(C)
 - "(i) such indebtedness--
 - (I) unconditionally requires the payment of a sum certain in money in 1 or more fixed payments on specified dates, and
 - (II) has a fixed maturity date not more than 15 years from the date of issue (or, in the case of indebtedness secured by real property, not more than 30 years from the date of issue).
 - (ii) the only other amount payable under such indebtedness is interest determined at--
 - (I) a fixed rate, or
 - (II) a rate which bears a fixed relationship to a specified market interest rate,
 - (iii) the interest payment dates are fixed,
 - (iv) such indebtedness is not by its terms subordinated to the claims of general creditors,
 - (v) except in a case where such indebtedness is in default as to interest or principal, such indebtedness does not grant voting rights to the person to whom the debt

is owed or place any limitation on the exercise of voting rights by others, and

(vi) such indebtedness--

(I) is not (directly or indirectly) convertible into an interest in the enterprise which would not be qualified debt, and

(II) does not otherwise grant any right to acquire such an interest.

The requirement of clause (i)(I) that the principal be payable on 1 or more specified dates and the requirement of clause (i)(I) shall not apply to indebtedness payable on demand if such indebtedness is issued in return for cash to be used to meet normal business needs of the enterprise."

b. Qualified debt includes start-up debt if:
§2036(c)(7)(D)

"(I) such indebtedness unconditionally requires the payment of a sum certain in money,

(II) such indebtedness was received in exchange for cash to be used in any enterprise involving the active conduct of a trade or business,

(III) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II) transferred any property (including goodwill) which was not cash to the enterprise or transferred customers or other business opportunities to the enterprise,

(IV) the person to whom the indebtedness is owed has not at any time (whether before, on, or after the exchange referred to in subclause (II) held any interest in the enterprise (including an interest as an officer, director, or employee)[] which was not qualified startup debt,

(V) any person who (but for subparagraph (A)(i)) would have been an original transferee (as defined in paragraph (4)(C) participants in the active management (as defined in section 2032A(e)(12)) of the enterprise, and

(VI) such indebtedness meets the requirements of clauses (v) and (vi) of subparagraph (C)."

5. The section shall not apply if such services were performed under an agreement providing for the performance of services over a period not greater than 3 years after the date of the transfer unless any amount is determined (in whole or in part) by reference to gross receipts, income, profits, or similar terms of the enterprise. Section 2036(c)(7)(B).
6. Buy sell agreements at the fair market value as of the time the option is (or the rights under the agreement are) exercised. Section 2036(c)(7)(A)iii.

D. Other Rules.

1. An individual and the individual's spouse are treated as one person. §2036(c)(3)(C)
2. Gift occurs at time original transferor transfers part or all of retained interest to extent of fair market value of transferred property. §2036(c)(4)(A)(i)
3. Gift occurs at time original transferee transfers any part of the property to a person who is not a member of the original transferor's family. §2036(c)(4)(A)(ii)

II. Internal Revenue Service Notice 89-99 (All Cites Are To The Notice).

A. Overview.

1. Many terms "are neither adequately defined in the statute nor susceptible to generally accepted interpretation." p. 3
2. Ways in which freeze techniques facilitate tax avoidance:

- a. "Adornment of the various interest with limited preferences and other ownership attributes calculated to depress or enhance value facilitates the undervaluation of property for transfer tax purposes." p. 4
 - b. "The exercise or non-exercise of rights and powers attendant to the various interests, contrary to the premises on which the original valuation of the interests was based, accommodates the shift of wealth without the imposition of a transfer tax." p. 4
 - c. "The transfer of appreciation coupled with the retention of an interest in income or other indicia of ownership enables the transferor to exclude the appreciation from his or her estate without parting with the enjoyment of the property, in contravention of the purposes of sections 2036 and 2038 of the Code." p. 4
3. Applies to other arrangements than corporations and partnerships. p. 6
- a. "Trusts in which the grantor retains beneficial interests, including grantor retained income and annuity trusts;
 - b. Intra-family sales, including installment sales, private annuities, and sales of remainder interests;
 - c. Transfer and leaseback arrangements;
 - d. Joint purchase of income and remainder interest."
4. Inclusion of appreciation interest and reduce by value of income interest.
- a. "To illustrate, if the owner of 100 percent of an enterprise transfers to his or her child interests representing 50 percent of the appreciation and 10 percent of the income stream, retaining interests representing 50 percent of the appreciation and 90 percent of the income stream, the general effect of section 2036(c) is to include in the transferor's estate 40 percent of the value of the enterprise.

To avoid inclusion of the same property under different sections of the Code, the value of the portion of the enterprise that is includible in the transferor's gross estate under section 2036(c) is reduced to the extent that the value of the corresponding portion of the transferor's retained interest or rights is includible in the transferor's gross estate under section 2033. Thus, in the illustration in the preceding paragraph, the amount included in the transferor's estate under section 2036(c) is reduced by the value of the interest that represents 40 percent of the income stream." p. 7

- b. Example: Assume common worth 1000x and preferred 1000x.

<u>Holdings</u>	<u>Parent</u>	<u>Child</u>
Preferred	900x	100x
Common	500x	500x

Enterprise value increases to 5000x

<u>Holdings</u>	<u>Parent</u>	<u>Child</u>
Preferred	900x	100x
Common	2000x	2000x

Amount included is 40% of 5000x or 2000x less 400x or 1600x. This is 40% of common stock value (4000x.4).

- c. Is it reduced by any dividends paid? Should value of preferred dividends be increased by reinvestment? Eg. if dividends paid on all preferred total 1500x, 40% would equal 600x.

B. Exceptions To The Application Of Section 2036(c).

1. Types of Property.

- a. Personal use property. p. 12
- b. Residence. p. 12
- c. Life Insurance. p. 12
- d. But consider Section 2036(a).

2. Types of Entity.

- a. Estate. p. 11
- 3. Nature of potential appreciation.
 - a. Minority discount. p. 33
 - b. Nonvoting. p. 33
- 4. Interest in enterprise.
 - a. Not an interest if incidental due to provision of de minimis property or service to child's business. p. 12
 - b. Provision of goods or services at fair market value is not an interest in the enterprise. p. 13
 - c. Acting as trustee with voting power is not a retained interest. p. 36
- 5. Expansion of exceptions.
 - a. GRIT--A contingent reversion or general power of appointment with respect to trust corpus is permitted if the value of such reversion or power does not exceed 25% of the value of the retained income interest at the time created. p. 41
 - b. Debt--If qualifying except subordinated to one or more specified general creditors. p. 43
 - c. Start-up Debt--May have made a transfer to the enterprise 3 years prior to the acquisition of debt. p. 44
 - d. New Enterprise--may obtain a preferred stock interest for cash. p. 45
 - (i) May not be a continuation of or successor to an existing enterprise. p. 45
 - (ii) Must be in active conduct of a trade or business. p. 45

- (iii) Must have in active management a person who would otherwise be considered an original transferee. p. 45
- (iv) Preferred characteristics. p. 45-46
 - (1) Cumulative fixed dividend.
 - (2) Nonlapse liquidation preference including right to receive accumulated dividends.
 - (3) Can not be redeemable for less than par value and accumulated dividend.
 - (4) Nonvoting.
 - (5) Convertible only into an interest that meets requirements.
- (v) Can not transfer any proscribed property (non-cash property, goodwill, customers or business opportunities) to the enterprise. p. 46
- vi. Can not hold an interest in the enterprise that would be a proscribed interest (officer, director or employee). p. 46
- e. Buy-Sell Agreement.
 - (i) May have "a formula, based on currently acceptable valuation techniques, that reasonably can be expected to produce a result that approximates the fair market value of the property as of the time the sale is consummated." p. 47
 - (ii) "A good faith buy-sell agreement that adopts a formula generally recognized as suitable to the valuation of the type of property involved and acceptable in arm's length negotiations taking place at the time the agreement is executed meets the requirements of the safe harbor." p. 47 (Can insurance be disregarded in determining value).

(iii) A "bona fide" buy sell agreement between non family members is exempted. p. 47

(iv) Service solicits requests on other ways to refine whether buy-sell agreements are subject to section 2036(c).

f. Employment Agreement--if provide for more than a three year term in an employment agreement, the safe harbor may still be met "if the agreement is terminable by the employer at will or for reasonable cause and otherwise meets the requirements for the statutory exception." p. 50

6. Spousal Unity Rule.

a. Transfer of retained rights to spouse in nontaxable transfer does not trigger a taxable event at that time. p. 52

b. Transfer of retained rights to spouse in taxable transfer does trigger a Section 2036(c) taxable event at that time but precludes later application. p. 52

c. Does not apply to disproportionate transfers that occurs by reason of the transferor's death. p. 53

(i) Thus a trust established in Taxpayer's will with income to spouse and remainder to children will not cause property to be included in spouse's estate.

(ii) Service solicits comments.

(iii) Does this mean that preferred can go to marital trust and common to family trust?

C. Rules Explained.

1. Substantial Interest of 10%.

a. Interest in income stream or voting power owned by an entity other than a trust or estate is considered as owned proportionately by the entity's owners. p. 20

- b. An interest in income owned by a trust is considered owned by beneficiaries to the extent they are eligible or entitled presently or in the future to receive income or principal p. 20 (Would every beneficiary of a discretionary trust be treated as owning it all?)
- c. Voting power is considered owned by transferor to trust if transferor or a member of the transferor's family alone or in conjunction with any other person is entitled to exercise such power. p. 20
- d. Income or voting power owned by an estate is considered as owned proportionately by the beneficiaries. p. 20
- e. Presumably the rules are limited to determining whether a substantial interest is held not whether the transferor has retained an interest.
- f. Service solicits comments on whether because of participation of a significant number of unrelated parties indicates that opportunity for disproportionate transfers does not exist. p. 23

2. Definition of Disproportionate Appreciation.

- a. Determined by comparing two fractions. The first is the percentage share in appreciation before transfer over 100. The second is the percentage share in appreciation over the value of that interest expressed as a percentage of the value of the transferor's interest immediately prior to the transfer. p 26. Example Preferred value is 1000x common value is 500x. Taxpayer owns all Preferred and common. Before transaction has 100% of appreciation over 100. After gift of 200x common has 60% appreciation over 1300x/1500x.
- b. If shift interest in appreciation assume the percentage share of potential appreciation by maximizing share of potential appreciation before the transfer and minimizing it after the transfer. p. 27

- c. Example of a partnership whereby A is entitled to first \$100x of any gain and 25% of any gain in excess of 200x B is entitled to gain between 100x and 200x plus 75% of gain in excess of 200x. Example assume B has greater potential appreciation p. 28. This assumes B is the child. (What if A is the child and it is unlikely that appreciation will exceed 100x? Probably not a problem as it would be difficult to undervalue A's interest at the time you establish it.)
- d. In the case of a loan to an enterprise, it is treated as if the lender obtained prior to the transfer a proportionate interest in the enterprise. p. 30

3. Retained Interest.

- a. An "interest in the income of an enterprise" may be embodied in any form of interest (present or future), agreement, or arrangement, including, without limitation a preferred equity interest in the enterprise, a promissory note, a life or term interest, an employment agreement, a retirement arrangement, a sale agreement, and a lease agreement."
 - (i) Breadth of the retained interest also effects substantial disproportionate test as such interests are to be measured in the formula in determining disproportionate appreciation.
 - (ii) "The enactment of limited exceptions implies that the arrangements they represent generally raise the concerns to which section 2036(c) is directed." p. 40
- b. Exceptions.
 - (i) Debt--Self canceling installment note does not meet the requirement of an unconditional obligation to pay a sum certain. p. 43
 - (ii) Buy-Sell Agreements--Book value for real estate enterprise can not be expected to approximate fair market value. p. 48

- (iii) Employment agreement--Covenant not to compete will be considered an agreement for the provision of services for the purposes of the exceptions p. 50 (does this mean if it exceeds 3 years it is a retained interest?)

4. Spousal Unity.

- a. Considering a rule that executor could elect to include child's common stock in taxpayers estate rather than spouse's estate if spouse was given preferred. p. 55 Comments are solicited.
- b. Extensive examples are provided as to who is deemed transferor when common given to child and preferred is disposed of in various alternatives. p. 56-63

5. Consideration.

- a. If consideration paid was not received from transferor, exclude portion of value arrived at by multiplying value by a fraction the numerator of which is consideration furnished by transferee and denominator is value of enterprise that would have been includable if transferor's gross estate had the transferor died immediately after the transfer including the value of the retained interest. p. 64
 - (i) Assume Preferred worth 1000x and common 500x and purchase common for 500x of "clean money"; common increases in value to 3000x at time of death, preferred value is 1000x. Exclude 4000x times 500/1500.
- b. Demonstration that consideration did not come from transferor. p. 65
 - (i) Sometime acquired property from other sources and considering reasonable rate of growth could have accumulated amount.

(ii) Financial ability to furnish portion of consideration was not to any extent dependent on acquisition of property from transferor during three years preceding disproportionate transfer. (probably can not receive gifts three years prior to transfer)

III. Application.

A. Corporate Recapitalization.

1. Corporation worth \$2,000,000. Parent wishes to retire; child active in business wants parent to retire. Parent gives child \$1,200,000 in common and obtains an \$800,000 preferred with cumulative 10% return. Transaction governed by Section 2036(c) even though there is no abuse.
2. Corporation worth \$2,000,000 and has 1000 common shares outstanding. Child owns 300 common shares. Parent exchanges 700 shares of common for preferred, even though no direct transfer is treated as an indirect transfer. P. 25. Does it matter if common purchased? Does it matter if common given before December 17, 1987? How much is included? (If transaction separate from gift, only 70% of appreciation should be included.)
3. Corporation worth \$2,000,000. Recapitalized prior to December 17, 1987, parent owns 70 shares common and child 30 shares, parent owns \$1,000,000 of preferred. If parent wants to give 70 shares common to child how much preferred must be given? What if only \$100,000 of preferred? What if preferred held by parent's mother? What if just giving 10 shares of common?
4. If recapitalize with 16% commulative preferred and common, which interest has disproportionately large share of appreciation? No possibility of abuse for substantial undervaluing preferred if give to child. See McGaffey, College Education with Pre-Tax Dollars, 15 Miami Inst. Est Plan ¶300 (1981) on Estate Thaw.
5. If Form new corporation, child contributes \$100,000 for common and parent \$300,000 for preferred, does section apply to new enterprises? Treated as deemed transfer. Applies even if loan funds. p. 30
6. In order to provide added compensation to employee, recapitalize with \$1,500,000 of preferred and \$500,000 of common Provide

restricted stock of 10% of common to key employee. When owner dies is employee's stock included in estate? Is the transfer for full and adequate consideration?

B. One Class of Stock With Gift of Common.

1. If give all common to child and retain an employment agreement or covenant not to compete of over 5 years.
2. If sell common to child with funds previously provided, and retain an employment agreement or covenant not to compete of over 5 years.
3. Gift of annual exclusion amount of common stock but have an employment agreement of over 3 years or bonus program based on profits.
4. Gift or sale of common with a loan subordinated to all creditors in order to get credit. Is entire amount of common included no matter how small the loan?

C. What Can Do.

1. Non-family member can have any interest if pay full and adequate consideration.
2. Parent can give or sell common, if one class of stock and no retention of interest other than stock and statutory exceptions to retained interest.
3. Sale of parent's stock to child as long as parent retains no interest in corporation.