1991

Planning Opportunities After Chapter 14 (Section 2701 and 2702)

Frederic A. Nicholson
Planning Opportunities After Chapter 14 (Section 2701 and 2702)

By: Frederic A. Nicholson
Willcox & Savage, P.C.

I. Section 2701 - Special Valuation Rules on Transfers of Interests in Partnerships or Corporations

A. The Preconditions to Application of Section 2701

1. The two requirements: (a) that of a transfer, and (b) that of a retained interest.

2. The Transfer Requirement

   a. The word "transfer" is expanded beyond its usual meaning to include contributions on the organization of a new entity, redemptions, recapitalizations and other forms of changes in the capital structure of a corporation or partnership, IRC § 2701(e)(5); Prop. Reg. § 25.2701-1(b)(2). But see exclusions in Paragraph (4)(e) below.

   b. The transfer must be of an equity interest in a partnership or a corporation.

   c. The transfer must be to or for the benefit of a "member of the transferor's family".

      (1) The phrase is defined for purposes of Section 2701 to mean: the transferor's spouse, a lineal descendent of the transferor or spouse; and the spouse of any such descendant. IRC § 2701(e)(1).

   d. There is an indirect ownership rule whereby an individual holding an interest in a corporation or partnership through another entity - as for example, through a trust - will be treated as having made a transfer of that interest as a result of a transaction causing the individual to no longer hold such interest. IRC § 2701(e)(5). Prop. Reg. § 25.2701-6.

3. The Retained Interest Requirement.

   a. Immediately after the transfer, the transferor or "an applicable family member" must hold an interest in the partnership or corporation that is an "applicable retained interest".
b. "Applicable family member" is defined to mean: the transferor's spouse, an ancestor of the transferor or spouse, and the spouse of any such ancestor. IRC § 2701(e)(2).

c. An "applicable retained interest" means a senior equity interest in an entity if with respect to that interest there is either an "extraordinary payment right" or a "distribution right", provided in the latter case that the entity is a "controlled entity". Prop. Reg. § 25.2702-2(b)(1).

(1) "Extraordinary payment right" is defined as "any put, call or conversion right, any right to compel liquidation or any similar right, the exercise or nonexercise of which affects the value of the transferor's interest." Prop. Reg. § 25.2701-2(b)(2). But it does not include "mandatory payment rights, liquidation participation rights, and non-lapsing conversion rights" - terms that are defined in the regulations. Prop. Reg. § 25.2701-2(b)(4).

(2) A "distribution right" means any right to distributions from a corporation or partnership, with certain exceptions. Prop. Reg. § 25.2701-2(b)(3).

(a) The distribution right does not cause an interest to be "an applicable retained interest" unless the transferor (together with applicable family members) is in control of the entity, i.e., at least 50% of stock ownership (by vote or value) or of either a 50% capital or profits in a partnership or, in a limited partnership, any interest as a general partner. IRC § 2701(b)(2). For this purpose, an individual is treating as owning an interest held by his brothers, sisters and lineal descendants. IRC § 2701(e)(3)(B).

4. The Statutory and Regulatory Exceptions.

a. Marketable Transfer Interest. Section 2701 does not apply to the transfer of an interest for which market quotations are readily
available on an established securities market. IRC § 2701(a)(1).

b. **Marketable Retained Interests.** The special valuation rules of Section 2701 do not apply in valuing a retained interest which is marketable, as above described. IRC § 2701(a)(2)(A).

c. **Same Class.** Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest - determined without regard to non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). IRS §2701(b)(2)(A); Prop. Reg. § 25.2701-1(c)(3).

d. **Proportionate Transfers.** Section 2701 does not apply to a transfer by an individual of an equity interest if the transfer results in a proportionate reduction of each class of equity interest held by the transferor and all applicable family members in the aggregate immediately before the transfer. Prop. Reg. §25.2701-1(c)(4).

e. **Excluded Transactions.** A transfer for purposes of Section 2701 does not include a shift of rights occurring on the execution of a disclaimer described in IRC §2518; or on certain exercises of a power of appointment; or on a capital structure transaction resulting in no change in the interest held before and after the transaction. Prop. Reg. §25.2701-1(b)(3).

B. **The Consequence of Section 2701 Application.**

1. **Special Valuation Rules.** For purposes of determining whether a transfer to which Section 2701 applies is a gift and the value of the gift, special valuation rules apply that differ from the willing buyer - willing seller rule generally prescribed in Reg. § 25.2512-1.


b. **Distribution Rights.** Valued at zero if in controlled entity, unless it is a "qualified

(1) A "qualified payment right" is a right to receive payment at least annually under cumulative preferred stock, to the extent determined at a fixed rate; or any other cumulative distribution payable at least annually with respect to an equity interest, to the extent determined at a fixed rate or a fixed amount. Prop. Reg. § 25.2701-2(e)(6).

(2) Special elections in or out of qualified payment status. Prop. Reg. § 25.2701-2(c)(1) and (2).

c. The "Lesser of" Rule. If the transferor (or applicable family member) has one or more extraordinary payment rights with respect to an applicable retained interest and the interest also confers a qualified payment right, the value of all of these rights is determined by assuming that each extraordinary payment is exercised in a manner that results in the lowest value being determined for all of the rights. Prop. Reg. §25.2701-2(a)(3). Illustrated by example at Prop. Reg. § 25.2701-2(a)(5).

d. Minimum Value Rule. The aggregate value of all junior equity interests must be no less than 10% of the total value of all equity interests in the entity plus the total amount of the entity's debt to the transferor or an applicable family member. Prop. Reg. § 25.2701-3(c)(1). Special rule for short term debt incurred with respect to the conduct of the business and for leases providing for fair rental. Prop. Reg. § 25.2501-3(c)(2).

2. Special Rules for Unpaid Distribution (Compounding). If qualified payments due on preferred stock (or comparable interests in a partnership) are not timely paid then there may be a later addition to the taxable estate or taxable gifts of the transferor.

3. Reporting Requirements. If a transfer of property subject to Section 2701 is not "adequately shown" on a gift tax return, the statute of limitations never expires on the assessment of the gift tax. Reg. § 301.6501(c)-1(e).
C. Growth Shifting Techniques Outside of Section 2701

1. Nonlineal Transfers. The special rules of Section 2701 do not apply to transfers to persons who are not lineal descendants of the transferor (or the transferor's spouse), even if of a younger generation.

   a. Example 1. A owns all of the stock of Corporation X. The corporation engages in a recapitalization in which the common stock is surrendered for new common stock and preferred stock with a par value equal to 95% of the estimated fair market value of Corporation X. A makes a gift of all of the common stock to her nephew. The preferred stock retained by A is noncumulative and gives A the right to put the stock to the corporation at any time for its par value.

   b. Prior Law. The fair market value of the common stock in the above example will be determined under the willing buyer-willing seller test as it applied prior to the enactment of Section 2701. This includes the very favorable (for the taxpayer) position taken by the Tax Court in Elizabeth W. Snyder, 93 TC 529 (1989).

   c. Reciprocal Trusts. A and B are brothers. Each owns 50% of the common and 50% of the preferred stock of corporation Y. A makes a gift of his common stock to his nephew, C, the son of B, and B makes a gift of his common stock to his niece, D, the daughter of A. Doubtlessly, the reasoning in the reciprocal trust cases, such as Lehman v. Commissioner, 109 F.2d 99 (CA2d 1940), would be invoked to deem each brother as the transferor of stock to his child.

2. Non-Equity Retained Interest.

   a. The application of Section 2701 requires the retention of an equity interest or a debt that is convertible into equity.

      (i) Example 2. S conducts a business through Corporation X, all of whose stock is owned directly by him. His mother, M, loans $500,000 to corporation X, receiving a nonconvertible note evidencing the
obligation.

(ii) Example 3. Father and son own all of the stock of Corporation X; father owning 60% and son owning 40%. Father redeems all of his common shares for cash plus a note for $600,000.

b. In neither of the above examples would Section 2701 apply to determine whether the parent has made a gift to the child or the amount of the gift, assuming the note is treated as debt for tax purposes. In either case, however, it is necessary that the note bear interest satisfying the applicable federal rate. If it does not, then in example 2, Section 7872 might apply to charge M with interest income which she will be deemed to have gifted to her son, S. In example 3, Section 1274 may apply (or where appropriate, Section 483) to charge father with interest income.

c. Under now repealed § 2036(c), the holding of the note in either of the examples was a retained interest that could cause part or all of the common stock to be included in the parent's taxable estate, or to be treated as part of a taxable gift if parent's interest was terminated during lifetime.

3. Compensation Arrangements. Father and son were owners of the stock of Corporation Z; father owning 60% and son owning 40%. Father redeems all of his shares, terminates his employment with the corporation, but continues as a consultant under an agreement providing that he is to receive compensation of a designated dollar amount annually for five years. In addition, father owns real estate which is leased to the corporation under a long term lease. Neither of these arrangements would bring Section 2701 into play. However, under general income tax principles, corporation Z could be denied a deduction for payments to father if they are unreasonable.

4. Same Class of Equity.

a. Example 4. Father owns all of the outstanding stock of Corporation X - consisting of 100 shares of common stock. He makes a gift of 20 shares to his son. Section 2701 will not apply in determining the value of the gift. If
instead father sold the 20 shares to his son, again Section 2701 would not apply to determine whether there was a hidden gift on the sale or the amount of the gift. In either case, general principles of valuation would apply to determine the existence or amount of the gift, and for that purpose a minority discount may be allowed to take into account the noncontrolling position of the son after the gift. Further, this would be true even if the common stock retained by father was voting stock and the shares given or sold to son were non-voting.

b. **Example 5.** Father and daughter organize a new partnership to which father contributes $800,000 and daughter contributes $200,000, with father receiving in exchange an interest as a general partner and daughter receiving an interest as a limited partner. The partnership agreement provides for an 80%-20% sharing of profits and losses - straight up and down - except that daughter as a limited partner is not obligated to make added contributions if losses reduce her capital account to zero, and as a limited partner she is not entitled to participate in the management of the partnership. Section 2701 is not applicable.

D. **Section 2701 Method for Determining Amount of Gift.**

1. **The Subtraction Method.** The amount of gift resulting from any transfer to which Section 2701 applies is determined by a subtraction method of valuation, as set forth in Prop. Reg. § 25.2701-3. Under this method, the amount of the gift is determined by subtracting the value of all equity interests senior to the transferred interests from the value of the entire entity, as determined immediately before the transfer, and then appropriately allocating the balance among the transferred interests and other interest of the same class and subordinate classes. The valuation methodology involves three steps:

a. **Entity Valuation.** Determine the value of the entity (the entire corporation or partnership) giving effect "to appropriate adjustments to reflect the actual fragmented ownership of the entity (e.g. minority discount or control premium)." Prop. Reg. § 25.2701-3(a).
b. Subtract the Preferred Interest. From the value determined in Step 1 is subtracted the value of the senior equity interests, with that value being determined under the valuation principles of Section 2701 with respect to preferred interests held by the transferor or applicable family members, and with any preferred interest held by outsiders being valued under general principles of valuation (also there is a special rule if the transferor and applicable family members hold a greater proportion of the preferred interest than of the common interest). Prop. Reg. § 25.2701-3(b)(2).

c. Allocate the Remaining Value. The value remaining after the second step is first reduced by the fair market value of any common interest held by persons other than the transferor and his family, and after that the remaining amount is allocated among the common interest held by the family, including the transferee, in a manner "that would fairly approximate their value if rights valued at zero under Section 2701 were not exercised or did not exist." If there is no clearly appropriate method of allocating the remaining value, then it is allocated to interests in proportion to their fair market values determined without regard to Section 2701. Prop. Reg. § 25.2701-3(b)(3).

2. Illustrations.

Example 6. Corporation X has two classes of stock outstanding, common and preferred, owned entirely by Father. The preferred is non-cumulative and no election has been made to treat it as a qualified payment. Assume that the value of the entity, applying general rules of valuation, is $1,000,000, but the preferred stock is valued under Section 2701 and has a value of zero. Father gives all of the common stock to his son. Under the subtraction method, the value of the common stock is $1,000,000, all of which is allocated to the gift to son.

Example 7. Assume the facts as in Example 6 except that instead of Father owning all of the preferred stock, he owns only one-half, with the other half being owned by an unrelated person. Further, assume that the preferred stock so owned, as valued without the application of Section 2701 has a fair market
value of $400,000. Under the subtraction method, the value of the common stock is $600,000, which is the value of the gift to Son.

3. **Minimum Value Rule.** This rule qualifies the subtraction method, in that it provides that the aggregate value of the common interest must not be less than 10% of the value of the entire equity (with certain adjustments). Thus if in the above examples the preferred stock had a value of $950,000, after applying Section 2701 valuation principles, the subtraction method would show a value of $50,000 for the common stock; but in that event the minimum value rule would apply to give a value of $100,000 to the common stock as an aggregate.

4. **Minority Discount.**
   
a. The effect of the subtraction method, as set forth in the proposed regulations, on a donor's right to a minority discount in valuing the gift is unclear. The only reference to a minority discount in the regulations is in the first step—the valuation of the entire entity—suggesting that any such discount would be made by reference to the share ownership before the transfer, so that, for example, a different value might be arrived at for the same business operation where there are three shareholders each owning a one-third interest as compared to the valuation where there are two shareholders, one owning 60% and the other owning 40%.

   b. The failure in the proposed regulations to make any reference to a minority discount in Step 3, regarding the allocation of remaining value among the junior equity, has created concern that the minority discount, if any is to be allowed, would be applied by reference to an overall average based on ownership before the transfer, without reference to the percentage interest transferred by gift. If so, then it would be mere happenstance to have a discount which is consistent with the interest actually transferred to the donee.

   c. A spokesman for the IRS, participating in forums since the proposed regulations were issued, has stated that the Section 2701 regulations are not intended to change the
rules pertaining to minority discount. The indication is that a minority discount could be allowed in Step 3, if the junior equity interest transferred to the donee is a minority interest. In other words, the gifted shares might attract less than their proportionate percentage of the aggregate value of the junior equity interest. Does this suggest that there might be a doubling up of the minority discount, applied in both Step 1 and Step 3? Presumably in that event the discount in Step 3 would have to be reduced to take into account the discount in Step 1. The IRS staff is aware that clarification is needed on these questions, and changes are likely to appear in the final regulations.

d. A further question relates to the application of the minority discount in the context of the minimum value rule. That rule states that the aggregate value of the junior equity interest may not be less than 10% of the total value of all equity interests in the entity (with certain adjustments). Is it intended that this aggregate value must be allocated evenly over all of the common shares, or may there be a disproportion in the allocation to reflect the fact that only a minority of the common shares are transferred? For example, suppose there are 100 common shares outstanding and the minimum value rule is applied to give a aggregate value of $1,000,000 to the common shares (assume that under the subtraction method without invoking that rule the value would have been $800,000). Further, assume that Father gives 20 shares of the common shares to Son. Does the minimum value rule apply to require a valuation of at least $200,000 to the gift? A literal reading of the regulation leaves the question open, but discussions with staff members of the IRS working on the regulations indicate that the intention is to give a minimum value of $200,000 in this example.

E. Failure to Pay Timely Dividends on Preferred (Section 2701(d)).

1. The Situation. There has been a gift of the entire junior equity (common stock) in a situation to which Section 2701 applies - from Father to Son. The retained cumulative preferred stock
interest, providing for a 12% annual dividend, has a par value of $1,000,000. Assume that the distribution right is a qualified payment right so that it avoids the zero value rule of Section 2701. Further, assume that under general valuation principles, by using a 12% discount rate the preferred stock is determined to have a value equal to $1,000,000, its par value, in computing the gift to the Son.

2. Failure to Pay. The question is the consequence if there is a failure to pay timely dividends on the preferred stock. For this purpose a payment made within four years of the due date is treated as having been made on the due date.

   a. The tax detriment for the failure to pay a dividend is imposed at a later date when Father transfers the preferred stock, either during lifetime - by gift or otherwise - or at death (such a transfer being called a "taxable event"). Prop. Reg. § 2701-4(b).

   b. The detriment takes the form of an increase in Father's taxable gifts, if the "taxable event" is a lifetime transfer, or in his taxable estate, if it occurs at death.

   c. There is an exception where the transfer causing the taxable event is to a spouse in a marital deduction transfer. In that event, the spouse steps into the transferor's shoes so that the increase in taxable gifts or taxable estate occurs on a later lifetime transfer by the transferee spouse or at the transferee's death. Prop. Reg. § 25.2701(b)(2)(ii).

   d. Further, if the transfer causing the taxable event is to an applicable family member other than the spouse, continued failure to pay dividends subsequent to the transfer can cause an increase in the applicable family member's taxable gifts or estate. Prop. Reg. § 25.2701-4(a)(2)(i).

3. Amount of Increase. Subject to the limitation discussed below, the amount of the increase is determined as follows (Prop. Reg. § 25.2701-4(c)):
a. Ascertain the total of the dividends payable on the preferred stock beginning on the date of the gift to Son and ending on the date of the taxable event;

b. Add to that total the earnings that Father would have derived from dividend payments determined hypothetically as if each dividend was paid on its due date and was immediately reinvested at a yield equal to the discount rate that was used in determining the value of the preferred stock (12% in our example); and

c. Subtract from the total so derived, the amount of dividends actually paid during the period from the gift to the date of the taxable event plus the earnings on those payments determined hypothetically as if each had been reinvested at the discount rate (12% in our example) and, to the extent required to prevent double inclusion, an amount equal to the portion of the unpaid dividends that has already been reflected in the fair market value of the preferred stock for gift or estate tax purposes.

4. Limitation on Increase. The increase in Father's taxable estate or taxable gifts, as determined above, is limited to the increase in the fair market value of the entire common stock during the period from the date of the gift to the date of the taxable event. Prop. Reg. § 25.2701-4(c)(4).

5. Illustration.

a. Example. Assume that Father in the above example dies a little more than nine years after the date of the gift to Son. Over that period the preferred stock accrues a dividend right of $120,000 per year, but no dividend is actually paid during Father's lifetime. Further, assume that Father survives his wife so that there is no marital deduction in his estate. The taxable estate would be increased by $1,984,000, of which $1,080,000 would be attributable to the accrued but unpaid dividends and $904,000 would be attributable to the compounding rule. This increase would be reduced by any amount otherwise in the taxable estate to reflect the accrued dividends.
b. Assume that Father and the corporation arrange for the payment of dividends on the preferred stock in a manner that is calculated to take advantage of the four year grace period; that is, the rule which treats dividend payments made within four years of the due date as if they were paid on the due date. Thus, starting five years after the date of the gift to Son, and four years after the first due date, the corporation pays a $120,000 dividend to Father and continues paying dividends of that amount each year thereafter until Father's death, which occurs shortly after the expiration of nine years from the date of the gift. At that time, four accrued dividends remain unpaid. There is added to Father's taxable estate $642,000, of which $480,000 is attributable to accrued dividends, and $162,000 is a phantom asset resulting from the application of the compounding rule over the last four years.

c. Assume the facts are as in b above except that shortly before Father's death a dividend of $480,000 is paid on the preferred stock. This avoids the need to compound. The effect is to reduce Father's taxable estate by $162,000 when compared with the result if the accrued but unpaid dividends are not paid until after death.

6. To Stop Compounding.

a. If more than four years elapse from the due date of a dividend to the date of payment, the payment will not be deemed timely and compounding will apply. Moreover, the delinquent payment of the accrued dividend will not satisfy the compounded amount. Therefore, absent any rule to the contrary compounding would continue into the future until there is a taxable event.

b. Example. $50,000 dividend is due annually on cumulative preferred stock. However, no dividend is paid until more than four years has elapsed from the first due date, at which time the corporation pays $100,000 of dividends, with $50,000 being applied to the first due date, and $50,000 being applied to
the second due date, which is within the four year period, so that the second dividend is deemed timely and there is no compounding with respect to it. There is, however, approximately $28,675 of compounding, as of the payment date, with respect to the first dividend, and if nothing more is done this amount will continue to compound until there is a taxable event, at which time it will result in a greater increase in the taxable gifts or taxable estate.

c. To provide for this, the taxpayer may elect to treat the delinquent payment of the dividend as a taxable event. If such an election were made in the above example, it would result in a phantom gift of $28,675 as of the date to which the election applies, but that amount would no longer continue to compound for the period after that date. Prop. Reg. § 25.2701-4(d).

7. Reporting Requirements. On a "taxable event" occurring in lifetime there must be an adequate disclosure on a gift tax return to start the running of the statute of limitations. This requirement does not apply to a "taxable event" caused by the death of the transferor. Prop. Reg. § 301.6501(c)-1(e), although the estate tax instructions may be revised to require a disclosure on the return.

F. Partnerships - Guaranteed Payments.

1. A distribution right does not include "a right [of a partner] to receive any guaranteed payment described in Section 707(c) of a fixed amount." IRC §2701(c)(1)(B)(iii). The proposed regulations recite the statutory language, with no elaboration. Proposed Reg. §25.2701-2(b)(3)(iii).

a. Two questions: what is a guaranteed payment, and what is the significance of its exclusion from the definition of a distribution right?

2. Example. Mother and Daughter form a partnership to which Mother transfers $800,000 and Daughter transfer $200,000, in exchange for partnership interests.

a. Distribution Preference. The partnership provides that distributions from cash flow of
operations are to go first to Mother until they have satisfied her "preference return", after which all such distributions go two thirds to Daughter and one third to Mother. The "preference return" is defined as a right to $84,000 per year (12% of $700,000), which is cumulative so that if there is a shortfall in an earlier year it must be made up in a later year, together with a current preference return, before the two-thirds one-third distributions may be made. Partnership profits are first allocated to Mother to the extent of the accrued preference return at the end of the year, after which profits are allocated two-thirds to Daughter and one-third to Mother. Distributions from sales (and refinancing) proceeds go first to satisfy any accrued but unpaid preference return, then to Mother to the extent of $700,000, after which proceeds go two-thirds to Daughter and one-third to Mother.

b. Guaranteed Payment. Alternatively, the partnership agreement provides for a cumulative payment of $84,000 a year to Mother, without regard to cash flow or profits. Distribution to partners in their capacity as such are made only after the cumulative right to $84,000 is satisfied and go one-third to Mother and two-thirds to Daughter. Distributions of sales (or refinancing) proceeds go first to Mother to the extent of $700,000 after which such proceeds go in the two-thirds, one-third ratio.

c. See McKee, et al. Federal Taxation of Partnerships and Partners, Volume 3; § 7.03, pages 7-55 to 7-129, for an extended discussion of distribution preferences and guaranteed payments.

3. What is the significance of classification of the preferred right as a guaranteed payment under Section 707(c) rather than as a preference distribution to Mother in her capacity as a partner? In either event the value of the junior equity interest acquired by Daughter must be determined by first ascertaining the value of Mother's senior rights.
a. If Mother's right is a guaranteed payment of a fixed amount described in Section 707(c) then she has no "applicable retained interest" (assuming no "extraordinary payment rights"), and Section 2701 does not apply, with these favorable consequences:

(i) The compounding rule of Section 2701 does not apply in the event of a failure to meet the annual distribution requirements;

(ii) The minimum value rule is not applicable; and

(iii) The special reporting requirements in §301.6501(c)-1(e) imposed on transfers subject to the valuation rules of Section 2701, would not apply.

b. But if the preferred is a guaranteed payment then Mother must include it in income for her "taxable year within which or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting". Reg. § 1.707-1(c). So if the partnership is on the accrual basis, Mother could be charged with income before receiving a cash payment.

c. Further, the guaranteed payment must be included in income even though it produces no deduction to the partnership because it must be capitalized under the rules of Section 263A.

G. The Role of Section 2701 - Does a Leveraged Gift Make Sense?

1. The question as to the role of Section 2701 should be addressed in two contexts.

a. The situation where a decision has yet to be made as to the form of entity in which business is to be conducted: corporation or partnership.

b. The situation where the decision has been made (because dictated by other considerations or because the business is already being conducted in one form or the
other), and the question is whether a Section 2701 leverage gift is advisable.

2. In the first context, the effect of Section 2701 in my view is to give added support to the conclusion that, other considerations being equal, tax considerations dictate in favor of the partnership form.

a. The inability to elect Subchapter S in a preferred/common leverage gift situation, because of the failure to meet the one class of stock requirement.

b. In a C corporation, Section 2701 creates a double tax problem by the need to provide for (and ultimately pay) a dividend on the preferred sufficient to create a large value for the preferred, thereby reducing the value of the common stock; and the burden of the corporate tax falls on the common stock that is the subject of the transfer to the younger generation.

c. See Schedules X at the end of this outline, Tables I and II, for a comparison of the leveraged gift in the partnership and corporate contexts.

d. The net effect may be that Section 2701 will be most frequently brought into play with respect to leveraged gifts of interests in family partnerships. It may be, as suggested in (i) and (ii) below, that the partnership will have one or more corporate partners; but the rules of Section 2701 will be applied to interests created by partnership rather than corporate documents.

(i) Two Subchapter S Corporations - one controlled by Parent and another by Child - enter into a partnership in which each S corporation is a partner, with the major part of the capital being contributed to the partnership by Parent's S Corporation and with that corporation receiving a preference right and a smaller proportion of the junior equity interest. But see Rev. Rul. 77-220, 1977-1 CB 263. Compare PLR 8823023.
(ii) A C Corporation owned primarily by a parent may enter into a partnership agreement with one or more family members, pursuant to which the corporation makes the major capital contribution, consisting perhaps of a going business, and has a preference position in the partnership.

3. In the latter context - where a decision has already been made as to the form of entity - the question is whether the potential tax advantage is worth the effort when compared with alternatives.

a. The new rules prohibit "estate freezing" in the literal sense, since they require a rate of return that is actually paid to the preferred interest held by the older generation; but they do permit leveraging in that the donor is allowed to transfer a significantly larger portion of the appreciation potential - a meaningful tax advantage where growth potential is great - the cost being the need to provide for and pay a competitive rate of return on the preferred interest.

(i) The crucial consideration will be the level of income preference needed to support the valuation objectives, under the methodology required by Section 2701.

(ii) Estate and valuation factors, rather than legal analysis, will be critical in reaching a determination.

(iii) A further question that must be addressed is: "compared to what". Specifically, in a given situation what are the alternatives to leveraging with two classes of equity. In this regard, see Schedule X, Tables III to VI, where the two class approach is compared with a single class of equity, in both the partnership and corporate context.

H. Special Planning Considerations.

1. Reverse Freeze
Example. Sam Selfmade and Betsy Bosdaughter form a partnership (Growing Ltd.) with two classes of partnership interests. Once class is analogous to cumulative preferred stock (the preferred class). It has a first right to the net profits of the partnership, up to an amount called a "preference return," which is equal to 18% of the initial capital account of the preference class. If income of the partnership is not equal to that 18% preference return in any year, and there is excess income in any subsequent year above that year's preference return, that excess income will be utilized to fully satisfy the prior year's "unpaid" preference return. Thus, the return on this class of partnership interest is cumulative, although the preference may be paid only out of net profits of the partnership. The other class of partnership interest is analogous to common stock (the growth class); it is entitled to any net profits of the partnership not allocated to the preference class. On liquidation of the partnership the growth class is entitled to all appreciation of the partnership above the initial capital investment for the preference class. Sam Selfmade contributes $800,000 for his partnership interest and Betsy Bosdaughter contributes $200,000 for her partnership interest. Sam has 80% of the vote and Betsy has 20% of the vote. Betsy receives a $50,000 growth interest and a $150,000 preferred class partnership for her investment. Sam receives a $600,000 preferred class partnership interest and a $200,000 growth class partnership interest for his investment. Sam (utilizing his unified credit) gives his $600,000 preferred class partnership interest to Betsy Bosdaughter. Sam now has only 20% of the vote. Unfortunately for Sam and the government, his growth interest in Growing Ltd. does not grow very much through the years. On the other hand, Betsy Bosdaughter's preferred interest doubles in

---

1 This example is taken from Tax Management Journal (Estate, Gift and Trust), dated July 11, 1991, pages 125 and 126, prepared by S. Stacy Eastland.
value every four years. Is any part of Betsy Bossdaughter's acquired interest subject to the new valuation rules under IRC § 2701?

b. Clearly, the answer to the question is "no," for the interest retained by Sam is not an applicable retained interest: it does not carry any "extraordinary payment right" or any "distribution right" as those terms are defined in Section 2701.

c. The thought is that the gift to Betsy will be determined by reference to the rules for the valuation of preferred stock - which are calculated to keep the value low. Turn the valuation rules around and make them work for the taxpayer.

d. Will the Commissioner or the courts follow the form of the transaction and view it as one calling for application of the usual methods of valuing preferred stock; or will they disregard the structure on the grounds that it obscures the reality of what is happening? Compare Estate of Harrison, 42 TCM 1306 (1987) with Estate of Murphy, 60 TCM 645 (1990).

2. Post-Death Freeze

a. Situation. Father, owning all of the stock - a single class - of Corporate A, dies survived by Wife and children. His will provides for a credit shelter (by-pass) trust for the benefit of children, with remainder of his estate going to Wife either directly or in a QTIP trust. The Estate recapitalizes Corporation A restructuring into two classes of stock, a noncumulative - preferred stock and common stock, with the common going to the shelter trust and the preferred to Wife. Does Section 2701 apply?

(i) Essentially, the question is whether there has been a transfer of common stock from mother (surviving Wife) to the children, with Mother retaining an applicable retained interest, the preferred stock, so that the preconditions of Section 2701 are present.

20
(ii) Look at the local law as it applies to the instrument in question to determine whether Mother's consent is required to make the disproportionate allocation.

(iii) The case for avoiding Section 2701 would be strengthened by having will give executor power to allocate particular assets between the two bequests in any proportion without the consent of any beneficiary. But suppose wife is the executor? It would be desirable to have a co-executor with power to allocate between bequests.

(iv) The position is further strengthened by having the will direct that there be a recapitalization with the preferred stock going to the marital disposition and the common stock, up to the exemption amount, going to the by-pass trust.

(v) This would seem to deal with the problem of spouse as executor, but prudence might still dictate in favor of naming a co-trustee with authority to exercise any discretion required with respect to the stock.

b. Aside from the question of local law, what of Section 2701(e)(3), regarding indirect holdings and transfers; and Prop. Reg. § 25.2701-6(a)4.

(i) Might be answered by a specific provision in will directing how common and preferred stock is to be transferred, so that surviving spouse wife cannot receive any of the common stock, except to the extent it exceeds the exemption amount.

(ii) IRS spokesman has indicated that he doesn't believe that Section 2701(e)(3) was intended to frustrate the post-death freeze.

3. **Cumulative Preferred With Section 2701(d) Election Out.**
a. Assume family business owned by Parents, with a value of no more than $1,200,000. They create two classes of stock: common and cumulative preferred. The dividend rate on the preferred is fixed at whatever rate of return is desired (without regard to the market rate). All of the common stock is gifted to Child, and a Section 2701(c)(3)(c)(i) election is made to avoid status as a qualified payment, and thereby avoid the compounding rule. Accordingly, the preferred stock is valued at zero after the application of Section 2701, and the gift has a value of approximately $1,200,000, which is free of tax because of the use of the exemption. At the death of Parent-donor Section 2701(e)(6) should apply to avoid a double tax resulting from the undervaluation of the preferred stock on this gift and its inclusion at value in the donor’s estate.

b. Therefore the approach permits parent to give business away at full value - which is within the exemption amount - while retaining a right to a return fixed at whatever rate is desired - there is no need to conform to the market - and also retain control if Parent so wishes, by giving voting rights to the preferred stock.

c. But if any dividend remains unpaid at death, it will be reflected in an increased value of the preferred stock, above that which is protected by the rule in Section 2701(e)(6) resulting in an estate tax under the valuation rules of Chapter 11.

d. If the preferred stock retained by Parent was noncumulative, there would be no risk of accrued but unpaid dividends being subject to the estate tax. But the failure to pay a dividend on noncumulative preferred stock might result in the finding of a taxable gift which would not be eligible for the gift tax annual exclusion.

4. Section 2701(d) and Marital Deduction

a. Assume Father owns cumulative preferred stock on which at death there are accrued but unpaid dividends in a situation to which § 2701 is applicable.
b. If survived by spouse, the effect of compounding can be postponed by having the preferred stock go to spouse in marital deduction disposition since that prevents there being a taxable event. But there will be a taxable event on spouse's death if the dividends have not been brought up to date by that time. IRC §2701(d)(3)(B).

c. On the other hand, if the limitation of § 2701(d)(2)(B) applies, because of little growth in the value of the common stock at Father's death, then it might be desirable to have a taxable event at first death, since at the second death values may have changed so that the limitation doesn't apply.

d. Executor should have absolute authority to determine how the preferred interest is to be divided between the marital and nonmarital bequest.

5. Other Approaches to Consider.

a. Example. Father owns all of the stock of Corporation S, a Subchapter S corporation, and Daughter is an important employee. Corporation S and daughter form new Partnership to which Corporation X transfers the business and to which daughter transfers cash, with Corporation X receiving a preferred equity interest and 90% of the junior equity position, with Daughter receiving 10% of the junior equity. Daughter becomes employed by Partnership and in connection with her employment receives an option to purchase an added junior equity interest at a bargain price which, if fully exercised, would increase her ownership of the junior equity to 60%, but voting control remains with the S Corporation.

b. Position Taken. Applying Section 83 and regulations thereunder, results in no tax consequences on the grant of the option to Daughter. On exercise, Daughter would have compensation income equal to the spread between the value of the interest received and the amount paid, but the Partnership would have a deduction of an equal amount. Therefore, if the value of the junior equity
is increased it should result in a standoff: an increase in income for Daughter should be offset by an increase in the Partnership deductions.

c. Risks.

(i) May it be said that the compensation at date of exercise is excessive and therefore is to same extent is non-deductible. Possibly, but if the option arrangement was reasonable when entered to then there should be no question of unreasonableness because of the substantial growth.

(ii) Can it be argued that there is a gift from Father to Daughter on grant of the option; or on exercise?

(a) Has there been a transfer? Doesn't the fact that Daughter is an important employee in the operation of the business support the contention that this is an arrangement between her and the operating entity and not a transfer to her from Father?

II. Section 2702 - Special Valuation Rules on Transfers of Interests in Trust

A. Historic Background - the Common Law GRIT

1. Two developments in the early 1980's contributed to the popularity of the grantor retained income trust ("GRIT"). One was the increase in the unified credit to exempt from estate and gift tax $600,000 of value for each individual ($1,200,000 with gift splitting between a husband and wife), phased-in starting in 1982; and the second was the change in the discount rate from 6% to 10% for valuing partial interests in property.

a. The first change permitted a larger value for the gifted portion (i.e., the remainder) without causing a tax, and the second change gave a larger value to the retained income interest (which was often overstated since few trusts earned accounting income at 10%) thereby lowering the value of the remainder interest that was the subject of the gift.
b. "Where the donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest." Reg. § 25.2512-5(a)(1)(i).

2. **Example.** Parent, age 55, transfers property to a new trust retaining the right to income for 15 years after which the trust terminates and the property goes in equal shares to his children. At a 10% discount rate, the value of the income interest is 76.06% of the property, and the value of the remainder (i.e., the amount of the gift) is 23.94%.

   a. If Parent and spouse had not used any part of their unified credit through previous taxable gifts, then a credit covering $1,200,000 in value would permit a tax-free transfer of $5,012,500 to the trust (23.94% of $5,012,500 equals $1,200,000).

   b. If in this example parent also retained a reversion of the trust property to his estate if he died during the 15 year term, then the aggregate value of the retained interest is increased to 81.51% of the total value of the property, and the value of the remainder—the subject of the gift—is reduced to 18.49%, increasing the permitted tax-free transfer to the trust to $6,490,000 ($6,490,000 x .1849 = $1,200,000).

   (1) The retained interest in this event consist of two rights: the right to income for a term of the earlier of 15 years or the prior death of a person age 55 (70.7%) and the right to a reversion if parent, age 55, dies during the 15 year term (10.81%).

3. The use of the contingent principle reversion to reduce the value of the gift created no downside risk; for even absent the reversion the entire trust corpus is included in the grantor's estate if he dies during the income term. Section 2036(a)(1).

4. Moreover, where the trust property is included in the grantor's estate, the estate recovered any
unified credit that was used to prevent or reduce the payment of a gift tax on the creation of the trust. Section 2001(b), last sentence.

a. However, where the grantor’s spouse consented to the gift to effect a split gift under Section 2513, on the inclusion of the gift in the grantor’s estate Section 2001(b) would not restore the spouse’s unified credit that was applied to the split gift.

(i) The solution was to have the grantor transfer a one-half interest in the property to the spouse, after which each spouse would create a GRIT transferring one-half of the property to it, with a retained income right for a term of years and a reversion of the principal in the event of death during the income term.

5. Another planning technique - made feasible by the unlimited marital deduction - was to have the entire gift made by the younger spouse, thereby decreasing the risk of a Section 2036(a)(1) inclusion because of death during the trust term. However, to utilize the lifetime exemption of both spouses and also to avoid the risk described in 4 above, it would be necessary to have the gift made one-half by each spouse.

6. The enactment of former Section 2036(c) did not destroy the usefulness of the GRIT; it did, however, restrict its use by imposing statutory requirements that limited the value to be placed on the retained interests (ie., a “Statutory GRIT”). Specifically, the term of the grantor’s income interest could not exceed ten years and the contingent principal reversion could not have a value exceeding 25% of the value of the income interest.

a. The changes made by Section 2036(c) were effective starting in December, 1987, but they were repealed retroactively by the 1990 Act which imposed new rules for transfers in trust after October 8, 1990.

b. It is as if Section 2036(c) never existed, so that transfers in trust before October 9, 1990 are governed by the GRIT rules outlined in (1) to (5) above (the “Common Law GRIT”).
B. The 1990 Legislation

1. On November 5, 1990 the Omnibus Budget Reconciliation Act of 1990 ("OBRA") was signed by the President. Section 11601 of OBRA repealed Section 2036(c) retroactively to its inception. Section 11602 enacted Chapter 14 of the Code consisting of four sections, one of which - Section 2702 - deals with retained interest trusts.

2. On March 22, 1991 a bill containing technical changes to OBRA was submitted to the tax-writing committees of the House and the Senate, HR1555 and S750.

3. Proposed Regulations under Section 2702 - as well as under Section 2701 and 2703 - were issued on April 4, 1991.

4. A second round of Proposed Regulations were issued in September, 1990 relating primarily to Section 2704. They also contain special rules for Section 2702 designed to prevent double taxation on transfers connected with retained interest trusts.

C. Section 2702 - General Overview

1. General Rule. For gift tax purposes, interests retained by the grantor on transfers in trust (or by the grantor's spouse or any other applicable family member) are valued at zero, the net effect being that under the general rule the value of the gift - the non-retained portion - equals the full value of the property transferred in trust.

2. Exceptions to the general rule of Section 2701.

   a. Non-family members. Section 2701 does not apply where the donee is not a "member of the family" - i.e., the transferor's spouse; any lineal descendant or ancestor of the transferor or the transferor's spouse; any brother or sister of the transferor; any spouse of any such lineal descendant, ancestor, brother or sister.

   (i) T transfers $600,000 to a trust retaining the right to income for 15 years with a reversion to T's estate if he dies during the 15 year income term
and at the end of the 15 year term, the trust property goes in equal shares to T's nephews and nieces. The value of the gift will be determined under the pre-OBRA rules pertaining to Common Law GRITs, but using a discount rate provided by Section 7520 (i.e., 120% of the applicable federal midterm rate for the month of the gift).

(ii) Suppose T and his brother, B, each create a GRIT for the benefit of his nephew, identical in all other respects. Doubtlessly, the reciprocal trust doctrine would apply to treat both T and B as if his trust was for the benefit of his son. U.S. v. Estate of Grace, 395 U.S. 316 (1969).

b. Noncomplete transfers. The new rules of Section 2702 do not apply to transfers that are incomplete for gift tax purposes.

(i) T transfers property to a trust, retaining an income interest for ten years, after which the trust property passes to his children. T also retains the right to revoke the trust at any time during the ten year period. There is no gift under Section 2701 on the initial transfer in trust, anymore than there was under the pre-OBRA law.

c. Qualified retained interest. The zero value rule of Section 2701 does not apply to a retained interest which is a "qualified interest" (i.e., a qualified annuity interest, a qualified unitrust interest, or a qualified remainder interest). IRC § 2702(a)(2).

(i) These are comparable to the types of partial interest transferred in trust for which a charitable deduction is allowed. Section 170(f)(2).

(ii) The value of a qualified interest in determined under Section 7520.

d. Residence exception. The zero value rule of Section 2701 does not apply where the only property in trust is a residence to be used as a personal residence by the person holding
the term interest. IRC § 2702(a)(3)(ii).
The proposed regulations expand on the statute by providing for a "qualified personal residence trust" which permits the trust to qualify for favorable tax treatment although going beyond the rigid literal terms of the statute.

(i) The effect of this exception is to apply the pre-OBRA rules regarding Common Law GRITS to a residence trust, with the right to use the residence being treated as a retained income interest. The discount rate used in valuing the interest in the trust is fixed by Section 7520 (ie., 120% of the applicable federal rate).

e. Tangible property exception. The zero value rule of Section 2701 does not apply to value a term interest in real property or tangible personal property where the failure of the term interest holder to exercise his right would not have a substantial effect on the value of the remainder interest (ie., for example, a right to use a painting or a right to use vacant land). IRC § 2702(c)4. If the special rule for tangible property applies, the term interest is valued at the amount for which the grantor establishes that it could be sold under the willing buyer/willing seller test. However, if the transferor can't establish this value, the general rule of Section 2702 requiring a zero value applies. The proposed regulations provide that this rule may not apply to depreciable property. Prop. Reg. § 25.2702-2(c)(2)(A).

D. Qualified Annuity Interest - Requirements

1. Annual payment. Payment must be made at least annually on the retained annuity; that is, payments must be made for each taxable year of the trust, although it may be made after the close of the year "provided payment is made no later than the date by which the trustee is required to file the income tax return of the trust for the taxable year (including extensions)." Prop. Reg. § 25.2702-3(b)(1)(i).

2. Annuity must be fixed. The annuity must be stated as a dollar amount or a fixed percentage of the amount transferred to the trust. The annuity is qualified only to the extent that the annuity is
the same amount each year. Prop. Reg. § 25.2702-3(b)(1)(ii).

a. The trust may permit income in excess of the annuity amount to be paid to the annuitant. However, the right to the excess income does not reduce the value of the gift of the remainder, only the value of the fixed annuity may be taken into account for that purpose. Prop. Reg. § 25.2702-3(b)(1)(iii).

3. **No additional contributions.** The trust instrument must specifically prohibit additional contributions to the trust. Prop. Reg. § 25.2702-3(b)(4).

4. **Prohibit distribution to others.** The trust must specifically prohibit distributions of trust income or corpus to anyone other than the person retaining an annuity interest, prior to the termination of the qualified interest. Prop. Reg. § 25.2702-3(d)(2).

5. **Permitted term.** The trust instrument must set forth the term of the trust, which may be for the life of the transferor or applicable family member, for a specified term of years, or for the shorter of the two. Prop. Reg. § 25.2702-3(d)(3).

6. **No commutation.** The trustee must be prohibited under the trust instrument from making any prepayment of the annuity interest at its actuarial value at the date of prepayment. Prop. Reg. § 25.2702-3(d)(4).

7. **Contingent reversionary interest.** The grantor may also retain a reversionary interest in the trust property in the event he or she dies during the annuity term. It does not, however, have the effect of reducing the value of the gift, since only the value of the qualified annuity has that effect. Moreover, the creation of a contingent reversion will have the effect of reducing the value of the annuity interest, and thus of increasing the value of the remainder (which is the subject of the gift).

8. **Other requirements.**

   a. **Incorrect valuations.** Where the annuity is stated in terms of a percentage of a fair market value of the trust, as opposed to a
designated amount, the instrument must contain a provision, comparable to that required in a charitable remainder trust, relating to incorrect valuations. Prop. Reg. § 25.2702-3(b)(2).

b. Short taxable years. The trust instrument must contain provisions, comparable to those in charitable remainder trusts, relating to the computation of the annuity amount in the case of a short taxable year or the last taxable year of the trust. Prop. Reg. § 25.2702-3(b)(3).

9. Exclusively from the creation. The retained annuity interest must meet the definition of and function exclusively as a qualified annuity interest from the creation of the trust. It cannot, for example, have attributes of both a qualified annuity interest and a qualified unitrust interest. Prop. Reg. § 25.2702-3(d)(1).

E. Qualified Unitrust Interest - Requirements

1. Annual Payment. Payment must be made at least annually. In this respect, the requirement is the same as with the Qualified Annuity Interest.

2. Annuity must be Fixed. Payment must be of a fixed percentage of the net fair market value of the trust assets determined annually. Reg. § 25.2702-3(c)(1). The payment is qualified only to the extent that it is the same percentage for each year of the retained term.

   a. The trust may permit income in excess of the annuity amount to be paid to the annuitant, although the right to the excess income may not be taken into account in determining the value of the remainder.

3. Prohibit Distributions to Others. The trust instrument must specifically prohibit distributions of trust income or property to any one other than the person retaining the annuity interest, prior to the termination of the qualified interest. Prop. Reg. § 25.2702-3(d)(2).

4. Permitted Term. The trust instrument must set forth the term of the trust, which may be for the life of the transferor or applicable family member, for a specified term of years, or for the

5. **No Commutation.** The trustee must be prohibited under the trust instrument from making any prepayment of the annuity interest at its actuarial value. Prop. Reg. § 25.2702-3(d)(4).

6. **Contingent Reversionary Interest.** The grantor may also retain a reversionary interest in the trust property in the event he or she dies during the annuity term. This retention does not, however, have the effect of reducing the value of the gift, since only the value of the qualified annuity has that effect. Moreover, the creation of a contingent reversion will have the effect of reducing the value of the annuity interest, and thus of increasing the value of the remainder which is the subject of the gift.

7. **Other Requirements.**
   
a. **Incorrect valuations.** The trust instrument must contain a provision, comparable to that required in a charitable unitrust, relating to incorrect valuations. Prop. Reg. § 25.2702-3(b)(2).

   b. **Short taxable years.** The trust instrument must contain provisions comparable to those in a charitable unitrust, relating to the computation of the annuity amount in case of a short taxable year or the last taxable year of the trust. Prop. Reg. § 25.2702-3(c)(3).

8. **Exclusively from the Creation.** The retained annuity interest must meet the definition and function exclusively as a qualified unitrust interest from the creation of the trust. It cannot have attributes of both a qualified annuity interest and a qualified unitrust interest. Prop. Reg. § 25.2702-3(d)(1).

9. **Additional Contributions.** Contrary to the qualified annuity interest, with the unitrust the trust instrument need not prohibit additional contributions to the trust.

F. **Grantor’s Death During Term of GRAT or GRUT.**

1. Possible results:
a. Trust terminates and property reverts to the grantor's estate.

b. Trust terminates and property goes to the remaindermen.

c. Trust continues for remainder of annuity term and annuity becomes payable to: (i) grantor's estate or (ii) someone else.

2. Effect on qualified status of retained interest under Section 2702.

a. A provision calling for a termination, as provided in 1(a) or (b), should have no adverse affect on the qualified status of the retained interest (although it may have an adverse affect on valuation as discussed below). Prop. Reg. § 25.2702-3(e) example 1.

b. As to the situation where the trust continues, Prop. Reg. § 25.2702-3(d)(2) states that the trust instrument must prohibit distributions from the trust to or for the benefit of any person other than the transferor retaining a qualified interest before the expiration of that interest. Nevertheless, example 5 in Prop. Reg. § 25.2702-3(e) indicates that a retained interest may be qualified where the trust continues on the death of the grantor with the annuity being paid to the grantor's estate for the balance of the term. There is no cross reference between these two provisions, and the Proposed Regulations are susceptible to the interpretation that the retained interest would not be qualified if on death of the grantor it continued to be paid to someone other than the grantor's estate.

3. Effect on amount of the gift on creation of the GRAT or GRUT.

a. A provision for a reversion on the death of the grantor during the trust term (or for an accelerated distribution to the remainderman) will decrease the value of the qualified retained interest - as compared with its value if the annuity remains payable for the fixed term notwithstanding death - with the
result that the value of the gift of the remainder is increased.

4. Amount included in taxable estate

a. If the trust property reverts to the estate, then the full value of the property would be included in the taxable estate.

b. If the trust continues in existence, then the rules governing inclusion under Section 2036 of remainder interest in charitable remainder trusts where the donor has retained an annuity or unitrust amount should apply to a GRAT or GRIT where the grantor dies during the trust term. See Rev. Rul. 76-273, 1976-2 C.B. 268, as to unitrust, and Rev. Rul. 82-105, 1982-1 C.B. 133, as to annuity trust. These rules could result in less than all of the trust property being included in the grantor's estate.

c. If the trust terminates and the trust property goes to the remainderman on the death of the grantor, then the inclusion in the taxable estate should be the same as in (b) above.

5. Avoidance of double tax per Section 2001(b).

a. Section 2001(b) is intended to avoid double tax where the gifted property is brought back into the grantor's gross estate. It does that by excluding such a gift from the "adjusted taxable gifts" of the decedent in applying the unified tax tables to the grantor's estate.

b. However, if the grantor's spouse consented to the gift under the gift splitting rules of Section 2513 and part or all of the spouse's unified credit is used on the transfer, it will not be restored if the trust property is included in the grantor's gross estate.

(i) This result may be avoided by having one spouse make a gift to the other of one-half of the property, with each spouse then creating a trust with respect to his or her one-half interest.
(ii) This alternative does not, however, allow for full use of the approach whereby the property is first transferred to the younger spouse who then makes a gift transfer to a GRAT or GRIT, the desire being to minimize the risk of the grantor dying during the trust term with trust property being included in his or her taxable estate.

c. Further, there is uncertainty as to how the rule in Section 2001(b) works even aside of the gift splitting problem.

(i) Where there is a reversion to the estate, the property is included under Section 2033 rather than Section 2036. Does this prevent a reduction of the "adjusted taxable gifts" by the amount of the gift of the remainder interest?

(ii) Where the trust continues in existence with the annuity being payable to the estate, may the IRS disregard Section 2036 and include the value of the remaining annuity in the estate under Section 2033, with no Section 2001(b) adjustment being in order on the grounds that no part of the gift on the creation of the trust is being included in the grantor's taxable estate?

(iii) The better answer is that Section 2001(b) should apply in each case to avoid double taxation, although there does not appear to be any authority on the point, and the statutory language is somewhat inexact.

6. The marital deduction

a. Where the trust property reverts to the grantor's estate on his death during the annuity term, it will pass pursuant to the terms of his will so that it may qualify for the marital deduction, assuming, of course, that there is a surviving spouse and that the will otherwise property takes the marital deduction.

b. If, however, the trust continues in existence, would it be possible to obtain the
marital deduction by providing for the surviving spouse to succeed to the annuity interest and by further providing that, in the event the grantor dies during the trust term, the remainder on the termination of the annuity interest is to go to the spouse rather than to the children?

G. Treatment as Grantor Controlled Trust for Income Tax Purposes ("GCT")

1. The grantor may want to have the trust treated as a complete GCT for income tax purposes (Sections 671 through 677), while avoiding powers or rights that would require the trust property to be included in the grantors estate.

2. The theory of Section 671 et seq. is that the grantor is treated as a direct owner of all assets of a GCT, as if the trust didn't exist. Rev. Rul. 85-13, 1985-1 C.B. 184; LTR 9026036.

   a. For contrary reasoning see Rothstein v. U.S., 735 F.2d 704 (2nd Cir. 1984), which was rejected by the IRS in Rev. Rul. 85-13.

3. In the context of a retained interest trust, qualification as a GCT could have the following favorable consequences:

   a. Transfer by the grantor to a GCT of property subject to a liability in excess of basis does not result in the recognition of taxable gain since grantor is treated as the 100% owner both before and after the transfer. Liability and basis carryover as if no transfer had occurred, and recognition of gain occurs when the property is distributed by the trust to the remainderman.

   b. Distribution of appreciated in value property from a GCT to the grantor does not result in the recognition of gain, even if the distribution is in satisfaction of an annuity amount. Basis carries over.

   c. A sale of assets from a GCT to the grantor or vice versa does not result in the recognition of taxable gain or loss - basis carries over.

   d. Grantor is taxed on all income of the GCT even if it exceeds the amount he gets as an
annuity. The effect is like a gift to the remainderman if the accumulated income is retained until termination and distributed to the remainderman; but there should be no taxable gift since the grantor is satisfying a personal liability imposed by the income tax law (assuming grantor does not have a right of reimbursement from the trust which he fails to exercise).

e. The GCT, if a completely controlled grantor trust, is a permitted shareholder for Subchapter S purposes, so that it can hold stock of an S corporation.

4. Possible approach - give a person other than the grantor - but not necessarily someone unrelated - a power in a nonfiduciary capacity to sell or otherwise transfer property of the trust to the grantor in exchange for other property of an equivalent value. See Section 675(4)(C). See LTR 9037011.

H. Valuation of Retained Interest: Zeroed-out GRAT.

1. The valuation of the retained interest is a function of three elements: the amount and frequency of the annuity payment, the term of the retained interest, and the applicable interest rate.

a. The higher the applicable interest rate, other things being equal, the lower the value of the retained annuity interest and the greater the amount of the gift of the remainder. Therefore, it is advantageous to make the transfer in a month in which the rate is low.

b. There is an opposite effect in a GRIT: the higher the applicable interest rate, the greater the value of the retained income interest and the lower the amount of the gift.

2. It is possible in a GRAT to create a retained interest in which the retained annuity has a value equal to the full value of the property transferred to the trust, resulting in a zero gift to the remainderman. The following shows the annuity needed to zero out the value of the
remainder in case of a 55 year old grantor who creates a GRAT for a 15-year term (or a 10-year term) and a reversion to his estate in the event of death during the 15 (or 10) years:

<table>
<thead>
<tr>
<th>Applicable Rate</th>
<th>Required Annuity %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>15 Yrs. or 10 Yrs. or Earlier Death Earlier Death</td>
</tr>
<tr>
<td>8.8%</td>
<td>13.22% 16.2%</td>
</tr>
<tr>
<td>9.4%</td>
<td>13.68% 16.66%</td>
</tr>
<tr>
<td>10%</td>
<td>14.2% 17.06%</td>
</tr>
</tbody>
</table>

3. There can be a further advantage - and greater leveraging - if the grantor is able to take a discount in the valuation of the property transferred to the trust because of nonmarketability or minority interest - as on the transfer of stock or in a family business.

a. Example. Father owns all of the stock of corporation X, a Subchapter S corporation, with a value of $3,000,000. The expectations are that it will produce annual income of 10% of its value and that assets will appreciate in value from year to year at a rate of 6%. The applicable midterm rate under IRC § 7520, at 120%, is 9%. Father transfers one-third of the stock of corporation X to a trust and after applying a 25% discount for minority interest and lack of marketability, the value is established at $750,000. If Father retains an annuity of $116,864 a year for ten years, with the remainder to his son, the value of the annuity would be $750,000, and there would be no taxable gift on the transfer in trust.

If expectations are met and Father survives the ten-year period, the transaction will result in a shift of value to son, free of tax, as determined by the following computations:
<table>
<thead>
<tr>
<th>Year</th>
<th>Undiscounted Value of Stock in Trust</th>
<th>Discounted Value of Stock in Trust</th>
<th>Income at 10%</th>
<th>Appreciation at 6%</th>
<th>Annuity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1,000,000</td>
<td>750,000</td>
<td>100,000</td>
<td>60,000</td>
<td>116,864</td>
</tr>
<tr>
<td>2</td>
<td>1,043,136</td>
<td>782,352</td>
<td>104,313</td>
<td>62,588</td>
<td>116,864</td>
</tr>
<tr>
<td>3</td>
<td>1,093,173</td>
<td>819,880</td>
<td>109,317</td>
<td>65,590</td>
<td>116,864</td>
</tr>
<tr>
<td>4</td>
<td>1,151,216</td>
<td>863,412</td>
<td>113,122</td>
<td>69,073</td>
<td>116,864</td>
</tr>
<tr>
<td>5</td>
<td>1,218,547</td>
<td>913,910</td>
<td>121,855</td>
<td>73,113</td>
<td>116,864</td>
</tr>
<tr>
<td>6</td>
<td>1,296,651</td>
<td>972,488</td>
<td>129,665</td>
<td>77,799</td>
<td>116,864</td>
</tr>
<tr>
<td>7</td>
<td>1,387,251</td>
<td>1,040,438</td>
<td>130,725</td>
<td>83,225</td>
<td>116,864</td>
</tr>
<tr>
<td>8</td>
<td>1,492,347</td>
<td>1,119,260</td>
<td>142,235</td>
<td>89,541</td>
<td>116,864</td>
</tr>
<tr>
<td>9</td>
<td>1,614,259</td>
<td>1,210,694</td>
<td>161,426</td>
<td>96,856</td>
<td>116,864</td>
</tr>
<tr>
<td>10</td>
<td>1,755,677</td>
<td>1,316,757</td>
<td>173,568</td>
<td>105,341</td>
<td>116,864</td>
</tr>
<tr>
<td>11</td>
<td>1,919,721</td>
<td>1,439,791</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

At the end of the ten years, the trust property, with an undiscounted value of $1,919,721 (and a discounted value of $1,439,791) will be distributed tax-free to the son.

4. For any year in which the annuity amount exceeds the income received by the trust on the stock, it may be necessary to fund the annuity in part by a distribution in kind (i.e., of S stock) to father. If the trust is a grantor-controlled trust for income tax purposes, then the distribution should not result in a realization of taxable gain.

5. Where the intention is to transfer more than one income producing asset to a zeroed-out GRAT, it might be desirable to create separate trusts, one for each asset. In that way, the annuity attributable to the bad performing assets will not be a drain against the good performance of other assets.

6. In a GRUT, the amount of the annuity will decline as corpus is invaded to pay the annuity, so that it is impossible to create a GRUT in which the value of the retained interest equals the full value of the property transferred to the trust. In other words, it is not possible to have a zeroed-out GRUT.
a. Further, if the value of the trust property increases, the annuity payable to the grantor also increases, which conflicts with the objective of freezing the estate and shifting value to the younger generation.

I. Transfer of Personal Residence

1. The zero valuation rule of Section 2702 does not apply to "the transfer of an interest in trust all the property in which consist of a residence to be used as a personal residence by persons holding term interest in such trust." IRC § 2702(a)(3)(A)(ii). The rules pertaining to the Common Law GRITs apply. See C2d, supra.

a. Personal residence is defined in the regulations as: the principle residence of the term holder (within the meaning of Code Section 1034); one other residence of the term holder as defined in § 280(A)(d)(1) [a second home used for personal purposes for the greater of 14 days during the year or 10% of the number of days for which it is rented at a fair rental]; or an undivided fractional interest in either. Prop. Reg. § 25.2702-5(c).

(i) Personal residence includes appurtenant structures used for residential purposes and adjacent land "not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location)."

(ii) Personal residence does not include any personal property (eg., household furnishings).

b. An individual may not be the holder of a term interest in more than two personal residence trusts (including a qualified personal residence trust). Prop. Reg. § 25.2702-5(b).

2. The Proposed Regulations create two types of residence trusts.

a. Personal Residence Trust ("PRT"): defined as a trust "the governing instrument of which prohibits the trust from holding, for the
entire term of the trust, any asset other
than one residence to be used as a personal
residence by term holders." Prop. Reg. §
25.2702-5(d).

b. Qualified Personal Residence Trust ("OPRT"): a trust meeting all of the requirements of Prop. Reg. § 25.2702-5(e) through provisions in the trust instrument which by their terms continue in effect throughout any term interest in the trust.

3. The requirements of a OPRT. (Prop. Reg. § 25.2702-5(e))

a. The trust instrument must prohibit distributions of income or corpus to any beneficiary other than the term holder during the period of term interest. -5(e)(2).

b. The trust instrument must prohibit the trust from holding, for the entire term of the trust, any asset other than one residence to be used as a personal residence by the term holder, with the following exceptions [-5(e)(3)]:

(i) The trust may permit additions of cash to the trust and the holdings of cash but not in excess of the amount required for: the payment of trust expenses (including mortgage payments) already incurred or reasonably expected to be incurred within the next three months, or for improvements to the residence to be paid for within three months;

(ii) On the creation of the trust, cash for the purchase of a personal residence within the next three months or thereafter for such a purchase within three months provides a contract to purchase has been entered into;

(iii) The trust may be permitted to hold any proceeds from the sale of the personal residence for a period not to exceed two years from the date of sale, if the trustee intends to use the proceeds within that period to purchase another personal residence. The trust may also hold insurance proceeds paid to the
trust as the result of damage or destruction of the personal residence for a period not to exceed two years, if the trustee intends to use the proceeds for repair and improvements or replacement of the personal residence.

c. The trust instrument must require that cash held by the trust in excess of that permitted by the above rules be distributed at least quarterly to the term holder. Also, the trust instrument must require that on termination of the term holder's interest any cash in the trust held for payment of expenses must be distributed outright to the term holder. Prop. Reg. § 25.2702-5(e)(4).

d. The trust must prohibit commutation of the term holder's interest. -5(e)(5).

e. With the exception to be discussed in 4 below, the trust must require that if the residence held by the trust ceases to be a personal residence, the trust must terminate and all trust property must be distributed outright to the term holder. Sale of the personal residence is not a cessation of use as a personal residence if the proceeds of sale are used within two years from the date of sale to purchase another residence to be used by the term holder as a personal residence. If no residence is purchased within the two years after sale or if there are excess proceeds after another residence is purchased, the proceeds or excess proceeds are subject to the rules regarding cash in the trust, including the mandatory distribution rule. -5(e)(b)(i).

4. Notwithstanding the foregoing rules, the trust instrument may provided that if the residence is sold or otherwise ceases to be a personal residence, the trust may be converted into a trust meeting the requirements of and functioning as a qualified annuity trust. The trust must require that the amount of the annuity be no less than the amount determined under rules provided in Prop. Reg. § 25.2702-5(e)(6)(ii).

a. Example. Parent establishes a QPRT retaining the right to use the residence for 15 years and if parent, then age 60, dies before the
termination of the term interest, the trust property reverts to his estate. The applicable rate for valuation purposes at the time of creation is 9.6% and the value of the residence transferred to the trust is $500,000. Under these facts, the value of the retained interest is $414,238. If the residence is sold and the trust converted at any time during the retained term, then the annuity to parent for the remainder of the term must be $59,443 a year, since an annuity of that amount for the shorter of 15 years or the life of a person age 60 would have been worth $414,238 given a 9.6% valuation rate.

b. The Prop. Reg. - 5(e)(6)(ii) states that under the conversion rule, the trust must function as a qualified annuity trust "from the date of receipt of the proceeds [on a sale]." There is a question of how to reconcile this with the provision which permits the trustee to take two years to apply the proceeds to the purchase of another residence. Suppose the trustee originally intends to purchase another residence, but during the two year period decides not to do so and instead wants to convert to a qualified annuity trust, the alternative being to distribute all of the assets to the grantor. Must annuity distributions be made for the back period starting with the date that the proceeds were received on the sale?

5. There is nothing in the Proposed Regulations that prevent the trustee from having a right to sell the residence to the grantor on any time during the trust term at its then fair market value. After the sale, the proceeds could be invested with the trust being converted into a qualified annuity trust for the remainder of its term.

a. Pursuant to Section 675 (4)(C), this should make the trust a complete grantor controlled trust for income tax purposes, which would have certain advantages as discussed at Paragraph G above.

6. Transfer of Residence to QPRT with Mortgage on the Property.

a. This is permitted; it does not destroy the qualification of the trust as a QPRT. Prop.
Reg. § 25.2702-5(c) and (e)(3)(ii)(A). The existence of a mortgage if not remaining the personal liability of the grantor will reduce the value of the property transferred to the trust and thus reduce the amount of the initial gift.

b. However, as added payments of principal are made on the mortgage, each such payment would have a gift factor to the extent of the then value of the remainder interest which would increase as the remaining trust term decreases. It may be preferable, if possible, to pay the mortgage off from the outset so that the gift will be measured by the then value of the remainder interest, rather than having periodic gifts made in the future with an increasing value attached to the remainder interest.

c. What about the interest payments on the mortgage? These should not result in gifts to the remainderman since interest is a liability of the income beneficiary. Further, if the QPRT is a grantor trust, under Section 671 to 677, the deduction for interest should pass through to the grantor.

J. Generation-Skipping Tax Considerations

1. On the termination of the fixed term of the grantor's retained interest in a GRIT, GRAT or GRUT, the property passing to grandchildren could be subject to the GST tax. Moreover, the transfer, assuming it occurs during the grantor's lifetime and therefore is not included in his taxable estate, would not qualify for the Section 2612(c)(2) exception from the generation-skipping transfer tax for direct skips to a grandchild where the child who is the parent of the grandchild is deceased.

2. This leads to the suggestion that the remainderman of the trust should be restricted to living children (or the estate of deceased children) in order to avoid a GST problem. The grantor could make the issue of a deceased child the beneficiary of other property to which the exception of Section 2612(c)(2) could apply since the transfer would be a direct skip.
K. Joint Purchase of Property

1. Joint purchase of property by members of the same family - for example parent and child - with parent acquiring a term interest and the child acquiring the remainder interest, will be viewed as if the person acquiring the term interest acquired the entire property and then transferred to the other person the interest acquired by that other person in the joint purchase. Reg. § 25.2702.4(c).

   a. Example. Parent purchases a 20-year term interest in a building and his child purchases the remainder interest, each paying a price equal to the value of his respective interest in the property determined under the Section 7520 valuation rules. For purposes of Section 2702, it will be viewed as if parent acquired the entire property and transferred the remainder interest to his child in exchange for the portion of the purchase price provided by the child. Section 2702 applies with the result that the retained interest is valued at zero because it is not a qualified interest. Result, a gift has been made equal to the excess of the value of the property over the consideration paid by the child.

2. Suppose parent and child jointly purchase a residence, with parent paying fair value for a term interest and child paying fair value for the remainder interest. The residence is then committed by the two to a trust that qualifies as a QPRT. On this reasoning, no taxable gift would result, and if parent died during the retained term, it could be argued that there was to be no retained interest in the residence resulting in inclusion in a parent's estate under Section 2036(a) on the grounds that the child paid full and adequate consideration for the value of the remainder interest.

   a. An IRS spokesman contends that the substance of the transaction is a purchase of the residence by the parent who places it in trust, followed by a sale of the remainder interest to the children. If this is the correct analysis, and parent dies during the trust term, then the spokesman's position is that the value of the residence will be

L. Grantor as Trustee

1. There is no prohibition in Section 2702 against the grantor acting as a trustee of a trust that is intended to qualify as a GRAT, GRUT or QPRT. But care must be taken to assure that as trustee the grantor does not have a right or power that would cause the trust property to be included in his taxable estate.

   a. Where the desire is to create a grantor controlled trust for income tax purposes (a GCT) through powers in the trustee, it may be advisable to have such powers exercisable by a co-trustee or other person other than the grantor.

M. Trust Owning Stock of Subchapter S Corporation.

1. To avoid disqualification as a Subchapter S corporation, the trust must be a permitted shareholder.

2. Trust will be a permitted shareholder if it is a complete grantor trust ("CGT") under the provisions of Sections 671 through 677. Section 1361(c)(2)(A)(i).

   a. The desire is to have a trust in which there are powers causing the grantor to be treated as an owner of the trust - of both income and corpus - for income tax purposes but which do not require that the trust property be included in the grantor's taxable estate for estate tax purposes.

3. There are various possibilities. What might be an acceptable solution is suggested by LTR 9037011. In that unpublished ruling, a parent created a trust for the benefit of his children naming another person as trustee (there is no reference to the relationship of the trustee to the grantor; apparently it was not deemed relevant for purposes of the ruling). A provision of the trust provided that the trustee, acting in a nonfiduciary capacity, could, without the approval or consent of any person, acquire property held in the trust
by substituting property of an equivalent value. The ruling holds that the trust was a complete grantor trust pursuant to Section 675(4)(C) so that the trust could be the shareholder of a Subchapter S corporation, and further the ruling holds that the parent did not possess any power or right which would cause the trust property to be included in his gross estate.

4. On the death of the grantor during the annuity term, the trust would no longer qualify as a complete grantor trust for income tax purposes.

a. If the S corporation stock reverts to the estate of the grantor, the estate can be a permitted shareholder, and provisions may be made in the grantor's will to assure that the stock will pass from the estate to the beneficiary who is also a permitted shareholder.

b. If the trust continues in existence for the remainder of the annuity term, then to avoid disqualification of the corporation as an S corporation, it is necessary that the trust satisfy the QSST rules of Section 1361(d)(3). In particular, note the requirement that there be only one income beneficiary of the trust, although for this purpose a separate and independent share of a trust within the meaning of Section 663(c) is treated as a separate trust.

5. An added benefit of holding Subchapter S stock during the grantor's lifetime is that under the grantor trust rules he will be obligated to pay tax on the full taxable income of the S corporation attributable to the trust stock and not simply on the portion of the income needed to satisfy the annuity. Thus, income accumulated for ultimate distribution to the remainderman may benefit from having the tax satisfied by payments by the grantor. Effectively, the grantor is making a "gift" to the remainderman, since he is paying taxes on income that will ultimately be distributed to the remainderman; but there should be no "taxable gift" because the grantor is satisfying his personal obligation for taxes imposed by the rules of Section 671 through 677.

III. Special Period of Limitation Rule
A. If a transfer of property is "subject to the special valuation rules of Sections 2701 or 2702" and is not "adequately shown" on a gift tax return, any gift tax imposed on the transfer (or resulting from a taxable event described in Section 2701(d)) may be assessed at any time. Reg. § 301.6501(c)-1(e).

1. This rule requires the filing of a gift tax return, with adequate disclosure, whenever Section 2701 applies, even though the taxpayer maintains that there has been no taxable gift (as, for example, with the zeroed-out GRAT) so that a return is not otherwise due.

B. To satisfy the "adequately shown" rule, Reg. § 301.6501(c)-1(e)(2) requires the submission of the following information with the return:

1. A description of the transaction;

2. A description of the transferred and retained interests and the methods used to value each;

3. A detailed description of the method used to determine the value of the property involved in the transaction.

a. Where this involves an equity interest that is not actively traded - such as stock of a closely held corporation - the required information includes "balance sheets and statements of net earnings, operating results, and dividends paid for each of the five years immediately before the valuation date."

4. The name, address and taxpayer ID number of the transferor, the transferee and "all other persons participating in the transaction or holding an equity interest in any entity involved in the transaction."

C. Even absent the special rule for Section 2701 and 2702 transactions, the filing of a gift tax return without the actual payment of a gift tax for a year does not protect against a later revaluation of a gift made during the year for the purpose of determining the rate bracket applicable to a later gift or to the estate on the death of the donor.

1. If a gift tax has been paid for the year in which a gift is made, then on the running of the statute
of limitations for that year, Section 2504(c) assures that the valuation placed on gifts for the year may not be increased for the purpose of determining the gift tax on gifts made in a later year. However, the protection afforded by Section 2504(c) does not apply for estate tax purposes, so that the IRS is not barred from revaluing prior taxable gifts, even though the period of limitations may have expired, for purposes of determining "adjusted taxable gifts" in computing the estate tax liability. Nevertheless, in calculating the amount of gift tax subtraction available under Section 2001(b)(2), the estate is entitled to have the gift tax adjusted in conformity with the increase in value of the gifts that is ultimately determined. Estate of Frederick R. Smith, 94 TC No. 55 (1990).
Parent owns business worth $2,400,000 with an anticipated profit and growth in value of 15% a year. An appraisal indicates that a cumulative preferred with a par of $1,200,000 and a dividend of 12% can support a value of $1,200,000 for the preferred interest. All of the junior equity interest is gifted to child at a value of $1,200,000, which is covered by the lifetime exemption.

**Table I**

**Leveraged Partnership**

<table>
<thead>
<tr>
<th>Year</th>
<th>Entity Value</th>
<th>Profit</th>
<th>Preferred Distribution</th>
<th>Distributed to Child</th>
<th>Remaining in Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,400,000</td>
<td>360,000</td>
<td>144,000</td>
<td>71,000</td>
<td>145,000</td>
</tr>
<tr>
<td>2</td>
<td>2,545,000</td>
<td>382,000</td>
<td>144,000</td>
<td>78,000</td>
<td>160,000</td>
</tr>
<tr>
<td>3</td>
<td>2,705,000</td>
<td>406,000</td>
<td>144,000</td>
<td>86,000</td>
<td>176,000</td>
</tr>
<tr>
<td>4</td>
<td>2,881,000</td>
<td>432,000</td>
<td>144,000</td>
<td>95,000</td>
<td>193,000</td>
</tr>
<tr>
<td>5</td>
<td>3,074,000</td>
<td>461,000</td>
<td>144,000</td>
<td>104,000</td>
<td>213,000</td>
</tr>
<tr>
<td>6</td>
<td>3,287,000</td>
<td>493,000</td>
<td>144,000</td>
<td>115,000</td>
<td>234,000</td>
</tr>
<tr>
<td>7</td>
<td>3,521,000</td>
<td>528,000</td>
<td>144,000</td>
<td>126,000</td>
<td>258,000</td>
</tr>
<tr>
<td>8</td>
<td>3,779,000</td>
<td>567,000</td>
<td>144,000</td>
<td>140,000</td>
<td>283,000</td>
</tr>
</tbody>
</table>

Child’s interest increases from $1,200,000 to $2,862,000 (4,062,000 less 1,200,000 value of Parent’s equity) over 8 years, resulting in an 11.5% return after taxes. If you add in the amount withdrawn for taxes the growth is to 3,677,000 or a $15.2% a year return before taxes.
Table II

Leveraged Corporation

<table>
<thead>
<tr>
<th>Year</th>
<th>Entity Value</th>
<th>Profit</th>
<th>Dividend</th>
<th>Corporate Tax</th>
<th>Remaining after Tax and Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,400,000</td>
<td>360,000</td>
<td>144,000</td>
<td>110,000</td>
<td>105,000</td>
</tr>
<tr>
<td>2</td>
<td>2,505,000</td>
<td>376,000</td>
<td>144,000</td>
<td>116,000</td>
<td>116,000</td>
</tr>
<tr>
<td>3</td>
<td>2,621,000</td>
<td>393,000</td>
<td>144,000</td>
<td>122,000</td>
<td>127,000</td>
</tr>
<tr>
<td>4</td>
<td>2,748,000</td>
<td>412,000</td>
<td>144,000</td>
<td>128,000</td>
<td>140,000</td>
</tr>
<tr>
<td>5</td>
<td>2,888,000</td>
<td>433,000</td>
<td>144,000</td>
<td>135,000</td>
<td>154,000</td>
</tr>
<tr>
<td>6</td>
<td>3,042,000</td>
<td>456,000</td>
<td>144,000</td>
<td>143,000</td>
<td>169,000</td>
</tr>
<tr>
<td>7</td>
<td>3,211,000</td>
<td>482,000</td>
<td>144,000</td>
<td>152,000</td>
<td>186,000</td>
</tr>
<tr>
<td>8</td>
<td>3,397,000</td>
<td>510,000</td>
<td>144,000</td>
<td>162,000</td>
<td>204,000</td>
</tr>
</tbody>
</table>

[After payment of $1,200,000 to Parent in redemption of Parent's preferred interest there is $2,401,000 to be distributed to Child, resulting in a capital gain tax on the distribution of $420,000 (35% of (2,401,000 - 1,200,000)), so that the after-tax increase in value for child over the 8 years is from $1,200,000 to $1,981,000.]

Under essentially the same facts the after-tax growth in value of child's interest is from $1,200,000 to $2,862,000 through a partnership and from $1,200,000 to $1,981,000 through a corporation.

Assume that at the end of eight years there is a going business value that gives and added $1,000,000 to the sale of the enterprise: a sale of assets in both a corporation and a partnership.

The tax amount available to child in the partnership is $670,000; in the corporation after the imposition of a 34% corporation tax on the sale and a 33% individual tax on the distribution in liquidation is $442,000. To summarize the bottom line effect of the two structures:

<table>
<thead>
<tr>
<th>Child's</th>
<th>After-tax Growth from</th>
<th>After-tax</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift to Child</td>
<td>Operations</td>
<td>Good Will</td>
<td></td>
</tr>
<tr>
<td>Partnership</td>
<td>1,200,000</td>
<td>$1,662,000</td>
<td>670,000</td>
</tr>
<tr>
<td>Corporation</td>
<td>1,200,000</td>
<td>781,000</td>
<td>442,000</td>
</tr>
</tbody>
</table>

In either case Parent's economic position is the same: $144,000 a year return on investment annually and a recovery of the $1,200,000 investment at the end of two years.
Situation B

Assume that Parent owns business with a value of $2,400,000 and a growth rate of 15% a year. However, instead of creating two classes of equity, Parent forms a partnership with a single class of equity 50% of which is gifted to Child.

Table III

<table>
<thead>
<tr>
<th>Entity Value</th>
<th>Profit</th>
<th>33% Tax Withdrawal</th>
<th>Remaining in Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,400,000</td>
<td>$360,000</td>
<td>$120,000</td>
<td>$240,000</td>
</tr>
<tr>
<td>2,640,000</td>
<td>396,000</td>
<td>131,000</td>
<td>265,000</td>
</tr>
<tr>
<td>2,905,000</td>
<td>436,000</td>
<td>144,000</td>
<td>292,000</td>
</tr>
<tr>
<td>3,197,000</td>
<td>480,000</td>
<td>158,000</td>
<td>322,000</td>
</tr>
<tr>
<td>3,519,000</td>
<td>528,000</td>
<td>174,000</td>
<td>354,000</td>
</tr>
<tr>
<td>3,873,000</td>
<td>581,000</td>
<td>192,000</td>
<td>389,000</td>
</tr>
<tr>
<td>4,262,000</td>
<td>639,000</td>
<td>211,000</td>
<td>482,000</td>
</tr>
<tr>
<td>4,690,000</td>
<td>703,000</td>
<td>232,000</td>
<td>471,000</td>
</tr>
<tr>
<td>5,161,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

At end of eight years, Child's interest has a value of $2,585,000 (one-half of $5,161,000), compared with $2,862,000 in the leveraged partnership shown in Table I.
Situation C

Suppose the facts are as set forth above. $2,400,000 value for business, 12% return on the preferred interest, but the business produces a 10% annual return instead of a 15% return. Compare the result of a leveraged partnership - 1,200,000 senior equity with a 15% annual preferred and the junior equity 100% to child with a partnership with one class of equity, 50% to the Child.

Table IV

Leveraged Partnership

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
<th>Profit</th>
<th>Preferred Distribution</th>
<th>Remaining in Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,400,000</td>
<td>240,000</td>
<td>144,000</td>
<td>32,000</td>
</tr>
<tr>
<td>2</td>
<td>2,464,000</td>
<td>246,000</td>
<td>144,000</td>
<td>34,000</td>
</tr>
<tr>
<td>3</td>
<td>2,532,000</td>
<td>254,000</td>
<td>144,000</td>
<td>36,000</td>
</tr>
<tr>
<td>4</td>
<td>2,605,000</td>
<td>260,000</td>
<td>144,000</td>
<td>38,000</td>
</tr>
<tr>
<td>5</td>
<td>2,683,000</td>
<td>268,000</td>
<td>144,000</td>
<td>41,000</td>
</tr>
<tr>
<td>6</td>
<td>2,766,000</td>
<td>277,000</td>
<td>144,000</td>
<td>44,000</td>
</tr>
<tr>
<td>7</td>
<td>2,855,000</td>
<td>285,000</td>
<td>144,000</td>
<td>47,000</td>
</tr>
<tr>
<td>8</td>
<td>2,949,000</td>
<td>295,000</td>
<td>144,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

At end of eight years Child's interest has a value of $1,850,000 ($3,050,000 less $1,200,000).

Table V

Non-Leveraged Partnership

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
<th>Profit</th>
<th>33% Distributed for taxes</th>
<th>Remaining in Partnership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,400,000</td>
<td>240,000</td>
<td>79,000</td>
<td>161,000</td>
</tr>
<tr>
<td>2</td>
<td>2,561,000</td>
<td>256,000</td>
<td>84,000</td>
<td>172,000</td>
</tr>
<tr>
<td>3</td>
<td>2,733,000</td>
<td>273,000</td>
<td>90,000</td>
<td>183,000</td>
</tr>
<tr>
<td>4</td>
<td>2,916,000</td>
<td>291,000</td>
<td>96,000</td>
<td>195,000</td>
</tr>
<tr>
<td>5</td>
<td>3,111,000</td>
<td>311,000</td>
<td>102,000</td>
<td>209,000</td>
</tr>
<tr>
<td>6</td>
<td>3,320,000</td>
<td>332,000</td>
<td>109,000</td>
<td>223,000</td>
</tr>
<tr>
<td>7</td>
<td>3,543,000</td>
<td>354,000</td>
<td>117,000</td>
<td>237,000</td>
</tr>
<tr>
<td>8</td>
<td>3,880,000</td>
<td>388,000</td>
<td>128,000</td>
<td>260,000</td>
</tr>
<tr>
<td>9</td>
<td>4,140,000</td>
<td>414,000</td>
<td>138,000</td>
<td>282,000</td>
</tr>
</tbody>
</table>
At end of eight years child's interest has a value of $2,070,000 as compared with $1,850,000 in the leveraged partnership.

Better to Have Done Nothing

At a return of 6% on the business, the profits in the above example would be only sufficient to meet the annual return on the preferred interest in a partnership. Thus on that assumption, the child's interest would show zero growth in value in the leveraged partnership. Just as if Parent had done nothing.

At a return on the business of less than 6%, the 12% preference on the senior equity would absorb all of the profits and more, so it's would be necessary to invade the amount given to the child to the cumulative preferred rights of the Parent's investment. In effect, part of the gift to child is returned to Parent's estate.
Situation D

Return to the corporate situation illustrated in Table II except that instead of creating two classes of stock the corporation has only one class -- common stock -- 50% of which is gifted to child -- 15% profit.

Table VI

Non-Leveraged Corporation

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
<th>Profit</th>
<th>Corporate</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2,400,000</td>
<td>360,000</td>
<td>111,000</td>
<td>249,000</td>
</tr>
<tr>
<td>2</td>
<td>2,649,000</td>
<td>385,000</td>
<td>119,000</td>
<td>266,000</td>
</tr>
<tr>
<td>3</td>
<td>2,915,000</td>
<td>411,000</td>
<td>128,000</td>
<td>283,000</td>
</tr>
<tr>
<td>4</td>
<td>3,198,000</td>
<td>439,000</td>
<td>138,000</td>
<td>301,000</td>
</tr>
<tr>
<td>5</td>
<td>3,499,000</td>
<td>469,000</td>
<td>148,000</td>
<td>321,000</td>
</tr>
<tr>
<td>6</td>
<td>3,820,000</td>
<td>501,000</td>
<td>159,000</td>
<td>342,000</td>
</tr>
<tr>
<td>7</td>
<td>4,162,000</td>
<td>535,000</td>
<td>171,000</td>
<td>364,000</td>
</tr>
<tr>
<td>8</td>
<td>4,526,000</td>
<td>571,000</td>
<td>183,000</td>
<td>388,000</td>
</tr>
</tbody>
</table>

4,914,000 ÷ 2 = $2,457,000 to child - compared with $2,401,00 in the leveraged corporation.

If facts are as stated in Table II and VI except that the rate of profit is 20%, there at the end of eight years the value of child’s interest would be

Table II Leveraged  $3,544,000
Table VI Non-Leveraged 3,331,000
ADDENDUM

Proposed Reg. § 25.2701-5 and § 25.2702-6
Adjustments to Mitigate Double Taxation

I. Section 2701 Non-Refundable Credit Against Estate Tax.

A. The special valuation rules of § 2701 may result in a higher-than-actual value to the junior equity interest which is gifted to the younger generation, as a result of an undervaluation of the preferred stock retained by the transferor. Nevertheless, the preferred equity interest remains as an asset of the transferor, ultimately to be included in his gross estate at its actual value, if he continues holding it until death, or, possibly, to increase his taxable gifts by the actual value if the preferred stock is gifted by him during lifetime. Accordingly, if no adjustment is made to take the foregoing into account, the net effect would be to impose into taxes on the same value.

1. Subsection (e)(6) of § 2701 directs the IRS to issue regulations dealing with the situation where there is a subsequent transfer or inclusion in the gross estate of "any applicable retained interest which was valued [under the special valuation rules of § 2701]". In such situations, "appropriate adjustments" are to be made for purposes of the gift, estate, and generation skipping taxes to reflect the increase in the amount of the prior taxable gift by reason of the special valuation under § 2701.

B. In September, 1991, the IRS issued proposed regulations which deal with the problem by giving the transferor's estate a nonrefundable credit if an applicable retained interest was valued under § 2701. Prop. Reg. § 25.2701-5(a).

C. The amount of the credit is equal to the amount of the gift tax that was payable (before the application of the unified credit) on the transfer to which § 2701 applied (the "initial transfer") times a fraction, the numerator of which is the amount by which the taxable gifts were increased as a result of the applicable of § 2701 and the denominator of which is the amount of the initial transfer determined under § 2701.

1. Example. In 1991, A, the owner of all of the preferred and common stock of X Corporation, makes a gift of all of the common stock to his child (the "initial transfer"). At the time of this
transfer, the actual fair market value of the common stock was $1,010,000, which would have resulted in a taxable gift after the annual exclusion of $1,000,000. However, because of the application of § 2701, A's taxable gifts for 1991 were increased by $1,500,000 to $2,500,000. A had not made a transfer subject to gift tax before the Initial Transfer and made no other taxable gifts thereafter. The gift tax on the 1991 transfer was $1,025,800, with $833,000 being paid after the application of the unified credit. A dies in 1996. His estate is entitled to a non-refundable credit against the estate tax of $615,480; that is, $1,025,800, the gift tax on the initial transfer (without regard to the unified credit), times a fraction, the numerator of which is $1,500,000 (the amount of the § 2701 increase in value) and the denominator of which is $2,500,000 (the amount of the initial transfer as determined under § 2701).

D. The effect of the formula, it should be noted, is to give relief at the lower end of the rate scale so that frequently the granting of the credit will not fully offset the added estate and gift tax liability resulting from the § 2701 valuation increase. Thus, if A in the above example had a taxable estate of $3,000,000 before taking into account the adjusted taxable gifts during lifetime, he would be in the 55% bracket and the tax cost of the $1,500,000 increase in adjusted taxable gifts would be $825,000 (55% of $1,500,000), whereas the credit is only $615,480.

1. There would have been a full offset if instead of a credit, the proposed regulations adopted the approach of decreasing "adjusted taxable gifts" by $1,500,000 in applying § 2001(b) in determining the estate tax. In that event, the effect of the § 2701 adjustment in value would be to cause a prepayment rather than an increase in tax.

   a. The overview memorandum accompanying the proposed regulations suggests that the persons preparing the proposed regulations may have been of two minds on this point. Thus, in that memorandum the IRS requests comments as to "whether the adjustment should be a reduction in adjusted taxable gifts or a credit against estate tax as proposed".

E. The non-refundable credit is allowed after the computation of the estate tax under § 2001 but before
the application of the unified credit, which is allowed under § 2010. Thus, in an estate where the decedent, survived by his/her spouse, takes the maximum marital deduction, subject to the creation of an exemption trust, the effect of the non-refundable credit will be to increase the amount which can go outside the marital deduction without the imposition of an estate tax. On the other hand, if the decedent left everything to the surviving spouse, so that there was no estate tax even absent a credit, the effect would be a failure to utilize the credit allowed by Prop. Reg. § 25.2701-5, since the excess over the actual tax cannot be refunded.

F. If the initial transfer is treated as made one-half by the transferor's spouse by reason of gift splitting under § 2513, then each spouse is treated as the initial transferor with respect to one-half of the transfer, for purposes of applying the non-refundable credit rule.

II. Section 2702 Reduction in Taxable Gifts on Transfer of Retained Interest.

A. Assume a situation in which an individual creates a retained interest trust in which the retained interest is valued under § 2702 rules, resulting in a zero valuation, and therefore a value for the gift of the remainder which exceeds its actual value. Later the individual makes a gift of the retained interest that was previously valued at zero. If full value is applied to the later gift, the effect will be to impose a double tax on the same value.

B. Alternately assume that the individual who created the retained interest trust in which the gift of the remainder was valued under § 2702 dies during the trust term with the result that the remainder interest is included in his gross estate.

1. If the full amount of the lifetime gift valued under § 2702 is included in "adjusted taxable gifts" in computing the estate tax under § 2001, the effect would be a double tax on the same value.

C. Unlike § 2701, § 2702 does not direct or authorize the issuance of regulations to prevent a double tax in the foregoing situation. Nevertheless, proposed regulations have been issued which provide relief in each of the foregoing situations.
1. In the first case, the relief is in the form of a reduction in the aggregate amount of the individuals taxable gifts for the later year of the transfer. Prop. Reg. § 25.2702-6(a)(1).

2. In the second case, the relief is in the form of a reduction in the individual's adjusted taxable gifts in computing the estate tax payable under § 2001.

D. If the gift to which § 2702 applies is treated as made one-half by the transferor's spouse as a result of gift splitting under § 2513, the reduction in the aggregate taxable gifts (or adjusted taxable gifts), is allocated one-half to the transferor and one-half to the consenting spouse (or their respective estates). Prop. Reg. § 25.2702-6(a)(3).

1. However, each spouse (or the spouse's executor) may assign the right to the other spouse by attaching an assignment to a gift tax return filed by the spouse (or the executor of the spouse) making the assignment at any time before a date that is 3 years after the date of the spouse's death.

2. Assume a situation in which an individual who was entitled to a reduction in aggregate taxable gift (or adjusted taxable gifts) subsequently transfers the retained interest in a split gift. Such an individual may assign one-half of the amount of the reduction to the consenting spouse on the split gift. The assignment may be attached to the gift tax return (Form 709) on which the consenting spouse reports the split gift. Prop. Reg. § 25.2702-6(a)(3)(ii).

E. The amount of the reduction in aggregate taxable gifts (or adjusted taxable gifts) is the lessor of:

1. the increase in the individual's taxable gifts resulting from the § 2702 valuation; or

2. the increase in the individual's taxable gifts resulting from the subsequent transfer of the interest.

   a. For purposes of determining the latter increase, the annual exclusion is conclusively presumed to apply first to other transfers during the year (that is, transfers other than that of the interest previously
valued under § 2702). This presumption works to the taxpayer's advantage since it maximizes the increase in taxable gifts and thus increases the amount of relief permissible under the special rule.