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VALUATION FREEZES AFTER THE 1988 ACT: THE IMPACT OF SECTION 2036(c) ON CLOSELY HELD BUSINESSES

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I know what an Act to make things simpler means. It means that the people who drew it up don't understand it themselves and that every one of its clauses needs a law-suit to disentangle it.¹

INTRODUCTION

In recent years, the federal taxes on wealth transfers have become widely viewed as essentially "voluntary."² Criticism of existing law has focused on the imperfect unification of the gift and estate taxes, the relatively small amount of revenue generated, and the ability of taxpayers to transfer wealth from one generation to another outside the transfer tax system.³ Commentators have paid particular attention to "estate freeze" techniques in the context of closely held family businesses.⁴ In a typical corporate or partner-

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1. D. SAYERS, *UNNATURAL DEATH* 163 (London 1969).

2. See Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

3. See generally Dodge, *Redoing the Estate and Gift Taxes Along Easy-to-Value Lines*, 43 TAX L. REV. 241 (1988); Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259 (1983); Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 VA. L. REV. 1183 (1983); Stephan, *A Comment on Transfer Tax Reform*, 72 VA. L. REV. 1471 (1986).

4. See, e.g., Abbin, *Taking the Temperature of Asset Value Freeze Approaches: What's Hot, What's Not*, 66 TAXES 3 (1988) [hereinafter Abbin, *Taking the Temperature*]; Abbin, *Is Bifurcation a Dirty Word? The IRS Seems to be Legislating Out Asset Valuation Freezes Based on Emotional, Not Legal, Rationale*, 29 TAX NOTES 297 (1985); Abbin & Zukin, *Have They Nuked the Freeze? Evaluating the Impact of Recent Decisions, Regulations and Rulings*, 19 INST. ON EST. PLAN. ¶ 500 (1985); Nelson & Genz, *New Uncertainties in the Equity Freeze: The Impact of Dickman on Capital Call Rights and Other Issues*, 63

ship freeze, an older generation transferor shifts the future equity growth in a business to younger generation family members while retaining a preferred income interest and control rights.⁵ In terms of planning, the goal is to minimize both the value of the transferred equity interest for gift tax purposes and the value of the retained interest for estate tax purposes. Apart from the gift and estate tax advantages, an estate freeze may also serve the purpose of transferring control of a closely held business to the younger generation while preserving the older generation's interest in the business.

In order to control estate freeze abuses and prevent further erosion of the transfer tax base, Congress added section 2036(c) to the Internal Revenue Code in the Omnibus Budget Reconciliation Act of 1987 (1987 Act).⁶ In substance, if a transferor makes a lifetime transfer of property representing a disproportionate share of the potential appreciation in an enterprise while retaining an income interest in the enterprise, section 2036(c) draws the value of the transferred property back into the transferor's gross estate at death on the theory that the retained interest represents "enjoyment of the transferred property."⁷ Although the examples in the

TAXES 999 (1985); *The Estate Freezing Rage: A Practical Look at Planning Opportunities and Potential Problems*, 15 REAL PROP., PROB. & TR. J. 21 (1980) [hereinafter *The Estate Freezing Rage*].

5. For a detailed discussion of the income and transfer tax aspects of corporate and partnership freezes, see, e.g., Elias, *The Partnership Capital Freeze: A Path Through the Maze*, 40 TAX LAW. 45 (1986); Kalb & Massey, *Estate Freezing Techniques Through Preferred Partnerships; Today's Problems*, 41 INST. ON FED. TAX'N ch. 44 (1983); Nelson, *The Partnership Capital Freeze: Income, Estate, & Gift Tax Considerations*, 1 VA. TAX REV. 11 (1981); Nelson & Woodward, *Structuring Estate Freezes: Estate and Gift Tax Aspects*, 33 MAJOR TAX PLAN. ch. 13 (1981); Wallace, *Recapitalizing the Closely Held Corporation: New Problems for an Old Technique*, 19 INST. ON EST. PLAN. ¶ 400 (1985).

6. I.R.C. § 2036(c) (added by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10402(a), 101 Stat. 1330, 1330-431 [hereinafter 1987 Act] and amended by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3031, 102 Stat. 3342, 3634 [hereinafter 1988 Act]). Unless otherwise indicated, all Internal Revenue Code references are to the Internal Revenue Code of 1986, as amended through October 1989.

7. I.R.C. § 2036(c)(1). For commentary on § 2036(c) as originally enacted in the 1987 Act, see, e.g., *Estate Freezes and IRC Sec. 2036(c)*, PRAC. DRAFT, Apr. 1988, at 1415; Foster & Rabun, *Planning Strategies to Cope with the Limits Imposed on Estate Freezes by RA '87*, 15 EST. PLAN. 130 (1988); Magner & Tencza, *The Freeze Gets Iced: Section 2036 After OBRA*, 39 TAX NOTES 505 (1988); Schlenger & Canning, *New Section 2036(c): A Critical View*, 13 TAX MGMT. EST., GIFTS & TR. J. 115 (1988); see also Dodge, *supra* note 3, at 361-

legislative history focus on corporate and partnership freezes, Congress drafted the statute as broadly as possible to reach a wide range of transactions.⁸ The operative provisions include many undefined or ambiguous terms that have no commonly understood meaning for federal tax purposes. In the Technical and Miscellaneous Revenue Act of 1988 (1988 Act), Congress substantially revised and expanded section 2036(c) without curing its vagueness or ambiguity.⁹

In view of the potentially broad reach of section 2036(c) and the uncertainty surrounding its mechanical operation, the statute has been criticized as an impediment to legitimate family transactions.¹⁰ In addition, section 2036(c) raises significant policy questions concerning the tax treatment of retained interests in general

66; Lane, *Intra-Family Sales: Toward a Uniform Tax Treatment*, 41 TAX LAW. 279, 324-27 (1988).

8. See H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 996, reprinted in 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1245, 2313-1742 [hereinafter 1987 CONFERENCE REPORT]; H.R. REP. NO. 391, 100th Cong., 1st Sess. 1041, reprinted in 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1, 2313-657 [hereinafter 1987 HOUSE REPORT].

9. See 1988 Act, § 3031, 102 Stat. at 3634; H.R. CONF. REP. NO. 1104, 100th Cong., 2d Sess. 71, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 5048 [hereinafter 1988 CONFERENCE REPORT]; H.R. REP. NO. 795, 100th Cong., 2d Sess. 418 (1988) [hereinafter 1988 HOUSE REPORT]; S. REP. NO. 445, 100th Cong., 2d Sess. 522, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 4517 [hereinafter 1988 SENATE REPORT]. For commentary on § 2036(c) as revised by the 1988 Act, see Aucutt, *Boreas v. Vulcan: The Estate Freeze Meets a Flame-Throwing Statute*, 47 INST. ON FED. TAX'N ch. 23 (1989); Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules* (pts. 1 & 2), 70 J. TAX'N 14, 74 (1989); Bogdanski & Brown, *Farewell to 'Freezes': Section 2036(c)*, 42 TAX NOTES 1633 (1989); Dees, *Section 2036(c): The Monster That Ate Estate Planning and Installment Sales, Buy-Sell Options, Employment Contracts and Leases*, 66 TAXES 876 (1988); Keydel, *The 1988 Version of Section 2036(c): "Anti-Freeze" Fantasy Overwhelms the Estate Tax*, 14 TAX MGMT. EST., GIFTS & TR. J. 3 (1989); Miller, *Gift (W)rapping the Estate Freeze*, 41 TAX NOTES 1335 (1988).

10. The estate planning bar has sharply criticized § 2036(c). See Letter from Charles W. Hall, Chair, ABA Section on Taxation to David H. Brockway, Chief of Staff, Joint Committee on Taxation (Nov. 19, 1987) (copy on file with author) (commenting on estate and gift tax revenue increases); *Technical Corrections Act of 1988: Hearing Before the Senate Finance Comm.*, 100th Cong., 2d Sess. 90 (1988) (statement of Malcolm A. Moore, President of the American College of Probate Counsel) [hereinafter *Moore Statement*]; *Report to the House of Delegates: Recommendation 107A*, 1988 A.B.A. SEC. REAL PROP., PROB. & TR. (urging repeal of § 2036(c) as "vague, overbroad and ambiguous") [hereinafter ABA RECOMMENDATION]. For an alternative proposal to § 2036(c), see Task Force of the ABA Section of Real Property Probate and Trust Law, ABA Section of Taxation & The American College of Probate Counsel, *Report of the Section 2036(c) Task Force* (contained in Letter from Irwin L. Treiger, L. Henry Gissel, Jr., and Geraldine S. Hemmerling of the Task Force to Ronald

and the appropriateness of applying the reinclusion approach of section 2036(c) to the valuation problems posed by estate freezes. In its long-awaited guidance on section 2036(c), released in September of 1989, the Service failed to resolve some of the most pressing questions relating to the operation of the statute.¹¹ Pending further interpretive guidance, continuing legislative attempts to clarify and refine the existing statute are likely.

This Article examines the scope and effect of section 2036(c), and seeks to define a framework for implementing its underlying policy objectives. Part I presents a historical overview of estate freezes and explores alternative approaches to valuation problems under prior law. Parts II and III analyze the scope of section 2036(c) and identify the need for technical refinements to clarify the existing statute. Part IV goes beyond the technical problems and proposes a transfer tax model derived from the income tax rules for family partnerships.¹² The model reallocates disproportionate shifts in value attributable to inadequate returns on invested capital and correlates the estate tax reinclusion rules of section 2036(c) to the reallocated value. In the transfer tax context of section 2036(c), these rules should make it possible to define the appropriate treatment of estate freeze transactions so that only the disproportionate shift in value is drawn back into the transfer tax base.

I. VALUATION FREEZES PRIOR TO SECTION 2036(c)

A. *Structuring a Freeze*

In its simplest form, an estate freeze involves the transfer of an interest representing future appreciation by an older generation transferor, coupled with the retention of another interest having a fixed value. Assume, for example, that A owns all of the common

A. Pearlman, Chief of Staff, Joint Committee on Taxation (July 27, 1989) (copy on file with author)).

11. See I.R.S. Notice 89-99, 1989-38 I.R.B. 4. For prior informal announcements by government spokespersons, see Loudon, *Forthcoming Estate Freeze Guidance Explained*, 42 TAX NOTES 1297 (1989); Matthews, *Conference Covers the Waterfront on 1989 Tax Issues*, 42 TAX NOTES 1540 (1989); *Section 2036(c) Estate Freeze Guidance is Imminent, IRS Official Says*, Daily Tax Rep. (BNA) No. 30, at G-4 (Feb. 15, 1989).

12. See I.R.C. § 704(e); see also *infra* notes 327-33 and accompanying text.

stock of a company worth \$1,000,000 and wishes to transfer the potential appreciation to B, a younger generation family member. A causes the company to issue preferred stock and common stock in exchange for A's voting common stock in a tax-free recapitalization. A retains the preferred stock and gives the common stock to B.¹³ If the retained stock is worth \$990,000, the transferred stock will be valued at \$10,000 for gift tax purposes.¹⁴ The intended result of the transaction is that the value of A's preferred stock will be "frozen" at \$990,000 and subsequent appreciation in the company, reflected in the common stock, will not be included in A's gross estate for estate tax purposes. Thus, under pre-1987 law, if the freeze were properly structured and the company were worth \$4,000,000 at A's death, the preferred stock (\$990,000) would be included in A's gross estate, but the interim appreciation in the value of the common stock (\$3,000,000) would not be taxed.

In theory, the estate freeze described above is not inherently abusive. If the respective values assigned to the preferred and common stock are properly determined, transfer taxes are not avoided because the gift tax is imposed on the value of the transferred property at the time of the transfer (\$10,000) and the estate tax is imposed on the value of the preferred stock in A's estate. The full \$3,000,000 of appreciation could just as easily have been removed from A's gross estate if A had given away the entire \$1,000,000 of stock and retained no preferred stock. By retaining the preferred stock, however, A may in effect be retaining a degree of control over the value of the transferred property subsequent to the initial gift.

13. The same result could be accomplished by a tax-free dividend of preferred stock on A's common stock, followed by a transfer of the common stock to B. Alternatively, if B already owns common stock, the recapitalization could be accomplished by a tax-free conversion of A's common stock into preferred stock. See Wallace, *supra* note 5, ¶ 400, at 4-3.

14. The recapitalization will not result in a gift if the value of the common and preferred stock received in the exchange is at least equal to the value of the common stock surrendered. An inadvertent gift may occur, however, if the recapitalization involves an exchange of unequal value. See, e.g., Treas. Reg. § 1.351-1(b)(1) (transaction may be recast "in accordance with its true nature"); Treas. Reg. § 25.2511-1(h)(1) (gift to corporation is a gift to shareholders).

B. Valuation

The potential abuse in the above example arises from undervaluation of the common stock for gift tax purposes and possibly from undervaluation of the preferred stock for estate tax purposes.¹⁵ It is unlikely that any operating company's assets and earnings could support a valuation of conventional preferred stock equal to 99% of the company's total value.¹⁶ If the preferred stock is entitled to a fixed rate of dividends and liquidation preference, the common stock generally has substantial value because of its exclusive right to future appreciation.¹⁷ To support a high value for the preferred stock and a correspondingly low value for the common stock at the time of the initial gift, the preferred stock might be issued with special features such as high noncumulative dividends, constant value conversion rights, and limited participation in liquidation proceeds exceeding a fixed liquidation preference.¹⁸ At least in theory, retained voting rights would represent the right to require the company to pay fair dividends.¹⁹ Similarly, a constant value conversion feature would in theory compensate for an inadequate yield because the preferred stock would presumably be worth no less to a willing buyer than the underlying common stock.²⁰ Such special features are intended to absorb nearly the entire value of

15. Such a situation would occur, for example, if the value of the preferred stock is discounted for voting or other rights that lapse at death. See *infra* notes 63-76 and accompanying text.

16. See, e.g., Nelson & Genz, *supra* note 4, at 1000; Wallace, *supra* note 5, ¶ 403.5, at 4-35; see also Rev. Rul. 83-120, 1983-2 C.B. 170, amplifying Rev. Rul. 59-60, 1959-1 C.B. 237 (most important factors in valuing preferred stock are yield, dividend coverage, and protection of liquidation premium). But see Estate of Anderson v. Commissioner, 56 T.C.M. (CCH) 553 (1988) (criticizing the valuation approach of Rev. Rul. 83-120).

17. See Rev. Rul. 83-120, 1983-2 C.B. 170 (equity's right to appreciation has substantial value).

18. See, e.g., Nelson & Genz, *supra* note 4, at 1000-01; Wallace, *supra* note 5, ¶ 403.5, at 4-33 to 4-41.

19. The importance of voting rights in valuing preferred stock is well illustrated by case law. See, e.g., Estate of Salisbury v. Commissioner, 34 T.C.M. (CCH) 1441, 1452 (1975) (38.1% control premium for voting preferred stock); cf. Behrend v. Commissioner, 30 T.C.M. (P-H) ¶ 61,604 (1961) (60% discount for nonvoting preferred stock).

20. A constant value conversion feature would permit conversion of the preferred stock into common stock having a value, at the time of the conversion, equal to the par or stated value of the preferred. See Wallace, *supra* note 5, ¶ 403.5, at 4-38 to 4-39. The value of the conversion feature might be discounted, however, to reflect the improbability of conversion. See Estate of Wallace v. United States, 566 F. Supp. 904, 915-17 (D. Mass. 1981).

the company and to compensate for an inadequate yield on the preferred stock. During the late 1970s and early 1980s, high interest rates and inflation gave rise to various innovative devices to augment the value of investments having below-market yields.

As a practical matter, preferred stock generally cannot be structured to absorb the entire value of a corporation if other classes of stock are outstanding.²¹ Moreover, giving the preferred stock meaningful rights to participate in future income and appreciation is impossible without defeating the estate planning value of the transaction.²² The high value assigned to preferred stock having special features is realistic only if unrelated parties who pursue their respective economic interests hold the common and preferred stock. In a typical estate freeze, however, the common stock is designed to have economic value in the hands of related family members far exceeding its hypothetical value in the hands of strangers.²³

Courts have generally adopted a valuation approach based on a hypothetical transaction between a "willing buyer" and a "willing seller."²⁴ The weight of authority suggests that the courts may disregard the family relationship between the parties to the actual transaction in valuing the transferred property because the parties to the hypothetical transaction are conclusively presumed to be unrelated.²⁵ This "open market" approach, which is not compelled by the existing statute or regulations, ignores the economic sub-

21. See *Estate of Lee v. Commissioner*, 69 T.C. 860, 877 (1978), *nonacq.*, 1980-2 C.B. 2 (holding that common stock had a value equal to at least 10% of the value of the entire corporation, even though the preferred stock had a liquidation preference equal to nearly 200% of the corporation's value); see also *The Estate Freezing Rage*, *supra* note 4, at 59 (valuation experts unlikely to assign less than 20% of company's value to common stock); Nelson & Genz, *supra* note 4, at 1001; Wallace, *supra* note 5, ¶ 403.5, at 4-40 to 4-41.

22. See Nelson & Genz, *supra* note 4, at 1001.

23. See *Estate of Wallace*, 566 F. Supp. at 918 (ignoring the practical value of the common stock "would create an open door to legitimate estate and gift tax avoidance").

24. See *id.* (hypothetical willing buyer/willing seller standard should not "insulate from consideration some characteristics of the property interests that the donor in fact transferred to the donee"); see also *Luce v. United States*, 4 Cl. Ct. 212, 220 (1983) (hypothetical buyer of a minority interest is not necessarily restricted to the general public, but may include potential buyers closely connected with the corporation).

25. See, e.g., *Estate of Hall v. Commissioner*, 92 T.C. 312, 337 (1989) (rejecting the assumption that the hypothetical purchaser is a related family member).

stance of the transaction.²⁶ Under a more realistic approach, the value of the preferred stock arguably should be discounted to reflect the likelihood that the nonpecuniary rights will not be exercised in a manner that maximizes the yield on the preferred stock. In light of the family's collective long range estate planning goals, the holder of the preferred stock probably would exercise such rights to enhance the value of common stock held by related family members.

C. *Retained Interests*

The basic problems raised by fragmentation of property into transferred interests and retained interests are not new. The Code has long required that lifetime transfers be drawn back into the transferor's gross estate at death if the transferor retains beneficial enjoyment or control of the transferred property until death.²⁷ The retained-interest provision, currently codified in section 2036(a), originally served, prior to enactment of the federal gift tax in 1932, to prevent the erosion of the estate tax base through lifetime gifts.²⁸ In the case of a revocable trust or other will substitute in which the transferor retains sufficient enjoyment or control of the transferred property, this provision ensures that the property will be valued ultimately for transfer tax purposes as of the date of death or the alternate valuation date. Section 2036(a) does not apply, however, if the transferor receives "adequate and full consideration in money or money's worth" for the initial transfer.²⁹ The rationale for this exception is presumably that the transferor's

26. See Cooper, *supra* note 2, at 226; see also Treas. Reg. § 25.2512-1 (noting that "[a]ll relevant facts and elements of value as of the time of the gift shall be considered"); Treas. Reg. § 25.2512-2 (identifying relevant factors in valuing stock and the weight to be accorded to such factors).

27. See I.R.C. § 2036(a); see also I.R.C. §§ 2035-2038.

28. The expansive language of present section 2036(a) was intended to reverse the landmark decision in *May v. Heiner*, 281 U.S. 238 (1930), holding that a reserved life estate transfer was not taxable on the death of the transferor because title vested in the transferee at the time of the transfer. See also the trilogy of cases following *May v. Heiner*: *Burnet v. Northern Trust Co.*, 283 U.S. 782 (1931) (per curiam); *Morsman v. Burnet*, 283 U.S. 783 (1931) (per curiam); *McCormick v. Burnet*, 283 U.S. 784 (1931) (per curiam). See *infra* notes 369-70 and accompanying text.

29. See I.R.C. § 2036(a).

gross estate will not be diminished if the transferred property is replaced by other assets of at least equal value.³⁰

The courts interpret section 2036(a) to require that the retained enjoyment or control relate directly to the transferred property. Indirect control in the form of retained voting stock does not trigger estate tax inclusion. This narrow reading of section 2036(a) flows from *United States v. Byrum*,³¹ in which the Supreme Court held that retained voting rights with respect to transferred stock did not constitute possession or enjoyment of the stock for purposes of section 2036(a).³² The "considerable breach in the federal estate tax" opened by that decision prompted Congress to enact section 2036(b),³³ which requires the value of transferred stock in a controlled corporation to be drawn back into the transferor's gross estate if the transferor retains the right to vote the transferred shares.³⁴ As the legislative history makes clear, however, section 2036(b) applies only to retention of voting rights in the transferred stock, not to retention of voting stock that indirectly controls the value of the transferred stock.³⁵ Thus, neither section 2036(a) nor section 2036(b) prevents the older generation from retaining voting control in the form of voting preferred stock while transferring eq-

30. See Dodge, *supra* note 3, at 279. See generally Lowndes, *Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family Annuities, the Widow's Election, and Reciprocal Trusts*, 35 GEO. WASH. L. REV. 50 (1966).

31. 408 U.S. 125 (1972). See generally Pedrick, *Grantor Powers and the Estate Tax: End of an Era?*, 71 NW. U.L. REV. 704 (1977) (criticizing *Byrum*).

32. *Byrum*, 408 U.S. at 150. The government also contended that the decedent continued to control corporate dividend policy and thus possessed the power to shift or defer beneficial enjoyment of income on the transferred stock. The Court rejected the government's arguments based largely on the economic and legal constraints that exist on a controlling shareholder's powers. *Id.* at 144.

33. Pedrick, *supra* note 31, at 712, 717; see Tax Reform Act of 1976, Pub. L. No. 94-455, § 2009(a), (e)(1), 90 Stat. 1520, 1893, 1896 (1976) (amending § 2036(a)(1)); see also H.R. REP. NO. 1380, 94th Cong., 2d Sess. 65, reprinted in 1976 U.S. CODE CONG. & ADMIN. NEWS 3356, 3419 (1976). The Revenue Act of 1978 added the parenthetical phrase "directly or indirectly" that appears in present § 2036(b)(1). Revenue Act of 1978, Pub. L. No. 95-600, § 702(i), 92 Stat. 2763, 2931 (1978) (adding § 2036(b) and amending § 2036(a)).

34. See I.R.C. § 2036(b).

35. See S. REP. NO. 745, 95th Cong., 2d Sess. 91 (1978); see also Rev. Rul. 81-15, 1981-1 C.B. 457; Prop. Treas. Reg. § 20.2036-2(a), 48 Fed. Reg. 35,143 (1983) (inclusion not required under § 2036(b) unless donor has retained voting rights in the transferred stock). The proposed regulations interpret the "direct or indirect" language more broadly than suggested by the legislative history. See *id.* § 20.2036-2(e), -2(e)(4), ex. (3).

uity growth to the younger generation in the form of nonvoting common stock.³⁶

*Estate of Boykin v. Commissioner*³⁷ reaffirmed the limited scope of section 2036(a). In *Boykin*, the transferor transferred voting common stock to a family trust and retained only nonvoting preferred stock until his death. The preferred stock was entitled to a ten-to-one dividend preference as well as a substantial liquidation preference.³⁸ The common stock was not entitled to any dividend unless the corporation's board of directors certified that the corporation's net worth was sufficient to pay all dividends and satisfy the liquidation preference of the preferred stock.³⁹ The government analyzed the *Boykin* transaction as a bifurcation of the transferor's original proportionate interest into two separate property rights: (i) voting common stock representing the right to future growth, and (ii) nonvoting preferred stock representing nearly all of the dividends that the corporation would ever pay.⁴⁰

The Tax Court rejected the government's argument that the preferred stock's "disproportionate" right to share in future dividends meant that the preferred stockholders had retained "nearly all of the income" from—and thus the enjoyment of—the voting common stock transferred to the family trusts.⁴¹ It held that the only retained rights were those accorded to the preferred stock, which were "separate and distinct rights from the rights enjoyed by the [transferred] voting shares."⁴² In reaching this conclusion, the Tax

36. See Pedrick, *supra* note 31, at 718; see also *Chambers v. Commissioner*, 87 T.C. 225 (1986) (gift not rendered incomplete because of transferors' retained right to vote stock in fiduciary capacity).

37. 53 T.C.M. (CCH) 345 (1987).

38. *Id.* at 346.

39. *Id.* The preferred stock was callable at \$100 per share by majority vote of the corporation's board of directors. *Id.*

40. See Tech. Adv. Mem. 85-04-011 (Oct. 1, 1984).

41. *Estate of Boykin*, 53 T.C.M. (CCH) at 347-48.

42. *Id.* at 348. The court distinguished two earlier cases advanced to support the government's argument that the decedent had retained an interest in the transferred stock. See *Estate of Cooper v. Commissioner*, 74 T.C. 1373 (1980) (retained-interest coupons from bearer bonds transferred to trust for grandchildren); *Overton v. Commissioner*, 6 T.C. 304 (1946), *aff'd*, 162 F.2d 155 (2d Cir. 1947) (creation of two classes of stock was a mere device to shift income between related parties); see also *Chambers v. Commissioner*, 87 T.C. 225, 234-36 (1986) (rejecting the government's argument that amounts designated as dividends on nonvoting common stock were in fact attributable to voting common stock).

Court noted that shareholders generally have no legal right to a share of corporate earnings or assets until declaration of a dividend or dissolution of the corporation.⁴³ It also indicated that the fiduciary duties of the preferred stockholders as trustees of the family trusts and as directors of the corporation limited their ability to pay an unreasonable dividend to themselves.⁴⁴ In a footnote, the Tax Court indicated that the real issue was not whether the common stock should be included in the decedent's gross estate under section 2036(a), but rather how the preferred stock, concededly includible under section 2033, should be valued.⁴⁵ The government's argument that creation of the preferred stock in effect stripped the common stock of much of its value might indicate that the value of the preferred shares accounted for the "bulk of the value of [the corporation's] equity."⁴⁶

The underlying problem in *Boykin* was the understatement of the value of the voting common stock (and the corresponding overstatement of the value of the nonvoting preferred stock) at the time of the initial recapitalization. The liquidation value of the preferred stock was capped at \$15,000,000, even though the net worth of the company was only approximately \$4,000,000 when the recapitalization occurred in 1969.⁴⁷ According to the company's board of directors, the net asset value of the company did not reach \$15,000,000 until 1978, after the company successfully renegotiated an important timber contract.⁴⁸ The high liquidation premium and ten-to-one dividend preference were intended to offset a discount in the value of the preferred stock because it lacked cumulative dividend rights. Indeed, the shareholders rejected an earlier recapitalization plan providing for a fixed dividend preference because the company would have lacked the cash to pay market rate cumulative dividends.⁴⁹ Despite the open ended nature of the

43. *Estate of Boykin*, 53 T.C.M. (CCH) at 348.

44. *Id.* at 349.

45. *Id.* at n.7.

46. *Id.* The court suggested that parties resolve valuation disputes by settlement because "[l]itigation is an inefficient, wasteful, and inherently imprecise method of resolving valuation disputes." *Id.*

47. See Reply Brief for Respondent at 7, *Estate of Boykin* (No. 38554-84).

48. *Id.* at 6.

49. See Brief for Petitioner at 17-18, *Estate of Boykin* (No. 38554-84).

preferred stockholders' formal dividend rights, the minimal dividends that the company actually paid indicated that the company never intended to pay a market rate of return on the preferred stock.⁵⁰ The recapitalization in *Boykin* thus allowed the transferor to dispose of the potential growth of the common stock at a negligible gift tax cost while retaining control over the dividends actually paid on the preferred stock.⁵¹

D. Periodic Gifts

In addition to the estate tax issues raised by retained control over transferred property, a gift tax problem exists relating to the ongoing, periodic transfer of value made possible by the transferor's retained control. In *Dickman v. Commissioner*,⁵² the Supreme Court held that an interest-free demand loan gave rise to periodic deemed gifts, on the theory that the gift tax encompasses "all transfers of property and property *rights* having significant value."⁵³ Under a narrow reading of *Dickman*, deemed gift treatment may be limited to situations in which the measure of the gift can be determined by reference to an objective external standard.⁵⁴ An expansive reading of *Dickman*, however, raises the possibility that preferred stockholders' periodic waiver of dividend rights, or failure to exercise conversion rights, may result in deemed gifts to common stockholders.⁵⁵

When a controlling shareholder periodically waives the right to receive annual noncumulative dividends on preferred stock, the waiver increases indirectly the value of the common stock held by other shareholders. The Internal Revenue Service has held that a

50. See *id.* at 85; *Estate of Boykin*, 53 T.C.M. (CCH) at 347.

51. The common stock was apparently reported for gift tax purposes as representing an equity investment of only \$40,000 in 1969. The government did not challenge the value reported on the gift tax return. See Reply Brief for Petitioner at 16-17, *Estate of Boykin* (No. 38554-84).

52. 465 U.S. 330 (1984).

53. *Id.* at 334. In response to *Dickman*, Congress enacted a specific statutory provision dealing with below-market loans. See I.R.C. § 7872.

54. *Dickman*, 465 U.S. at 344 n.14 ("[T]o support a gift tax . . . it is sufficient . . . to establish that a certain yield could readily be secured and that the reasonable value of the use of the funds can be reliably ascertained."); see *id.* at 350 (Powell, J., dissenting) (noting uncertainty that majority opinion would create in other situations).

55. See Nelson & Genz, *supra* note 4, at 1005-10.

shareholder who forgoes an economic opportunity to receive an adequate yield on preferred stock in a closely held business makes a taxable gift to the extent of the forgone dividend.⁵⁶ Under the Service's view, even bona fide business reasons for such nonpayment of a noncumulative dividend are ineffective to prevent deemed gift treatment if the company could adequately protect the preferred stockholder's rights by other means, such as declaring an unpaid dividend or issuing a corporate note in lieu of an actual cash payment.⁵⁷ Unless a waiver primarily benefits related family members, however, it does not result in a taxable gift if prompted by valid business considerations.⁵⁸

The Service also has held that a preferred stockholder's periodic failure to exercise conversion rights operates to divert corporate earnings to common stockholders and triggers annual taxable gifts.⁵⁹ By failing to protect his right to an adequate share of corporate earnings, the preferred stockholder increases indirectly the value of the transferred common stock. By analogy to *Dickman*, the Service indicated that (i) the increase in the value of the common stock was a legally recognized interest, (ii) the transfer was gratuitous, and (iii) the transfer represented a significant sum. In addition, the Service noted that the preferred stockholder failed to receive the high yield typically associated with preferred stock.

The economic distinctions between a conversion right and a below-market loan, however, make it difficult to determine whether failure to exercise a conversion right gives rise to a taxable gift and, if so, the timing and value of such a gift.⁶⁰ By analogy to a below-market lender, the preferred stockholder arguably makes his capital available for the benefit of the common stockholders for less than full and adequate consideration. By contrast, the preferred stockholder cannot exercise the conversion right without some loss of security and liquidity. The additional risk associated

56. Tech. Adv. Mem. 87-23-007 (Feb. 18, 1987) (taxable gifts to trusts for the benefit of waiving shareholder's grandchildren).

57. *Id.*

58. See Rev. Rul. 67-14, 1967-1 C.B. 591; see also Priv. Ltr. Rul. 89-31-063 (May 11, 1989) (related parties must not receive more than 20% of total dividends distributed to nonwaiving shareholders).

59. Tech. Adv. Mem. 87-26-005 (Mar. 13, 1987).

60. See Nelson & Genz, *supra* note 4, at 1006.

with common stock would presumably deter some preferred stockholders from exercising conversion rights.⁶¹ The administrative difficulty of determining the timing and value of a deemed gift may be sufficient to prevent application of *Dickman*-type principles to the nonexercise of conversion rights.⁶²

E. Disappearing Value

Another problem raised by estate freezes involves the valuation of retained nonpecuniary rights that lapse at death. Such rights may be used to support a high value for property interests retained by the transferor (and a correspondingly low value for the transferred property) for gift tax purposes at the time of the lifetime transfer. When the rights lapse upon the transferor's death, however, the government is likely to face the argument that it should disregard the lapsed rights when valuing the retained interest for estate tax purposes. The government has sought to prevent the "disappearing value" from escaping transfer tax entirely. Case law has not reached a consensus concerning the appropriate standard for valuing property interests that are affected by the act of transfer or the holder's death.⁶³ It is unclear whether the transfer tax base is to be determined by reference to (i) the value of the interest in the hands of the transferor immediately before the transfer, (ii) the value of the interest in the hands of the transferee immediately after the transfer, or (iii) the greater or lesser of the first two alternatives.⁶⁴

Relying on cases such as *United States v. Land*,⁶⁵ the government has argued that the value attributable to lapsed voting rights should be includible in the decedent's gross estate because the retention of voting rights until the moment of death constitutes a

61. *Id.* at 1006-07.

62. See *Estate of Snyder v. Commissioner*, 93 T.C. No. 43 (1989) (failure to exercise conversion rights resulted in periodic constructive gifts; amount determined by reference to increase in net worth rather than imputed interest under *Dickman*).

63. See Dodge, *supra* note 3, at 253.

64. *Id.*

65. 303 F.2d 170 (5th Cir.), *cert. denied*, 371 U.S. 862 (1962). In an often cited but enigmatic passage, the Fifth Circuit noted that "[b]rief as is the instant of death, the court must pinpoint its valuation at this instant." *Id.* at 172. The court went on to observe that "valuation is determined by the interest that passes, and the value of the interest before or after death is pertinent only as it serves to indicate the value at death." *Id.*

"passive transfer" to the remaining shareholders.⁶⁶ If the passive transfer theory prevails in litigation, it may have quite different implications depending on whether the premise for estate tax inclusion is section 2033 or the retention provisions of section 2036. Under section 2033, the amount includible in the gross estate would be limited to the value of the preferred stock owned at the time of death, valued as a voting interest. If section 2036 applies, the post-transfer appreciation in the value of the transferred common stock would be drawn back into the decedent's gross estate as well. On its facts, at least one case has raised, but not resolved, the issue of whether disappearing voting rights should give rise to value includible in the gross estate under sections 2033 or 2036.⁶⁷

Recently, the Service held that a taxable gift occurred in a recapitalization when a controlling shareholder exchanged his voting common stock for a new class of common stock with voting rights that would terminate at his death.⁶⁸ The Service viewed the recapitalization as shifting part of the value of the controlling shareholder's stock to the remaining outstanding stock held by a generation-skipping trust.⁶⁹ This view seems inconsistent with the Service's earlier position that the value attributable to lifetime voting rights should be included in the decedent's gross estate.⁷⁰ Presumably, if the shift in value attributable to the lifetime voting rights is measured and taxed as a completed gift at the time of the recapitalization, those voting rights should be disregarded in valuing the shareholder's stock for estate tax purposes. The gift tax payable on a deemed lifetime transfer may be significantly less

66. Tech. Adv. Mem. 84-01-006 (Sept. 28, 1983) (value attributable to expiring voting rights of preferred stock includible under § 2033; alternative holding that value of the transferred stock includible under § 2036(a)); see Gen. Couns. Mem. 39,140 (Sept. 6, 1983) (recommending a published ruling indicating that § 2036(b) requires inclusion of voting rights that lapse at death in the transferor's gross estate).

67. *Benz v. Commissioner*, [1985 Transfer Binder] Tax Ct. Rep. (CCH) No. 33586-85; see Abbin, *Taking the Temperature*, *supra* note 4, at 7; see also Tech. Adv. Mem. 86-10-011 (Nov. 15, 1985) and Tech. Adv. Mem. 85-10-002 (Nov. 26, 1984) (discussing issues raised in *Benz*).

68. Rev. Rul. 89-3, 1989-2 I.R.B. 5; see Gen. Couns. Mem. 39,784 (Mar. 1, 1989).

69. Gen. Couns. Mem. 39,784 (Mar. 1, 1989); see I.R.C. § 2601 (imposing generation-skipping tax). The transfer did not trigger any immediate generation-skipping transfer tax consequences because a nonskip person (the controlling shareholder's son) owned an income interest in the trust. See I.R.C. §§ 2613, 2652(c).

70. See *supra* notes 65-67 and accompanying text.

than the estate tax that would be payable if the value of the stock at death included the value of the voting rights.

The problem of disappearing value attributable to voting rights also arises when a controlling shareholder fragments his controlling block of shares into several minority blocks and transfers the less valuable minority blocks to various family members. If the minority blocks are not viewed as related portions of a controlling block, the control premium attributable to the family's aggregate stock holdings may escape transfer tax altogether. Recognizing this possibility, the Service has held that a control premium may be attributed to shares of a closely held family corporation when an individual family member owns more than 50% of the voting stock.⁷¹ Several cases cited by the Service illustrate the potential abuses arising from the ability to fragment a single valuable property interest into several less valuable parts that may be transferred at various times, at minimal transfer tax cost, and subsequently recombined into their more valuable configurations.⁷² According to the Service, these cases "require a transferor's gift to be measured by the value of property relinquished by the donor rather than the value of the property acquired by the donee."⁷³ Because the donor originally owned a controlling interest, the gift tax would be imposed upon the value of the stock as a controlling interest in the donor's hands rather than upon its value as a minority interest in the donee's hands.⁷⁴

If the transfer tax is defined by reference to the diminution in the transferor's wealth caused by a transfer, the value of the property in the transferor's hands is generally a better measure than

71. Tech. Adv. Mem. 89-07-002 (Nov. 1, 1988) (redemption triggered gift of "corporate equity" to remaining shareholders); see Rev. Rul. 81-253, 1981-2 C.B. 187 (simultaneous transfer of one-third interests in all of the stock of a closely held corporation to three children; children could exercise control over the corporation only by acting jointly).

72. See, e.g., *Citizens Bank & Trust Co. v. Commissioner*, 839 F.2d 1249 (7th Cir. 1988); *Estate of Curry v. United States*, 706 F.2d 1424 (7th Cir. 1983); *Ahmanson Found. v. United States*, 674 F.2d 761 (9th Cir. 1981); *Estate of Chenoweth v. Commissioner*, 88 T.C. 1577 (1987).

73. Tech. Adv. Mem. 89-07-002 (Nov. 1, 1988).

74. The Service indicated that although Rev. Rul. 81-253 reaches the correct result, it rests on the faulty assumption that the value for gift tax purposes of a minority interest in family held stock is the fair market value of the stock in the hands of the donee. *Id.*

the value in the transferee's hands.⁷⁵ Alternatively, a transfer tax base defined by reference to the greater of the value of the property in the hands of either the transferor or the transferee may be justified by revenue considerations as well as the need to prevent artificially low valuations of property interests transferred during life or at death. The problem of disappearing value is analytically distinguishable from changes that affect the total value of property in the hands of both the transferor and the transferee.⁷⁶ Valuation rules that sanction temporary artificial reductions in the value of assets encourage transactions with no independent economic benefit.

F. Partnership Freeze

As an estate-freeze vehicle, partnerships offer unrivaled flexibility at the cost of a corresponding increase in complexity.⁷⁷ In a typical partnership freeze, the holder of a "frozen" partnership interest is entitled to receive a fixed annual return and a liquidation preference equal to the value of his original capital contribution. The holders of the other interests are entitled to any additional income as well as any capital appreciation in the contributed property.⁷⁸ In theory, no gift should occur on formation of a partnership as long as the value of the frozen partnership interest is at least equal to that of the contributed property. Under an entity view, a partner's retention of an indirect ownership interest in the partnership assets should not trigger section 2036(a).⁷⁹ If the initial contribution of property exchanged for a partnership interest is treated as a partial gift, however, section 2036(a) may require inclusion in the gross estate of the contributed property to the extent

75. See Cooper, *supra* note 2, at 226-28.

76. *Citizens Bank & Trust Co.*, 839 F.2d at 1255 (pre-transfer restrictions intended merely to depress artificially the value of property transferred to long term family trusts). But see *Estate of Hall v. Commissioner*, 92 T.C. 312, 337 (1989) (transfer restrictions served valid purpose of keeping company private).

77. See Nelson, *supra* note 5, at 13 ("Of all the vehicles for avoiding transfer tax on shifts of future appreciation, the partnership is the most flexible, the most complex, and the least understood by tax planners and representatives of the fisc.").

78. *Id.* at 16; see Kalb & Massey, *supra* note 5, § 44.02, at 44-3 to 44-9.

79. See, e.g., Harmon, *Should Partnership Interests Gifted in Multi-Level Freeze Be Included in the Donor's Gross Estate Under Section 2036?*, 64 TAXES 741, 745 (1986) (entity versus aggregate approach); see also *infra* notes 101-07 and accompanying text.

that its fair market value at the partner's death exceeds the consideration received in the initial exchange.⁸⁰ Although valuation of partnership freeze interests has received relatively little attention from the Service and the courts, valuation principles developed in the analogous context of corporate freezes provide a useful starting point.⁸¹

1. *Liquidation Rights*

If a general partner's liquidation right disappears at death, it is unclear whether the full liquidation value of his pro rata share of partnership property is includible in his gross estate under section 2033.⁸² In *Estate of Harrison v. Commissioner*,⁸³ the Tax Court rejected the government's contention that the disappearing value attributable to conversion of a general partner's right into a mere equitable interest at death constituted an indirect transfer includible in the decedent's gross estate.⁸⁴ The case involved a limited partnership formed by a father and his two sons. In exchange for a contribution of approximately \$59,000,000, the father received a 1% general partnership interest and a 77.8% limited partnership interest. Each of the two sons contributed approximately \$8,000,000 of property to the partnership in exchange for 10.6% general partnership interests.⁸⁵ The father, who was seriously ill, had previously executed a power of attorney authorizing one son to manage his assets, including the assets transferred to the limited partnership.⁸⁶ The assets held by the partnership consisted primarily of real estate, oil and gas interests, and marketable securities.

Under the partnership agreement, each general partner, but not the limited partner, had a right during life to dissolve the partner-

80. Under certain circumstances, a gift may also trigger application of the family partnership rules of § 704(e). See *infra* notes 327-33 and accompanying text.

81. See Elias, *supra* note 5, at 64-65; Nelson, *supra* note 5, at 46-50.

82. The value of a general partnership interest is seldom less than a pro rata share of the partnership's assets because a general partner could cause a dissolution or liquidation of the partnership. See *Harwood v. Commissioner*, 82 T.C. 239 (1984). But see *Estate of Watts v. Commissioner*, 823 F.2d 483 (11th Cir. 1987) (discussing value of limited partnership interest in which liquidation right terminated at death).

83. 52 T.C.M. (CCH) 1306 (1987).

84. *Id.* at 1309.

85. *Id.* at 1307.

86. *Id.*

ship. The partnership was to be dissolved on the death of a general partner unless all other general partners agreed within ninety days to continue the partnership. The partnership agreement also gave the remaining general partners the right to purchase the deceased partner's general partnership interest. When the father died five months after the formation of the partnership, the sons exercised their option to purchase the father's general partnership interest for approximately \$750,000 and agreed to continue the partnership.⁸⁷ The sole issue before the court was the estate tax value of the father's limited partnership interest. The government argued for a value of approximately \$59,000,000, and the estate argued that the value should be discounted to approximately \$33,000,000.⁸⁸ The parties stipulated that the nearly \$26,000,000 discount was attributable to the father's unexercised right to dissolve the partnership prior to his death.⁸⁹

The government contended that the Tax Court should disregard the dissolution provisions of the partnership agreement as "an attempt to artificially depress the value of decedent's property for estate tax purposes."⁹⁰ According to the government, the formation of the partnership represented a mere fragmentation of the father's property rights with no effect on the total value of the property transferred to the partnership.⁹¹ As general partners and their father's successors in interest, the sons possessed the same power to dissolve the partnership and receive the full liquidation value of the father's limited partnership interest after his death as the father had possessed during life.⁹²

The court concluded, however, that the father's limited partnership interest was correctly valued without regard to his lifetime right to dissolve the partnership because that right expired at death.⁹³ The court indicated that it would ignore the partnership

87. *Id.*

88. *Id.* at 1308.

89. *Id.*

90. Brief for Respondent at 38A, *Estate of Harrison* (No. 19980-84).

91. *Id.* (noting that "[t]he decedent's sons will ultimately succeed to the entire interest which the decedent possessed in the partnership prior to his death").

92. *Id.* at 38A-38B.

93. *Estate of Harrison*, 52 T.C.M. (CCH) at 1308-09. The court found that the argument that "something of value" passed to the sons was inconsistent with the government's stipulation that the value of the sons' interests was the same (i) immediately before the dece-

agreement "only if there is no business purpose for the creation of the partnership or if the agreement is merely a substitute for testamentary disposition."⁹⁴ It found an adequate business purpose for formation of the partnership because the partnership's purpose was to manage and conserve the father's assets during his illness.⁹⁵ Because a willing buyer could have purchased only a limited partnership interest with no power of dissolution, the court accepted the taxpayer's valuation of the father's limited partnership interest, in effect allowing a \$26,000,000 discount for lack of liquidity and control.⁹⁶ The court also rejected the government's argument that the father's initial transfer of property to the partnership was without adequate consideration, noting that none of the general partners reserved a power of dissolution exercisable by their respective successors in interest after death.⁹⁷

The court's assumption that the power of dissolution had the same value in the case of the father's partnership interest as in the case of the sons' partnership interests is questionable. Because of the father's advanced age and ill health, the lifetime limitation on his ability to dissolve the partnership reduced the value of his partnership interest more than the similar limitation on his sons' interests. Arguably, the initial formation of the partnership gave rise to a taxable gift from the father to the sons because of the disparate effects of the limitations on their respective interests.

2. *Capital shift*

The partnership freeze may be enhanced through special allocations of income and deductions to shift both capital and unrealized appreciation from the frozen partner's interest to the other partners' interests.⁹⁸ In a partnership capital shift, disproportionate

dent's death, (ii) at the moment of the decedent's death, and (iii) immediately after the decedent's death. *Id.* at 1309.

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* Through this argument, the government sought to include the value of the property originally transferred to the partnership under the provisions of §§ 2035, 2036, 2038 and 2041.

98. See Kalb & Massey, *supra* note 5, § 44.02, at 44-9. Such allocations would be subject to the substantial economic effect test under § 704(b). See I.R.C. § 704(b) and regulations thereunder; see also Rev. Proc. 88-51, 1988-2 C.B. 711 (revoking the Service's no-ruling pol-

loss allocations and cash flow distributions in excess of taxable income reduce the frozen partner's capital account balance.⁹⁹ Conversely, the partnership's net taxable income retained in the partnership increases the other partners' capital account balances. Because a partner's capital account balance at the time of liquidation generally equals the amount distributable to him, a portion of the original equity attributable to the frozen partner's interest in effect shifts to the other partners. The result of a partnership capital shift is thus similar to a bargain sale of the frozen partner's interest to the other partners.¹⁰⁰

Recently, the Service attacked a partnership capital shift on the grounds that (i) the transferor retained the right to income from the contributed property, and (ii) the transferor received less than adequate and full consideration in exchange for his partnership contribution.¹⁰¹ A father contributed ranching property with a stated value of \$1,725,000 to a limited partnership in exchange for a general partnership interest. His two adult children contributed \$5,000 each for limited partnership interests. The father was entitled to a special allocation of partnership income equal to at least the "net cash receipts attributable to the rental of capital assets," as well as any additional net cash receipts, until he recovered his capital contribution.¹⁰² The partnership agreement also allocated 99% of partnership capital losses and 90% of all other losses to the father. Although the property the father contributed had appreciated to nearly \$6,000,000 when the father died, his partnership interest was valued at less than \$2,000,000.

The Service held that by reserving the right to rental payments from the ranching property, the partnership's only capital asset, the father had retained an income right under section 2036(a).¹⁰³

icy with respect to special allocations for the purpose of freezing the value of a partner's partnership interest).

99. A partner's capital account is generally credited with the cash and the fair market value of property contributed in exchange for a partnership interest. It is increased by additional capital contributions and the partner's share of partnership income, and decreased by distributions and the partner's share of partnership losses. See Treas. Reg. § 1.704-1(b)(2)(iv)(b).

100. See Kalb & Massey, *supra* note 5, § 44.02, at 44-12.

101. Tech. Adv. Mem. 88-21-005 (Feb. 22, 1988).

102. *Id.*

103. *Id.*

The Service distinguished *Boykin* and *Harrison* on the ground that a "direct relationship [existed] between the decedent's retained right to receive the rent and the transferred rental property."¹⁰⁴ The Service then considered whether the father had received adequate and full consideration in money or money's worth for his contribution to the partnership. Without making a factual determination of the fair market value of the father's partnership interest at the time of the original transfer, the Service stated that "a determination of the rights attributable to the [father's partnership] interest (and whether the rights are reducible to a money value as consideration in money or money's worth) is a question of law."¹⁰⁵

To determine the nature of the consideration received, the Service looked at the specific rights attributable to the father's interest under the partnership agreement. Neither the father's reserved right to rental payments nor the potential allocation of tax losses was "reducible to an adequate and full equivalent of a money value."¹⁰⁶ Finally, the Service indicated that the father's interest was subject to a "buy-out" under the partnership agreement because the special allocation of losses and excess income distributions would gradually reduce his capital account to zero. For estate and gift tax purposes, the Service refused to assign any value to the buy-out arrangement because it did not represent consideration in money or money's worth.¹⁰⁷

The Service's position, if upheld, would severely restrict the partnership freeze technique. In a typical partnership freeze, a major portion of the value of the frozen partner's interest consists of a preferred return on property contributed to the partnership. As a practical matter, it would be virtually impossible to meet the "adequate and full consideration" standard of section 2036(a) if the value of the preferred return were disregarded. Thus, the Service's approach would almost automatically require inclusion of the contributed property under section 2036(a) whenever the preferred return could be traced to the contributed property. Moreover, the

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

initial exchange would give rise to a taxable gift equal to the excess in value of the contributed property over the partnership interest received by the senior generation. To the extent that the frozen partner actually receives a preferred return, it seems inappropriate to disregard the preferred return when valuing the frozen interest. The Service's position seems more justifiable, however, as a response to the abusive technique of disproportionate loss allocations that shift capital from the senior generation to the younger generation outside the transfer tax base.

II. CONGRESSIONAL RESPONSE: OPERATION OF SECTION 2036(c)

A. Overview

Section 2036(c) was originally included in the revenue-raising proposals of the Joint Committee on Taxation.¹⁰⁸ The House version was considerably simpler and more straightforward than the statutory provision ultimately enacted in the 1987 Act.¹⁰⁹ Under the House version, property transferred during life subject to a retained interest would have been drawn back into the transferor's gross estate if the transferred property, "appreciation property," represented a disproportionately large share of the potential appreciation. As amended by the Conference Committee, section 2036(c) required inclusion for estate tax purposes only if the transferor held the retained interest at death, or transferred it within three years of death in conformity with the three-year rule applicable to section 2036 generally.¹¹⁰ Thus, section 2036(c) could be avoided by a transfer of the retained interest more than three

108. See STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., DESCRIPTION OF POSSIBLE OPTIONS TO INCREASE REVENUES 266 (1987) (noting that "[t]he parent's estate could include the full value of property which is effectively subject to the retained life interest (i.e., the common stock as well as the preferred stock, in the recapitalization case . . ."); see also Schlenger & Canning, *supra* note 7, at 117-18 (discussing legislative history of § 2036(c)).

109. The House version of § 2036(c)(1) provided: "In general. — If (A) any person holds a substantial interest in an enterprise, and (B) such person in effect transfers a disproportionate share of the potential appreciation in the enterprise, then the transferred property shall be included in his gross estate." H.R. 3545, 100th Cong., 1st Sess. § 10108 (1987); see 1987 HOUSE REPORT, *supra* note 8, at 1044.

110. As originally enacted in 1987, § 2036(c)(4) provided: "Coordination with section 2035.— For purposes of applying section 2035, any transfer of the retained interest . . . shall be treated as a transfer of an interest in the transferred property" Arguably,

years before death.¹¹¹ The statute applied only to estates of persons dying after December 31, 1987, and to transfers made after December 17, 1987.¹¹² The 1988 Act repealed the three-year rule and essentially reinstated the broader reinclusion rule originally contained in the House bill.¹¹³

According to the 1988 House Report, section 2036(c) addresses two concerns: (i) the creation or transfer of disproportionate interests in a business or other property that permits the transfer of wealth outside the transfer tax system and (ii) the retention of a disproportionate share of the income of, or rights in, an enterprise in which the transferor "in fact retains enjoyment of the whole enterprise."¹¹⁴ The legislative history indicates that a disproportionate transfer of business interests may permit the transmission of wealth to escape transfer taxes because of undervaluation of the transferred property at the time of the initial transfer, or because of the exercise or nonexercise of retained rights subsequent to the initial transfer.¹¹⁵ In addition to the valuation problems, Congress was concerned that a transfer with retained enjoyment until death was a substitute for a testamentary transfer and therefore should be drawn back into the transferor's gross estate.¹¹⁶

The 1988 Act sought to conform section 2036(c) more closely to its underlying purpose by foreclosing numerous "loopholes," expanding the scope of covered transactions, and adding safe harbors for certain retained interests.¹¹⁷ It also granted the Treasury broad regulatory authority to implement the purposes of section 2036(c) and deter circumvention "through distributions or otherwise."¹¹⁸

§ 2036(c)(4) was redundant because § 2035 already applied to § 2036 transfers. See I.R.C. § 2035(d)(2).

111. *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1437. A sale of the retained interest for its full fair market value within three years of death would not avoid reinclusion. See *United States v. Allen*, 293 F.2d 916, 917-18 (10th Cir. 1961); 1987 CONFERENCE REPORT, *supra* note 8, at 995 n.1.

112. See 1987 Act, § 10402(b), 101 Stat. at 1330-432 (as amended by the 1988 Act, § 3031, 102 Stat. at 3634).

113. See *infra* notes 256-91 and accompanying text.

114. See 1988 HOUSE REPORT, *supra* note 9, at 422-23.

115. *Id.* at 422.

116. *Id.* at 423.

117. See *infra* notes 211-91 and accompanying text.

118. I.R.C. § 2036(c)(8).

The Treasury's regulatory authority is especially far-reaching because the statute uses numerous undefined or ambiguous terms.

B. Statutory Terms

Section 2036(c) applies if a person holding a "substantial interest" in an "enterprise" transfers a disproportionately large share of the potential appreciation while retaining an income interest or rights in the enterprise.¹¹⁹ The term "enterprise," as used in the legislative history, "includes a business or other property which may produce income or gain."¹²⁰ Under the interpretation adopted by the Service, an enterprise generally includes any "arrangement" that has "significant business or investment aspects" in light of the particular facts and circumstances involved.¹²¹ These definitions could potentially embrace almost any activity relating to property held for personal use as well as business or investment property. The Service has acknowledged, however, that an arrangement involving exclusively "personal use property,"¹²² such as a life insurance contract or a principal residence, will ordinarily be presumed not to constitute an enterprise.¹²³ The Service has also indicated that a person will not be treated as owning an interest in an enterprise based on "incidental or tangential" involvement in another person's business or investment activities. For example, the Service does not intend to treat a person who provides property or services to a family member in the ordinary course of business or in a nominal amount as a transferor under section 2036(c).¹²⁴

119. *Id.* § 2036(c)(1).

120. 1987 CONFERENCE REPORT, *supra* note 8, at 996.

121. I.R.S. Notice, *supra* note 11, at 7. The relevant factors include (i) the capacity to produce income or gain, (ii) the form of organization, (iii) prior business or investment use of the property, and (iv) the property's investment potential. *Id.*

122. Personal use property is property "substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212." I.R.C. § 1275(b)(3).

123. The presumption is conclusive if the arrangement involves exclusively property (including a "reasonably appropriate" amount of adjacent land) to be used as the principal residence of the transferor or transferee, or a contract that qualifies as life insurance under § 7702 of the Code. In the case of other kinds of personal use property, the presumption may be rebutted if the personal use aspects of the arrangement are subordinate to significant business or investment aspects. I.R.S. Notice, *supra* note 11, at 7 & n.17, exs. 3-8.

124. *Id.* at 6; see I.R.C. § 2036(c)(7)(A)(ii) (exception for arm's length transactions).

A person holds a "substantial interest" only if he owns, directly or indirectly, 10% or more of the "voting power" or "income stream" in the enterprise. The terms "voting power" and "income stream" are not defined in the statute.¹²⁵ For purposes of the substantial interest test, a person owns any interest owned directly or indirectly by family members.¹²⁶ The statute defines the term "family" to include an individual's spouse, descendants, spouse's descendants, parents, grandparents, and any spouses of the foregoing. The term does not include siblings.¹²⁷ Under the Service's attribution rules, any interest in the voting power or income stream that is owned by an entity other than a trust or estate is generally treated as owned proportionately by the owners of the corresponding interests in the entity. Special rules apply to interests owned by trusts and estates.¹²⁸ The Service has indicated that it will consider adopting safe harbor exceptions for transactions in which the substantial interest test is satisfied but the presence of unrelated parties with widely held interests diminishes the risk of a disproportionate transfer.¹²⁹

The transfer requirement is satisfied if the transferor, "in effect," transfers a "disproportionately large share" of the potential appreciation of his interest in the enterprise.¹³⁰ The legislative history indicates that a transfer "encompasses, but is not limited to, all transactions whereby property is passed to or conferred upon another, regardless of the means or device employed."¹³¹ The "in

125. See *infra* notes 136-40.

126. I.R.C. § 2036(c)(3)(A).

127. *Id.* § 2036(c)(3)(B). The definition of family is not affected by the spousal unity rule of § 2036(c)(3)(C). I.R.S. Notice, *supra* note 11, at 8.

128. I.R.S. Notice, *supra* note 11, at 8. In the case of interests owned by a trust, any interest in the income stream is treated as owned by the beneficiaries to the maximum extent of their respective actual or potential shares of trust income or principal, and any voting power is treated as owned by the transferor to the extent such power is exercisable (other than in a fiduciary capacity) alone or in conjunction with any other person, by the transferor or a family member. Interests owned by an estate are treated as owned by the beneficiaries in proportion to their respective beneficial interests. *Id.* at exs. 9-12.

129. *Id.* at n.19 (transaction in which unrelated parties who receive the same treatment as related parties own more than 50% of the voting power and value of an enterprise).

130. I.R.C. § 2036(c)(1)(B); see *infra* notes 142-44 and accompanying text.

131. 1987 CONFERENCE REPORT, *supra* note 8, at 996. The Service has reiterated that a transfer includes "any agreement, arrangement, transaction, act [or] failure to act." I.R.S. Notice, *supra* note 11, at 9.

effect" language is intended to encompass indirect transfers, including recapitalizations, stock issuances, and changes in the form of existing businesses. Section 2036(c) does not specify whether the enterprise, or the transferor's interest therein, must be in existence at or before the time of the transfer.¹³² In response to the argument that contributions of property to a newly formed enterprise fall outside the literal terms of the statute, the Service has interpreted the statute to require only that the substantial interest "exist at the time of the transfer."¹³³ Moreover, the Service has taken the view that an enterprise may exist even though "the specifics of its business or investment aspects remain undefined."¹³⁴ Regardless of the sequence of formal steps, a transferor's contribution of property to a newly formed enterprise could almost certainly be brought within the ambit of section 2036(c) by recasting the transaction as an exchange of a fractional undivided interest in the enterprise for a disproportionate interest in the income or rights in the enterprise.¹³⁵

Section 2036(c) applies only if the transferor retains an interest in "the income of, or rights in, the enterprise."¹³⁶ A transferor is deemed to have retained an interest in income or rights if he "has arranged to receive the income or exercise the rights, whether or not such arrangement is legally enforceable."¹³⁷ The Conference Committee Report indicates that the term "rights" includes "voting rights, conversion rights, liquidation rights, warrants, options, and other rights of value."¹³⁸ The Service has clarified, however, that the term "rights" does not include rights to serve exclusively

132. The House version of the 1988 Act would have "clarified" the substantial interest test to provide that the transferor must hold a substantial interest in the enterprise either before or after the transfer. The Conference Committee, however, followed the Senate version that left the substantial interest test unchanged. *See* 1988 HOUSE REPORT, *supra* note 9, at 424; 1988 CONFERENCE REPORT, *supra* note 9, at 74.

133. I.R.S. Notice, *supra* note 11, at 10 n.24.

134. *Id.* at 7. "Thus, an arrangement that contemplates the conduct of an undefined business activity or the purchase of unidentified property for investment may be an enterprise." *Id.*

135. *See id.* at 10, ex. 16 (split-interest purchase of securities).

136. I.R.C. § 2036(c)(1)(B).

137. I.R.S. Notice, *supra* note 11, at 10-11.

138. 1987 CONFERENCE REPORT, *supra* note 8, at 996.

in an agency or other fiduciary capacity.¹³⁹ A retained income interest may encompass, subject to certain exceptions, a preferred equity interest, a promissory note, a life or term interest, an employment or retirement agreement, or a sale or lease.¹⁴⁰ In determining the extent of the interests or rights retained by the transferor, interests or rights owned by an entity are attributed to the transferor to the extent of his proportionate interest in the entity. Forthcoming regulations will prescribe rules for determining the extent of such indirect ownership.¹⁴¹

C. *Disproportionality Requirement*

Prior to the 1988 Act, it was unclear whether the disproportionality requirement comprised two separate tests—one relating to the transferred property and the other relating to the retained interest—or a single test stated in two different ways.¹⁴² The 1988 Act “clarifies” the statute by deleting the disproportionality requirement with respect to the retained interest, leaving the parallel requirement with respect to the transferred interest unchanged.¹⁴³ This change is intended to confirm that “granting a disproportionately large share of potential appreciation necessarily entails the retention of a disproportionately large share of income or other rights in the enterprise.”¹⁴⁴

To determine whether a transfer is disproportionate, the Service looks at whether the ratio of “appreciation” to “value” in the transferor’s interest immediately before the transfer is greater than the corresponding ratio immediately after the transfer.¹⁴⁵ The ap-

139. I.R.S. Notice, *supra* note 11, at 11, exs. 20-21 (voting power and management rights exercisable solely in fiduciary capacity).

140. *Id.*

141. *Id.*; cf. I.R.C. § 2036(c)(3)(A) (attribution only for purposes of the substantial interest test).

142. Former § 2036(c)(1)(B) required that the transferor transfer a disproportionately large share of the potential appreciation “while retaining a disproportionately large share in the income of, or rights in, the enterprise.” I.R.C. § 2036 (c)(1)(B) (West 1988) (current version at I.R.C. § 2036 (c)(1)(B)).

143. See I.R.C. § 2036(c)(1)(B). The 1988 Act described this change as a “clarification of the retention test.” 1988 Act, § 3031, 102 Stat. at 3634.

144. 1988 HOUSE REPORT, *supra* note 9, at 423.

145. The Service describes the disproportionality test in terms of two fractions:

The first [fraction] is the percentage share of the potential appreciation in the value of the enterprise attributable to the transferor’s interest before the trans-

preciation-to-value ratio is apparently calculated as a fraction in which the numerator equals the amount of potential appreciation in the transferor's interest divided by the amount of potential appreciation in the enterprise as a whole, and the denominator equals the value of the transferor's entire interest divided by the value of the transferor's entire pre-transfer interest.¹⁴⁶ If the pre-transfer ratio is greater than the post-transfer ratio, the Service considers the transferor to have transferred a disproportionately large share of the potential appreciation in his original interest in the enterprise.

For example, assume that A owns all of the outstanding stock of X corporation, consisting of 100 shares of preferred stock worth \$1 per share and 100 shares of common stock worth \$1 per share. The pre-transfer ratio is 100% $[(100/100)/(\$200/\$200)]$.¹⁴⁷ A transfers 10 shares of preferred stock and 50 shares of common stock to his son, B, and retains 90 shares of preferred stock and 50 shares of common stock. The post-transfer ratio is approximately 71% $[(50/100)/(\$140/\$200)]$. Because the appreciation-to-value ratio has decreased, A is considered to have transferred a disproportionately

fer over 100 percent (representing the value of the transferor's interest prior to the transfer). The second [fraction] is the percentage share of the potential appreciation in the value of the enterprise attributable to the transferor's interest after the transfer over the value of that interest (expressed as a percentage of the value of the transferor's interest immediately prior to the transfer). If the first fraction is larger than the second (i.e., if the ratio of appreciation to value is larger before the transfer than after the transfer), the transferor in effect has transferred a disproportionately large share of the potential appreciation in the value of his or her interest in the enterprise.

I.R.S. Notice, *supra* note 11, at 9; see 1988 HOUSE REPORT, *supra* note 9, at 427 n.120.

146. The Service's ratios can be expressed in algebraic terms as follows: The pre-transfer ratio of appreciation to value is equal to $a/100\%$, or $a/(x/x)$, where a represents the percentage value of the potential appreciation in the enterprise attributable to the transferor's pre-transfer interest and x represents the value of the entire pre-transfer interest. The post-transfer ratio is equal to $b/(y/x)$, where b represents the percentage value of the potential appreciation in the enterprise attributable to the transferor's post-transfer interest and y represents the value of the retained interest. Although the term "potential appreciation" is not defined in the statute, the Service determines potential appreciation "by reference to the rights that the transferor's interest carries with respect to any future increase in the value of the enterprise." I.R.S. Notice, *supra* note 11, at 9.

147. The numerator of the ratio, representing the transferor's percentage share of the potential appreciation in the enterprise, can be expressed either in terms of value or in terms of number of shares, assuming that common stock is viewed as appreciation property and preferred stock is viewed as income property.

large share of the potential appreciation in his original interest in X.¹⁴⁸

The same analysis apparently applies if the transferor originally owns less than all of the enterprise. For instance, in the previous example, assume that A originally owned only 80 out of 100 shares of preferred stock and 20 out of 100 shares of common stock, and that A transferred 60 shares of the preferred stock and 15 shares of the common stock, retaining 20 shares of the preferred stock and 5 shares of the common stock. Prior to the transfer, the ratio of appreciation to value in A's interest would be 20% $[(20/100)/(\$100/\$100)]$; after the transfer the ratio would still be 20% $[(5/100)/(\$25/\$100)]$.¹⁴⁹

By its terms, the disproportionality requirement could apply to a typical "common on common" recapitalization, in which the older generation transfers nonvoting common stock while retaining voting common stock. Although the voting and nonvoting stock may be entitled to the same value per share on liquidation, the nonvoting stock has more "leverage," and thus a higher rate of appreciation per share, because it is presumably less valuable than the voting stock.¹⁵⁰ Nevertheless, the Service has confirmed that section 2036(c) does not apply if the transferred and retained interests differ only with respect to voting rights.¹⁵¹ For this purpose, any appreciation in the transferred and retained interests is deemed to accrue in proportion to the respective values of the voting and nonvoting stock.¹⁵² Similarly, the distinction between a general and

148. Disproportionality can also be stated in terms of the difference between the reduction in value of A's preferred stock and the reduction in value of his common stock: Following the transfer, A owns 90% ($\$90/\100) of his original preferred stock, but only 50% ($\$50/\100) of his original common stock. A would have to transfer an additional 40 shares of preferred stock to maintain proportionality.

149. In order to maintain proportionality, A must transfer four shares of preferred stock for each share of common stock so that the ratio of appreciation to value in his retained interest will not decrease.

150. See, e.g., *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1428. The nonvoting stock has leverage, by contrast to the voting stock, to the extent that a ratable share of liquidation preference can be purchased at a discount reflecting the lack of voting power.

151. I.R.S. Notice, *supra* note 11, at 10. The Service reaches this result by assuming that the value of the voting stock should be determined as if the stock were to be sold prior to liquidation. This assumption may contradict the reasonably expected facts because closely held stock is often held until liquidation.

152. See *id.* at ex. 17.

limited partnership interest with respect to management rights is not sufficient by itself to trigger section 2036(c).¹⁵³

If the share of potential appreciation attributable to a particular interest is based on a formula containing variable factors or may otherwise shift over time, the Service requires that the ratio of potential appreciation to value "be determined by assuming specific circumstances."¹⁵⁴ This hypothetical test is applied by "assuming circumstances that maximize the share of potential appreciation attributable to the transferor's interest before the transfer and minimize the share of potential appreciation attributable to the transferor's interest after the transfer."¹⁵⁵ Accordingly, the disproportionality requirement is satisfied if "under any reasonably foreseeable circumstance" the transferor's share of potential appreciation would be disproportionately reduced as a result of the transfer.¹⁵⁶ Under the Service's approach, it will be extremely difficult to demonstrate that in no reasonably foreseeable circumstance would the transferor's share of potential appreciation be reduced as the result of the transfer.

In the case of a disproportionate transfer, if the transferor retains an interest in the enterprise, the transferor is generally treated as if he had retained "the enjoyment of the transferred property."¹⁵⁷ The statute does not provide any *de minimis* exception to the disproportionality rule. If an individual originally owns 100% of an enterprise, consisting of common stock valued at 99% of the total value of the enterprise and preferred stock valued at 1% of the total value of the enterprise, and transfers the common stock (but no preferred stock) in a disproportionate transfer, the

153. *Id.* at ex. 18.

154. *Id.* at 9 ("Because the rights of the various interests are determined by agreement between the holders of those interests, it is assumed that there is a reasonable possibility that any (but not necessarily all) events anticipated by the agreement may, in fact, occur.").

155. *Id.*

156. *Id.* Assume that A and B are two equal general partners and that the partnership agreement provides that gain on disposition of the partnership's property will be allocated 50% to A and 50% to B. If A and B amend the partnership agreement to provide instead that the first \$100X of gain is allocated to A, the second \$100X of gain is allocated to B, and any further gain above \$200X is allocated 25% to A and 75% to B, the Service's approach requires that the total gain on disposition will exceed \$200X. Because A's share of the potential appreciation falls below 50% if the total amount of gain exceeds \$200X, the transfer is considered to be disproportionate. *Id.* at ex. 14.

157. I.R.C. § 2036(c)(1).

common stock will apparently be drawn back into the transferor's gross estate at death. If a transfer is only partially disproportionate, however, only the disproportionate part of the transferred property is subject to section 2036(c). This point is illustrated by an example in the legislative history:

[I]f a person who owns a substantial interest in an enterprise and whose only holdings in the enterprise consist of 100 shares of common stock and 100 shares of preferred stock transfers 80 shares of the common stock and 20 shares of the preferred stock, only 60 shares of the transferred common stock are included in his estate¹⁵⁸

To reach the result illustrated by this simple example, the Service apparently applies a three-step method. First, it calculates an inclusion factor. The inclusion factor is equal to the excess of (i) the value of the income or rights in the retained interest divided by the value of the income or rights in the pre-transfer interest, over (ii) the value of the potential appreciation in the retained interest divided by the value of the potential appreciation in the pre-transfer interest.¹⁵⁹ Second, the Service multiplies the inclusion factor by the total value of the enterprise at the time of the transferor's death to determine a gross inclusion amount.¹⁶⁰ Third, the value of any retained income or rights counted in arriving at the gross inclusion amount is subtracted from that amount, leaving a net inclusion amount to be included in the gross estate under section 2036(c).¹⁶¹ As applied to the above example from the legisla-

158. 1987 CONFERENCE REPORT, *supra* note 8, at 996.

159. The inclusion factor can be expressed as $[(y - b)/(x - a)] - b/a$, in which x represents the value of the pre-transfer interest, y represents the value of the retained interest, a represents the value of the potential appreciation in the pre-transfer interest, and b represents the value of the potential appreciation in the retained interest. Presumably, any portion of the value of the enterprise or the transferor's interest that is not attributable to potential appreciation is attributable to income or rights. The inclusion factor represents "[t]he portion of the transferred appreciation that is disproportionately large," which is "determined with reference to the transferor's retained interest in the income of, or rights in, the enterprise." I.R.S. Notice, *supra* note 11, at 5.

160. The gross inclusion amount represents "the value of the portion of the enterprise that corresponds to the portion of the transferred appreciation that is disproportionately large." *Id.*

161. *Id.* The Service has stated:

To avoid inclusion of the same property under different sections of the Code, the value of the portion of the enterprise that is includible in the transferor's

tive history, the inclusion factor would be $(80/100 - 20/100)$, or 60%. Assuming that the value of each share of stock was \$1 at the time of the transfer, that the value of the preferred stock remains unchanged, and that the value of each share of common stock increases to \$2 by the time of the transferor's death (so that the total value of the enterprise is then \$300), the gross inclusion amount would be 60% of \$300, or \$180. The net inclusion amount, however, would be only \$120, reflecting a \$60 reduction for the value of the preferred stock included in the gross inclusion amount and independently includible in the transferor's gross estate under section 2033. Thus, the net inclusion amount should be equal to the value at the transferor's death of the 60 shares of common stock that constituted a disproportionate transfer of potential appreciation.

If the transferor originally owns less than all of the enterprise, however, the inclusion factor presumably should be applied only to the aggregate date-of-death value of the transferor's original interest; otherwise, the Service's three-step method would overstate the gross inclusion amount. For example, assume that corporation X has outstanding 50 shares of preferred stock (worth \$1 per share) and 100 shares of common stock (worth \$2 per share), and that A originally owns 40 shares of the preferred stock and 20 shares of the common stock. Assume further that A transfers 5 shares of preferred stock and 15 shares of common stock to a family member, retaining 35 shares of preferred stock and 5 shares of common stock. The transfer constitutes a disproportionate transfer with respect to a portion of the transferred common stock. After the transfer, A has retained 87.5% ($35/40$) of his original interest in the income property and 25% ($5/20$) of his original interest in the appreciation property. Assuming that the value of the enterprise as

estate under section 2036(c) is reduced to the extent that the value of the corresponding portion of the transferor's retained interest or rights is includible in the transferor's gross estate under section 2033.

Id.; see I.R.C. § 2036(c)(5) (adjustment for value of retained interest). The Service's method is apparently intended to give meaning to the statutory provision for "[a]ppropriate adjustments . . . for the value of the retained interest." *Id.* A simpler way to reach the intended result would be to multiply the inclusion factor by the aggregate date-of-death value of the appreciation property owned by the transferor immediately before the transfer. This would prevent the value of the nonappreciation property from entering into the calculation and avoid the need to subtract that value from the gross inclusion amount.

a whole is still \$250 at A's death, the combined value of A's original preferred and common stock at that time (\$80) will represent only 32% of the total value of the enterprise (\$250). The inclusion factor representing the excess percentage of the retained income property (62.5%) should accordingly be applied to 32% of the total date-of-death value of the enterprise, yielding a gross inclusion amount of \$50 ($62.5\% \times 32\% \times \250). This amount should be reduced by \$25 (representing the value of the preferred stock counted as part of the gross inclusion amount and independently includible in A's gross estate under section 2033), yielding a net inclusion amount of \$25.¹⁶² The net inclusion amount is equal to the value of the 12.5 shares of transferred common stock that constituted a disproportionate transfer of potential appreciation.¹⁶³

If the total value of the enterprise in the previous example increased to \$450 at A's death and the entire \$200 of appreciation were allocated to the common stock, the inclusion factor (62.5%) would be applied to 27% ($\$120/\450) of the value of the enterprise at A's death and the gross inclusion amount would be \$75.¹⁶⁴ The reduction for the retained preferred stock would still be \$25, yielding a net inclusion amount of \$50. This amount corresponds to the date-of-death value of the excess 12.5 shares of common stock.

162. One can determine the amount of the adjustment for the retained interest by multiplying the inclusion factor (62.5%) by the percentage of the nonappreciation property in the enterprise originally owned by A (40 of the 50 shares of preferred stock originally outstanding or 80%) and multiplying that product by the value of the nonappreciation property at the time of A's death (\$50).

163. This result can be verified by calculating the "excess" number of shares of transferred common stock as follows: A retained 87.5% ($35/40$) of his original preferred stock, and thus would have had to retain an equivalent percentage ($87.5\% \times 20$ shares or 17.5 shares) of his original common stock to avoid making a disproportionate transfer. Because A retained only 5 shares (rather than 17.5 shares) of common stock, the difference of 12.5 shares represents the excess amount of the transferred common stock.

164. The portion of the date-of-death value of the enterprise to which the inclusion factor applies is determined as follows: A originally owned 40 shares of preferred stock and 20 shares of common stock. The date-of-death value of those shares is the sum of \$40 (40 shares of preferred stock at \$1 per share) and \$80 (20 shares of common stock at \$4 per share), or \$120, which in turn represents 27% of the total date-of-death value of the enterprise.

D. Unitary Rule for Spouses

A special rule provides that an individual and spouse shall be treated as one person, except as otherwise provided in regulations.¹⁶⁵ This rule is intended to prevent an individual from manipulating the retention requirement of section 2036(c) by transferring appreciation property to a family member and simultaneously transferring the retained interest to a spouse.¹⁶⁶ The unitary rule for spouses could be read to require inclusion of the transferred property in the estate of the first spouse to die and again in the surviving spouse's estate.¹⁶⁷ To prevent double inclusion, the 1988 Act gives the Treasury regulatory authority to override the unitary rule in appropriate circumstances.¹⁶⁸

The Service has determined that the principal purpose of the unitary rule is to identify the spouse who is considered the transferor for purposes of section 2036(c).¹⁶⁹ Moreover, the Service has indicated that the unitary rule should be generally limited to non-taxable interspousal transfers, namely, transfers that qualify for the marital deduction or the annual exclusion. According to the Service, Congress believed that such transfers posed a greater potential for abuse than interspousal transfers that are fully subject to transfer tax. Based on these considerations, the Service has announced four operating rules for applying the unitary rule.¹⁷⁰

First, in the case of a lifetime interspousal transfer of all or an undivided portion of the retained interest or rights not subject to

165. I.R.C. § 2036(c)(3)(C).

166. See, e.g., *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1422. Under I.R.C. § 2036(c)(4), a deemed gift of the appreciation property occurs if the original transferor subsequently transfers the retained interest. See *infra* notes 256-68 and accompanying text. The Service has clarified, however, that a nontaxable interspousal transfer of the retained interest does not trigger a deemed gift of the appreciation property. See I.R.S. Notice, *supra* note 11, at 14-15.

167. For example, assume that H transfers preferred stock to W, H's spouse, and common stock to their child. If H and W are treated as a single individual, both the common stock and the preferred stock would be drawn back into H's gross estate at his death. Although the preferred stock transferred to W might qualify for the marital deduction, the common stock would be fully taxable in H's gross estate. At W's death, all of the stock would be fully taxable in her gross estate. The value of the common stock would thus be taxed once in H's estate and again in W's estate without any offset for the prior inclusion.

168. See I.R.C. § 2036(c)(3)(C); see also 1988 CONFERENCE REPORT, *supra* note 9, at 75.

169. I.R.S. Notice, *supra* note 11, at 14.

170. See *id.*

gift or estate tax, the transferee spouse is substituted as the transferor with respect to a corresponding portion of the appreciation property. Moreover, the interspousal transfer is not treated as a taxable event under section 2036(c), and the transaction is held "open" until the transferee spouse subsequently disposes of the retained interest.¹⁷¹ Second, in the case of a lifetime interspousal transfer of all or an undivided portion of the retained interest that is subject to estate or gift tax, the transfer results in a deemed termination of the original transferor's retained interest, triggering a taxable event under section 2036(c). The transaction is thus treated as "closed," and further application of section 2036(c) is precluded with respect to the retained interest in the transferee spouse's hands. Third, in the case of an interspousal transfer of a divided interest in the retained interest that results in both spouses' retaining interests or rights with respect to the same portion of the enterprise, the transferor spouse is treated as the owner of the retained interest for purposes of section 2036(c) until death.¹⁷² Fourth, the unitary rule generally does not require that section 2036(c) apply to a disproportionate transfer that occurs as a result of the transferor's death.

For purposes of these operating rules, an interspousal transfer generally is considered subject to transfer tax except to the extent that it is sheltered by the annual gift tax exclusion or the estate or gift tax marital deduction, or is for adequate and full consideration.¹⁷³ Under a special rule, an interspousal grant of a general power of appointment is treated as a "transfer subject to the transfer tax" if (i) the power, by its terms, lapses before the later of the ninetieth day after it is granted or the end of the calendar year in which it is granted; (ii) the power is not exercised to any extent during such period; and (iii) the lapse of the power is not treated to any extent as a taxable release under the "five or five" rule of

171. The transferee spouse ceases to be considered the transferor if the original transferor subsequently reacquires the retained interest in a nontaxable interspousal transfer. *See id.* at 14-15, ex. 30 (reacquisition restores transferor status).

172. At the transferor spouse's death, if the transferee spouse survives, either a taxable event or a shift in transferor status will occur, depending on the taxable or nontaxable nature of the original interspousal transfer. *Id.* at 15, ex. 38.

173. *Id.* at 14.

section 2514(e).¹⁷⁴ For example, assume that H transfers a portion of the retained interest to a trust, under the terms of which W, H's spouse, has a right to withdraw up to \$5,000 of any contribution within the current calendar year. If the special rule applies, the transfer to the trust will be treated as a taxable event under section 2036(c)(4) with respect to H, and W will not be treated as the original transferor with respect to any portion of the appreciation property.¹⁷⁵ In the absence of the special rule, the transfer to the trust would generally cause W to be substituted as the original transferor with respect to a portion of the appreciation property, triggering a taxable event under section 2036(c) upon disposition or termination of W's interest in the retained property.¹⁷⁶

The operating rules generally allow the parties considerable flexibility in treating one spouse or the other as the transferor and in controlling the timing of the taxable event for purposes of section 2036(c). Because a taxable interspousal transfer precludes further application of section 2036(c) with respect to the transferee spouse, any subsequent appreciation in the value of the enterprise attributable to the appreciation property will not be drawn back into the transferee spouse's estate. It is also possible to achieve a limited freeze for the surviving spouse's lifetime if the transferor spouse dies leaving preferred stock to the surviving spouse and common stock to the children.¹⁷⁷ According to the Service, the exception for transfers at death is appropriate because "such transfers present limited opportunities for the kinds of abuses that Congress had in mind when it enacted section 2036(c)."¹⁷⁸ The Service is considering regulations that would permit an election to terminate application of the unitary rule upon the original transferor's death.¹⁷⁹

174. *Id.*; see I.R.C. § 2514(e).

175. See I.R.S. Notice, *supra* note 11, at 15, ex. 37.

176. See *id.* at ex. 33.

177. See *id.* at ex. 39. *But cf. id.* at ex. 40 (right of transferee spouse, acting in nonfiduciary capacity, to allocate assets in residuary estate).

178. *Id.* at 14. The guidance warns, however, that this exception does not apply if the transferor's spouse is, in substance, the transferor. *Id.*

179. See *id.* Under this option, a deceased transferor's executor could elect to include in the transferor's gross estate the value of any appreciation property with respect to which the decedent's spouse would otherwise be substituted as transferor under the unitary rule. *Id.* For example, assume that the decedent made a lifetime transfer of common stock to a child and preferred stock to a spouse. The election would permit the executor to include the value

E. Proportional Exclusion for Consideration

No exception for bona fide sales applies to a transfer described in section 2036(c) if the transferee is a member of the transferor's family.¹⁸⁰ Thus, a sale to a family member of the appreciation property for adequate and full consideration will not prevent the appreciation property from being drawn back into the transferor's gross estate if the transferor retains a prohibited interest in the enterprise. If the transferor receives consideration for the transferred property, an offset is provided in determining the amount reincluded in the transferor's gross estate under section 2036(c).¹⁸¹ Moreover, if the initial transfer constitutes a taxable gift, the amount of the gift will be eliminated in computing the transferor's adjusted taxable gifts under section 2001(b), and the transferor will be allowed a credit for the gift tax previously paid.¹⁸² The transferor's estate also has a statutory right of recovery against the recipient of section 2036 property for a pro rata share of the federal estate tax.¹⁸³

Generally, the retained-interest provisions of sections 2036 through 2038 are intended to prevent a transferor from depleting his gross estate through an inter vivos transfer of property for in-

of the child's common stock in the decedent's gross estate, thereby terminating application of § 2036(c) with respect to the transferee spouse. *Id.*

180. I.R.C. § 2036(c)(2)(A). For this purpose, the transferor's "family" is defined in § 2036(c)(3)(B). In addition, the Service has indicated that this definition also includes "certain members of the transferor's spouse's family and any trust in which a member of the transferor's family holds a present or future beneficial interest (including an interest as an eligible recipient under a power of appointment held by a member of the transferor's family)." I.R.S. Notice, *supra* note 11, at 15.

181. I.R.C. § 2036(c)(2)(B); see *infra* notes 184-207 and accompanying text.

182. See I.R.C. § 2001(b) (defining cumulative transfer tax base to include the taxable estate and post-1976 taxable gifts other than those included in the taxable estate). This provision ensures that transfers subject to both gift and estate tax will ultimately be included in the transfer tax base at the date-of-death value. See *id.*

183. I.R.C. § 2207B(a). With respect to amounts includible "solely by reason of section 2036(c)," the right of recovery applies as if § 2207B(a) had been included in the 1987 Act. See 1988 Act, § 3031(h)(1), 102 Stat. at 3639. With respect to amounts includible under § 2036 "other than solely by reason of section 2036(c)," the right of recovery applies only with respect to transfers of property with a retained interest made after the date of enactment of the 1988 Act. *Id.* § 3031(h)(3), 102 Stat. at 3639. Unless the right of recovery is specifically waived, the estate's failure to enforce its recovery rights will apparently give rise to a taxable gift when such right of recovery ceases to be enforceable. See I.R.C. § 2207B(a)(2); see also *infra* notes 260-64 and accompanying text.

adequate consideration. Under the general rule of section 2036(a), however, an inter vivos transfer for adequate and full consideration is not drawn back into the transferor's gross estate. Because the transferred property is replaced by assets of equal value, the transaction is presumed not to have diminished the transferor's gross estate. The section 2036(a) exception for bona fide sales thus ensures that the transferor's gross estate will not be increased through an unwarranted inclusion of both the transferred property and the consideration that is a substitute for the transferred property. In the case of a transfer for partial consideration, section 2043 serves a similar function by allowing a partial offset to the value of the transferred property drawn back into the transferor's gross estate.

The treatment of consideration in a section 2036(c) transfer requires careful attention. Unless the amount includible under section 2036(c) is reduced or eliminated to the extent of any consideration received in the original transfer, the transferor will be overtaxed. As originally enacted, the statute provided that, in lieu of the consideration offset provisions of section 2043, "appropriate adjustments shall be made for the value of the retained interest."¹⁸⁴ Without additional clarification, this language was virtually unintelligible.¹⁸⁵ An example in the legislative history indicated that Congress intended to allow an adjustment at least to the extent of the consideration received on the initial transfer.¹⁸⁶ It was unclear, however, whether Congress intended the provision to permit compounding the consideration to reflect the full date-of-death value of such consideration or its proceeds in the transferor's gross estate. If compounding were not permitted, an intrafamily sale would be treated in effect more harshly than if the transferor had retained his entire interest in the enterprise until death. The proposed Senate amendment to section 2036(c) would have adopted rules similar to those of section 2043 and would have directed the Secretary of the Treasury to undertake a study concerning "the

184. Former § 2036(c)(5) provided: "Coordination with section 2043. — In lieu of applying section 2043, appropriate adjustments shall be made for the value of the retained interest." I.R.C. § 2036 (c)(5) (West 1988) (current version at I.R.C. § 2036(c)(5)).

185. See, e.g., *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1426-27; see also I.R.S. Notice, *supra* note 11, at 5-6.

186. 1987 CONFERENCE REPORT, *supra* note 8, at 997.

appropriate adjustment for consideration under 2036(c)."¹⁸⁷ The Conference Committee, however, established a new rule to determine the excludible portion of property transferred for partial consideration in an intrafamily sale.¹⁸⁸

Under the new rule, a portion of the enterprise's value is excluded from the transferor's gross estate under section 2036(c). The excluded amount is equal to the date-of-death value of the enterprise multiplied by an "applicable fraction," the numerator of which is the amount of the consideration received and the denominator of which is the total value of the retained and transferred interests immediately after the transfer.¹⁸⁹ This rule applies, however, only upon a showing that the person providing the consideration originally owned such consideration and never received or acquired it, directly or indirectly, from the transferor for less than adequate and full consideration in money or money's worth.¹⁹⁰ The requirement concerning the origin of the consideration was apparently modeled directly on the similar provision in section 2040(a).¹⁹¹

The Conference Report illustrates application of the new provision with an example in which a parent owns all of the common and preferred stock in a corporation worth \$2,000,000. If the parent sells the common stock to the child for \$1,000,000, which was not directly or indirectly received or acquired from the parent, and continues to hold the preferred stock until death, one half of the corporation's value will be includible in the parent's gross estate.¹⁹² At the parent's death, if the entire corporation is worth \$3,000,000 and the preferred stock is still worth \$1,000,000, the amount includible in the parent's estate under sections 2033 and 2036(c) will be \$1,500,000: \$1,000,000 of preferred stock and \$500,000 of common stock.¹⁹³ The remaining \$1,500,000 of common stock is exclud-

187. See 1988 CONFERENCE REPORT, *supra* note 9, at 73.

188. *Id.* at 76; see *infra* notes 189-208 and accompanying text.

189. See I.R.C. § 2036(c)(2)(B). The statutory language does not precisely track the intended result. See *infra* notes 194-95 and accompanying text.

190. See I.R.C. § 2036(c)(2)(B)(i)(II).

191. See I.R.C. § 2040(a) (relating to proportionate inclusion in the gross estate of jointly owned property with a right of survivorship).

192. 1988 CONFERENCE REPORT, *supra* note 9, at 76.

193. *Id.* (referring to certain adjustments for the value of the retained interest intended to prevent double inclusion).

ible from the parent's gross estate under the proportional exclusion rule.

Congress apparently intends the proportional exclusion rule to approximate the result that would have occurred in the absence of a disproportionate transfer if each class of stock shared equally in the appreciation of the enterprise as a whole. The example in the Conference Report, however, illustrates a result that may be difficult to reach under the literal language of the statute. The statute describes the denominator of the applicable fraction as the value of "the portion of the enterprise which would [otherwise] have been included in the gross estate of the transferor by reason of [section 2036(c)] (determined without regard to any reduction . . . for the value of the retained interest)" immediately after the transfer.¹⁹⁴ One might argue that only the value of the transferred interest is included under section 2036(c), while the value of the retained interest is technically included under section 2033. This reading of the statute would exclude the value of the retained interest from the denominator of the applicable fraction, producing a result quite different from that described in the Conference Report.¹⁹⁵

This interpretation of the statute seems untenable for two reasons. First, it ignores the parenthetical language indicating that the denominator of the applicable fraction is to be determined "without regard to any reduction . . . for the value of the retained interest."¹⁹⁶ Although the drafters apparently overlooked the technical distinction between section 2036(c) and section 2033 as the basis for including the retained interest in the gross estate, they evidently contemplated that the value of the retained interest would be included in the denominator of the applicable fraction. Second, a literal interpretation would reinstate in effect bona fide sale treatment for intrafamily transfers generally. Pending further guidance, the Service appears to interpret the ambiguous statutory

194. See I.R.C. § 2036(c)(2)(B).

195. In the Conference example, the applicable fraction would be 1/1 (\$1,000,000/\$1,000,000) based on this interpretation. The value of the common stock drawn back into the transferor's gross estate would then be zero, regardless of the total value of the common stock and preferred stock at the time of death. 1988 CONFERENCE REPORT, *supra* note 9, at 76.

196. I.R.C. § 2036(c)(2)(B)(i).

language as intended to accomplish the result described in the legislative history.¹⁹⁷

The statute gives the Treasury broad authority to issue regulations that specify when the consideration received will be presumed not to have been acquired or received from the original transferor.¹⁹⁸ The legislative history provides that such regulations, when issued, may require a higher standard of proof or raise a presumption linking consideration to prior gifts made by the transferor to the transferee within a certain period of time.¹⁹⁹ The Service has established a rebuttable presumption that consideration furnished by the transferee is derived from the transferor.²⁰⁰ To rebut this presumption, the transferor or his estate must establish to the Service's satisfaction that (i) the transferee at some time received sufficient property from sources other than the transferor to enable the transferee to accumulate such consideration, assuming only a reasonable rate of growth, and (ii) the transferee's ability to furnish such consideration was to no extent dependent on receipt of any property from the transferor during the three years immediately preceding the transfer.²⁰¹ For this purpose, "property acquired or received from the transferor" includes property derived from the transferor's spouse, and any proceeds, income or gain from property is traced to the same source as the underlying property.²⁰² Borrowed proceeds are treated as derived from the transferor only if they are (i) borrowed from the transferor under a below-market "gift loan" within the meaning of section 7872(f)(3), or (ii) borrowed from persons other than the transferor to the extent that the transferee's repayment obligation is guaranteed or collateralized by the transferor for less than adequate and full con-

197. Without expressly addressing the statutory ambiguity, the Service has reiterated that the denominator of the fraction is "the value of the portion of the enterprise that would have been includible in the transferor's gross estate under section 2036(c) had the transferor died immediately after the transfer, including the value of the retained interest." I.R.S. Notice, *supra* note 11, at 16.

198. See I.R.C. § 2036(c)(2)(B)(i)(II); see also 1988 CONFERENCE REPORT, *supra* note 9, at 76 ("The conferees intend that the Secretary of the Treasury promulgate regulations as are deemed appropriate . . .").

199. 1988 CONFERENCE REPORT, *supra* note 9, at 76.

200. I.R.S. Notice, *supra* note 11, at 16.

201. *Id.*

202. *Id.*

sideration.²⁰³ Any property originally acquired from the transferor for adequate and full consideration is deemed to be derived from the transferor only if the original consideration was itself derived from the transferor under the above rules.

In some ways, the requirements set forth in the guidance are relatively lenient. For example, gifts from grandparents are treated as derived from a source other than the transferor. Thus, if the transferor demonstrates that the transferee could have accumulated an amount equal to the consideration based on such prior gifts plus a reasonable return, no portion of the consideration will be treated as derived from the transferor.²⁰⁴ This favorable treatment assumes that the transferee did not receive any property from the transferor within the three-year period before the transfer. If the three-year rule is applicable, the transferor must also demonstrate that the transferee's financial ability to furnish such consideration was to no extent dependent upon such consideration. For example, assume that a transferee receives \$25 from the transferor within the three-year period and uses the cash to purchase Blackacre. If the fair market value of Blackacre is \$50 when the appreciation property is sold, \$50 of the consideration is presumed to be tainted because of the prior cash gift.²⁰⁵ The Service has provided one example of circumstances in which the presumption is considered conclusive.²⁰⁶ If money is considered fungible for these purposes, however, it may be difficult to show that the transferee's financial ability to furnish consideration was independent of the prior gift. Pending further clarification, a prudent transferor would avoid any gifts to the transferee within the three-year period.

If the standard of proof is not met, it remains unclear how the adjustment for consideration received will be determined. The statute specifically provides that the proportional exclusion rule takes the place of section 2043, but does not specify whether sec-

203. *Id.*

204. *Id.* at ex. 41.

205. *See id.* at ex. 43.

206. *See id.* at ex. 45. In the example, the transferee uses cash received from the transferor within the three-year period to satisfy a margin call. But for the cash, the transferee would have had to sell or encumber Blackacre to satisfy the margin call. Because the transferee uses Blackacre plus cash as consideration for the appreciation property, a portion of the consideration is considered tainted.

tion 2043 may apply if the new rule is inoperative in a particular case.²⁰⁷ If section 2043 applies in these situations, the adjustment is apparently limited to the value of the consideration received at the time of the original transfer. For example, if the appreciation property is sold to a nonfamily member for less than adequate and full consideration, the provisions of section 2043 may control because the proportional exclusion rule of section 2036(c) is inapplicable. A bargain sale to a nonfamily member may thus be treated more harshly for purposes of the consideration offset than a similar sale to a family member. This apparently inadvertent result is difficult to justify on policy grounds.

The statute contains new language requiring an appropriate adjustment for the "value of the retained interest, extraordinary distributions, and changes in the capital structure of the enterprise" occurring after the transfer that triggers section 2036(c).²⁰⁸ The statute also grants broad regulatory authority to the Treasury to prescribe regulations to carry out the purposes of section 2036(c) and to "prevent avoidance of its purposes through distributions or otherwise."²⁰⁹ For example, the regulations might treat distributions to the transferee as giving rise to a deemed gift if the distribution is substantially equivalent to a liquidation of the enterprise or would otherwise permit circumvention of the statutory purpose.²¹⁰

III. SCOPE OF SECTION 2036(c): CONTINUING UNCERTAINTIES

A. Overview

Prior to the 1988 Act, the estate planning bar advocated outright repeal of the statute,²¹¹ or at least considerable narrowing of its scope through more precise definitions of its vague and ambiguous terms.²¹² Instead of refining the positive scope of section 2036(c), the 1988 Act carved out safe harbor exceptions for certain kinds of transactions. This approach not only sidestepped several difficult

207. See I.R.C. § 2036(c)(2)(B)(iii).

208. See I.R.C. § 2036(c)(5).

209. 1988 HOUSE REPORT, *supra* note 9, at 421.

210. *Id.*

211. ABA RECOMMENDATION, *supra* note 10.

212. See Moore Statement, *supra* note 10.

policy issues, but also left continuing uncertainty about the application of section 2036(c) to transactions falling outside the safe harbors. In the 1988 Act, Congress also sought to tighten the operation of the statute to close perceived loopholes. The new rules concerning deemed gift treatment and terminations add considerable complexity to the original statute and significantly broaden its scope.

B. Safe Harbors

The original version of section 2036(c) gave rise to speculation that the term "income" might be interpreted to include interest on debt, compensation arrangements, director's fees, and intrafamily royalties or rents.²¹³ The 1988 Act addressed the retention of such nonequity rights only obliquely through safe harbor provisions for clearly nonabusive transactions. In light of the legislative history indicating that Congress intended no inference concerning the application of the statute to transactions falling outside the terms of the safe harbors,²¹⁴ some commentators suggested that the safe harbors should be disregarded in defining the positive scope of section 2036(c). The Service has rejected this view, stating that by "reasonable inference" the nonexclusive safe harbors "illustrate the types of arrangements that are within the scope of the statute."²¹⁵

1. Loans

The Service has indicated that, absent a specific safe harbor, a loan to a new or existing enterprise generally triggers a disproportionate transfer under section 2036(c). The disproportionality test is applied by "comparing the proportionate undivided share of ownership rights in the enterprise originating with such loan . . . with the share of each such right actually allocated to the trans-

213. See Dees, *supra* note 9, at 884.

214. See 1988 HOUSE REPORT, *supra* note 9, at 424.

215. I.R.S. Notice, *supra* note 11, at 5. The Service rejects the contrary argument because it "implies that Congress either did not know what it intended or added the exceptions as a meaningless appendage." *Id.* at n.2. If an arrangement is "similar in purpose and effect" to an arrangement covered by a statutory exception, the application of § 2036(c) depends on examination of all relevant facts and circumstances. *Id.* at 11.

feror.”²¹⁶ In determining the ratio of appreciation to value before the transfer, the lender is treated as if he had acquired an undivided fractional interest in the enterprise equal to the amount of the loan divided by the value of the enterprise including the loan.²¹⁷ This fraction is compared to the ratio of appreciation to value after the transfer based on the lender’s actual rights. For example, assume that A makes a loan of \$50 to a business worth \$100 before the loan. A is deemed to have acquired a one-third (\$50/\$150) share of the enterprise, or 33% of the potential appreciation and income. After the transfer, A has none of the potential appreciation because he has traded his one-third share of potential appreciation for an income interest.²¹⁸

Because a loan provides capital that may be used to generate future appreciation, the Service views loan transactions as raising valuation problems similar to those addressed generally by section 2036(c). In the family context, it is difficult to determine whether a loan bears an adequate rate of interest, taking into account the riskiness of the enterprise. Any safe harbor based on the applicable federal rate is likely to understate the interest rate that a third-party lender would require in an arm’s length transaction, because the applicable federal rate reflects the low-risk borrowing rate of the federal government. If the transferor receives a below-market rate of interest, the excess value attributable to the loan may be disproportionately shifted. Evidently, the Service considered the provisions of section 7872 concerning below-market intrafamily loans insufficient to safeguard against such disguised wealth transfers.

Congress created a safe harbor, however, for “qualified debt” meeting certain statutory requirements.²¹⁹ The legislative history explains that a safe harbor is appropriate because qualified debt is easily valued, provides limited opportunities for disguised wealth transfers, and does not constitute retained enjoyment of the enterprise.²²⁰ The primary importance of the safe harbor for qualified

216. *Id.* at 10.

217. The value of the enterprise is increased by the amount of the loan because any repayment obligation is ignored for purposes of this test. *Id.* at 9-10.

218. *See id.* at ex. 15 (capital contribution treated the same as a loan).

219. *See* I.R.C. § 2036(c)(7)(C).

220. *See* 1988 SENATE REPORT, *supra* note 9, at 527.

debt is apparently to permit an installment redemption of the senior generation's entire stock interest.²²¹ In the absence of such a safe harbor, an installment redemption might be treated as an "in effect" transfer to the nonredeeming family members, coupled with a retained interest. Although an installment redemption may thus avoid adverse estate tax consequences, the 1988 Act rendered certain installment sales of closely held business interests less attractive for income tax purposes.²²²

Qualified debt must constitute debt "within the generally accepted meaning of that term."²²³ Qualified debt must also provide for fixed payments on specified dates and must have a fixed maturity date not more than 15 years from the date of issue, or 30 years in the case of debt secured by real property.²²⁴ Although qualified debt must be paid generally on or before the fixed maturity date, this requirement does not apply if a business purpose exists for nonpayment of the debt, such as when immediate payment would reduce the holder's ability ultimately to collect the entire debt.²²⁵ The requirement that the loan be payable on one or more fixed dates does not apply to indebtedness payable on demand if such indebtedness is issued in return for cash to be used in meeting the normal business needs of the enterprise.²²⁶ The only amount permitted to be paid in addition to the principal of qualified debt is interest that (i) must be calculated at a fixed rate or a rate determined by reference to a specified market rate, and (ii) is payable

221. See I.R.C. § 302(b)(3), (c) (complete termination of shareholder's interest and waiver of family attribution rules, respectively).

222. See I.R.C. § 453A, as amended by the 1988 Act, § 5076, 102 Stat. at 3682 (imposing an interest charge for the deferred tax liability on certain installment sales); see also Bogdanski & Brown, *supra* note 9, at 1641 n.64. Under § 453(k), use of the installment method is not permitted for sales of publicly traded securities. I.R.C. § 453(k).

223. See 1988 HOUSE REPORT, *supra* note 9, at 424-25; see also, e.g., *Estate of Nixon v. United States*, 464 F.2d 394, 402-03 (5th Cir. 1972); *Liflans Corp. v. United States*, 390 F.2d 965, 968-69 (Ct. Cl. 1963); *Hambuechen v. Commissioner*, 43 T.C. 90, 101 (1964) (distinguishing bona fide debt from a capital contribution).

224. I.R.C. § 2036(c)(7)(C)(i)(II). The Service has indicated that the safe harbor does not apply to debt if the repayment term is "substantially in excess of that offered by commercial lenders for similar loans." I.R.S. Notice, *supra* note 11, at 12.

225. 1988 CONFERENCE REPORT, *supra* note 9, at 74. Debt is not disqualified merely because the obligor has a right to prepay the loan, but a self-cancelling note does not meet the requirements for the qualified debt safe harbor. I.R.S. Notice, *supra* note 11, at 12.

226. I.R.C. § 2036(c)(7)(C) (last sentence).

on fixed dates. In addition, qualified debt (i) may not be subordinated by its terms to the claims of general creditors, (ii) may not be convertible, and (iii) may not grant or restrict voting rights except in case of default.²²⁷

A separate safe harbor exists for "qualified startup debt."²²⁸ Although the statute does not specifically define the term "startup," the legislative history indicates that the requirements for qualified debt are relaxed in the case of startup debt because of the likelihood that appreciation in the enterprise's value will be attributable primarily to the entrepreneurial efforts of the younger generation transferee.²²⁹ Qualified startup debt must require unconditionally the payment of a sum certain in money and must be received in exchange for cash to be used in an enterprise involving an active trade or business.²³⁰ In addition, the obligor may not have transferred any noncash property (including goodwill but disregarding prior incidental transfers and transfers occurring within the ordinary course of business)²³¹ or have transferred customers or business opportunities at any time to the enterprise.²³² The obligor also may not hold any interest in the enterprise other than qualified startup debt, including an interest as an officer, director, or employee, at any time.²³³ Any person who would otherwise be considered an "original transferee" of appreciation property must also participate in the active management of the enterprise.²³⁴ Unlike the safe harbor for "qualified debt," the qualified startup debt provision does not impose a fixed maturity requirement, but is limited to active businesses.

227. I.R.C. § 2036(c)(7)(C)(ii)-(vi); see 1988 CONFERENCE REPORT, *supra* note 9, at 74.

228. I.R.C. § 2036(c)(7)(D).

229. See 1988 SENATE REPORT, *supra* note 9, at 528.

230. I.R.C. § 2036(c)(7)(D)(ii)(I)-(II).

231. The Service has acknowledged that neither prior incidental transfers nor transfers occurring in the ordinary course of business violate this requirement. Moreover, any transfer that occurs more than three years before acquisition of the startup debt is ignored in determining whether the requirements of the safe harbor are met. I.R.S. Notice, *supra* note 11, at 12.

232. I.R.C. § 2036(c)(7)(D)(ii)(III).

233. *Id.* at (IV).

234. *Id.* at (V). As defined in § 2032A(e)(12), "[t]he term 'active management' means the making of the management decisions of a business (other than the daily operating decisions)." *Id.* § 2032A(e)(12).

The Service has indicated that it intends to establish a safe harbor for certain preferred interests that generally meet requirements similar to those for qualified startup debt.²³⁵ To qualify for the Service's new safe harbor: (i) The preferred interest must be in a new enterprise, rather than in a continuation of or successor to an existing enterprise; (ii) the new enterprise must have been formed to conduct an active business; (iii) any person who would otherwise be considered an original transferee must also participate in the active management of the business; and (iv) the preferred interest must have rights and privileges that are analogous to those of straight debt.²³⁶ Moreover, the restrictions on prohibited transfers and the holding of other interests under the safe harbor for qualified startup debt also apply to the receipt of a preferred interest in such a new enterprise.²³⁷

2. Sales or leases; employment contracts

The statute also provides a safe harbor for rights under an arm's length contract for the sale or lease of property or provision of services, as long as the contract does not otherwise involve any change in interests in the enterprise.²³⁸ Payments under the contract may not be determined by reference to gross receipts, income, profits or similar items of the enterprise.²³⁹ In the case of services, this exception does not apply if the contract provides for services to be rendered over a period longer than three years after the date of the transfer, including extensions at the option of the service provider.²⁴⁰ If the arm's length requirement is not met because the

235. See I.R.S. Notice, *supra* note 11, at 12.

236. Generally, such a preferred interest must be entitled to a cumulative dividend with a fixed rate of return and have a right to a nonlapsing liquidation preference, including the right to accumulated dividends. In addition, it must be nonvoting and must not be redeemable for less than par plus accumulated dividends or convertible into nonqualifying stock. *Id.*

237. Such a preferred interest may, however, be held in conjunction with qualified startup debt. *Id.*

238. See I.R.C. § 2036(c)(7)(A)(ii). The requirement that the agreement not otherwise alter the interests in the enterprise is intended merely to preclude issuance of preferred stock and similar equity interests as compensation for entering into the agreement or providing services under the agreement. I.R.S. Notice, *supra* note 11, at 13.

239. I.R.C. § 2036(c)(7)(B)(ii).

240. *Id.* § 2036(c)(7)(B)(i). An employment agreement extending beyond the three-year term will nevertheless be treated as falling within the safe harbor if it is terminable by the

compensation for services is unreasonable, the retained income interest may cause section 2036(c) to apply.

3. *Options and buy-sell agreements*

A statutory safe harbor also exists for "[a]n option or other agreement to buy or sell property at the fair market value of such property as of the time the option is (or the rights under the agreement are) exercised."²⁴¹ An option, prior to its exercise by the holder, may be analogized to convertible preferred stock because the optionor retains rights equivalent to those of a preferred stockholder and the optionee receives any equity growth.²⁴² Under prior law, a person might grant an option to family members to acquire common stock at a formula price fixed at the time of grant.²⁴³ If the option was exercised prior to the transferor's death, the appreciation in the optioned stock escaped transfer tax. If the transferor died before exercising the option, the estate tax value of the optioned stock was limited to the option price, provided that the option agreement represented a "bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than adequate and full consideration."²⁴⁴ Under present section 2036(c), however, the value of the optioned stock is determined without regard to the option.

The fair market value requirement also applies to "other agreement[s] to buy or sell property,"²⁴⁵ including buy-sell agreements between family members. A buy-sell agreement represents a relatively inexpensive means of shifting future appreciation, but avoids the need to sacrifice control of the property during lifetime, in con-

employer at-will or for reasonable cause. For purposes of the safe harbor, a covenant not to compete is treated as an agreement to provide services. See I.R.S. Notice, *supra* note 11, at 13.

241. I.R.C. § 2036(c)(7)(A)(iii).

242. See, e.g., *Estate Freezes and IRC Sec 2036(c)*, *supra* note 7, at 1432-33.

243. See, e.g., *Dorn v. United States*, 828 F.2d 177 (3rd Cir. 1987); see also Rev. Rul. 80-186, 1980-2 C.B. 280 (gift tax value of an option must reflect appreciation potential).

244. Treas. Reg. § 20.2031-2(h).

245. I.R.C. § 2036(c)(7)(A)(iii); see 1988 HOUSE REPORT, *supra* note 9, at 427. Prior to the 1988 Act, the legislative history provided oblique support for the proposition that section 2036(c) did not encompass buy-sell agreements. See 1987 CONFERENCE REPORT, *supra* note 8, at 996 (section 2036(c) "only makes certain property includible in the estate; it does not affect the valuation of such property for estate tax purposes").

trast to an installment sale or private annuity arrangement.²⁴⁶ A buy-sell agreement based on a fixed or formula price also facilitates orderly succession of ownership in a family held business by establishing a funding mechanism, such as life insurance, for the buy-out price. Although a buy-sell agreement potentially freezes appreciation uniformly for all of the parties, it may provide disparate economic benefits if the parties have different actuarial life expectancies or if one of the parties is seriously ill.²⁴⁷ Under prior law, a buy-sell agreement that fixed the purchase price by reference to a dollar amount or formula was sufficient to limit the value included in the seller's gross estate to the stated purchase price if the fixed or formula price was reasonable at the outset and no substantial changes occurred in the nature of the business.²⁴⁸

If section 2036(c) applies, however, the fair market value of the decedent's stock will be determined for estate tax purposes without regard to any restrictions under the agreement.²⁴⁹ A strict reading of the statute raised concerns that the purchase price under the buy-sell agreement would have to be determined by appraisal of the value of property at the time of the sale. Recognizing that one of the primary purposes of a buy-sell agreement may be to "avoid the expense and administrative difficulties involved in an appraisal of the property," the Service has indicated that the purchase price may be determined by a formula that meets certain conditions.²⁵⁰ The formula must be based on "currently acceptable valuation techniques" that can be reasonably expected to approxi-

246. See Solberg, *Buy-Sell Agreements Can "Freeze" Asset Values and in Some Cases Make Them Disappear*, 59 TAXES 437 (1981).

247. The execution of a buy-sell agreement generally does not give rise to a taxable gift because the parties receive adequate and full consideration through their mutual promises. See Treas. Reg. § 25.2511-1(g)(1); see also *Estate of Littick v. Commissioner*, 31 T.C. 181, 188 (1958) (disregarding terminal illness of one of the parties). But see Tech. Adv. Mem. 87-10-004 (Nov. 21, 1986) (disregarding buy-sell agreement because of decedent's ill health and lack of mutuality).

248. See Treas. Reg. § 20.2031-2(h); see also *St. Louis County Bank v. United States*, 674 F.2d 1207, 1210 (8th Cir. 1982); *Estate of Hall v. Commissioner*, 92 T.C. 312, 334-35 (1989); *Bischoff v. Commissioner*, 69 T.C. 32, 39-42 (1977).

249. See 1988 HOUSE REPORT, *supra* note 9, at 427. As drafted, the statute could conceivably apply to a buy-sell agreement between unrelated parties subject to the exception for bona fide sales. See *infra* note 254 and accompanying text.

250. See I.R.S. Notice, *supra* note 11, at 13.

mate fair market value at the time of the sale.²⁵¹ A good faith buy-sell agreement will thus come within the safe harbor if it adopts a formula "generally recognized as suitable to the valuation of the type of property involved and acceptable in arm's length negotiations" at the time the buy-sell agreement is undertaken.²⁵² For example, a formula based on book value may be an acceptable valuation technique for valuing the incidental tangible property of a service business, but such a formula cannot be reasonably expected to approximate the fair market value of an enterprise involving real property held for investment purposes.²⁵³ For this purpose, a bona fide buy-sell agreement between persons who are not members of the same family will come within the safe harbor.²⁵⁴

C. *Deemed Gift Treatment*

The purpose of section 2036(c) as originally enacted was to backstop the estate tax by triggering inclusion in the decedent's gross estate of the date-of-death value of the transferred property if the transferor held the retained interest until death. Under the retention provisions generally, the rationale for estate tax inclusion is that a transfer with retained enjoyment of property is a substitute for a testamentary transfer. Because of the nontestamentary nature of the transfer, literal adherence to this purpose would render the retention provisions inoperative if the retained interest is transferred more than three years before death. The valuation difficulties addressed by section 2036(c), however, are distinct from the concern that a transfer with retained enjoyment is a substitute for a testamentary transfer. In order to backstop this valuation function, the 1988 version of section 2036(c) added a new deemed gift rule for inter vivos transfers of either the transferred or retained interests.²⁵⁵

251. *Id.*

252. *Id.*

253. *Id.* at exs. 26-27. The formula must also reflect reasonable standards for valuing goodwill. *See id.* at ex. 27.

254. *Id.* at 13.

255. I.R.C. § 2036(c)(4).

1. General

Under section 2036(c)(4), a subsequent transfer of either the transferred or retained interest may result in a proportionate deemed gift of the appreciation property at the time of such transfer.²⁵⁶ If section 2036(c)(4) applies, the original transferor is treated as making a gift of property at the time of the subsequent disposition in an amount equal to the "paragraph (1) inclusion": the amount that would have been drawn back into the original transferor's gross estate under section 2036(c) had he died at that time.²⁵⁷ The amount of the paragraph (1) inclusion is reduced by the amount, if any, of the taxable gift resulting from the initial disproportionate transfer of the appreciation property.²⁵⁸ Thus, the amount of the deemed gift will generally be equal to the growth in value of the appreciation property during the time between the initial disproportionate transfer and the deemed gift.²⁵⁹ The statute also specifically provides that the amount of the deemed gift will be reduced to reflect prior deemed gifts and any right of recovery under section 2207B.²⁶⁰

Unlike the right of recovery with respect to estate taxes paid, the transferor apparently may not waive the right of recovery with respect to gift taxes paid. The Conference Report indicates that the failure of the original transferor to enforce the right of recovery will result in a taxable gift when such right ceases to be enforceable.²⁶¹ The right of recovery runs against the "original transferee," defined as the person receiving property in a disproportionate transfer to which section 2036(c)(1) applies, or any member of the original transferor's family to whom such property is subsequently

256. *Id.* New § 2036(c)(4) should not be confused with the provision of the original statute bearing the same paragraph number but dealing with the three-year rule. See 1988 Act, § 3031(h)(2), 102 Stat. at 3639 (regarding effective date of amendment).

257. I.R.C. § 2036(c)(4)(A), (D)(iii). The "paragraph (1) inclusion" is determined without regard to §§ 2032 (alternate valuation date) and 2032A (special valuation rules for farmland and closely held business realty). *Id.* § 2036(c)(4)(D)(iii).

258. *Id.* This adjustment is necessary because § 2001(b) does not apply to "wash out" the prior gift.

259. See Miller, *supra* note 9, at 1337.

260. See I.R.C. § 2036(c)(4)(A).

261. See 1988 CONFERENCE REPORT, *supra* note 9, at 75; Prop. Treas. Reg. § 25.2207A-1(a), 49 Fed. Reg. 21363 (1984).

transferred.²⁶² The right of recovery converts the gift into a net gift by subtracting the amount of the gift tax from the value of the gift.²⁶³

The deemed gift treatment, coupled with the right of recovery for gift taxes paid, gives the original transferor the ability to trigger substantial gift tax liability on the part of the original transferee. For example, assume that A gives away all of the common stock to B, who is A's child, while retaining preferred stock. Under B's management, the company prospers and the value of the common stock increases greatly. If relations between A and B become strained, A can transfer his preferred stock to a third party, thereby triggering a deemed gift of the common stock to B, who must ultimately bear the gift tax liability.²⁶⁴

To the extent that a deemed gift occurs under section 2036(c)(4), the appreciation property will not be subject to inclusion in the original transferor's gross estate under sections 2036(a) or 2035(d)(2).²⁶⁵ The original transferor's gross estate will be increased, however, by the gift tax attributable to deemed gifts within three years of the original transferor's death.²⁶⁶ The deemed gift rule avoids difficult tracing problems when subsequent transfers occur,²⁶⁷ but may also trigger more burdensome tax consequences than if the retained interest were held until death. The lower effective transfer tax rates on deemed gifts may be outweighed by the loss of the section 1014 basis step-up for income

262. See I.R.C. §§ 2036(c)(4)(D)(ii), 2207B(b). If more than one original transferee exists, the deemed donee is presumably the original transferee, whose subsequent transfer of the appreciation property triggers § 2036(c)(4). The statutory approach is consistent with the underlying notion of treating the "section 2036(c)(4) transfer as the act which finally completes the gift of the original growth interest." Miller, *supra* note 9, at 1338 n.27.

263. If the right of recovery attributable to the gift tax exceeds the original transferor's basis in the property, the original transferor will recognize gain on the excess of the gift tax over his basis. See *Diedrich v. United States*, 457 U.S. 191, 199-200 (1982).

264. See Keydel, *supra* note 9, at 14. If A retains the preferred stock, B may be liable for a pro rata share of the estate taxes attributable to the transferred common stock at A's death, or at the death of A's spouse if A transfers the preferred stock to his spouse in a nontaxable transfer.

265. I.R.C. § 2036(c)(4)(B).

266. See *id.* § 2035(c); 1988 HOUSE REPORT, *supra* note 9, at 420.

267. See Lowndes & Stephens, *Identification of Property Subject to the Estate Tax*, 65 MICH. L. REV. 105, 138-41 (1966).

tax purposes and the unavailability of the estate tax provisions favoring closely held businesses.²⁶⁸

2. *Triggering events*

Deemed gift treatment may be triggered by three types of dispositions: (i) the original transferee's transfer of the appreciation property to a nonfamily member; (ii) the original transferor's transfer of the retained interest, other than to a spouse in a non-taxable transfer; or (iii) the original transferee's transfer of the appreciation property back to the original transferor. If the original transferee subsequently transfers the appreciation property to a member of the original transferor's family, other than the original transferor, deemed gift treatment is postponed until the property is retransferred to a person who is not a member of the original transferor's family.²⁶⁹ For example, if a parent transfers common stock to a child while retaining the preferred stock, and the child subsequently transfers the common stock to the transferor's grandchild, a deemed gift would occur only when the grandchild transfers the common stock to a nonfamily member.²⁷⁰

If a deemed gift occurs because the original transferee retransfers the appreciation property to the original transferor, the amount of the deemed gift is reduced by the excess of the fair market value of the transferred property over any consideration paid by the original transferor for such property.²⁷¹ This rule is intended to ensure that no deemed gift results to the extent that the returned property increases the original transferor's gross estate.²⁷² For example, assume that the original transferee transfers the appreciation property back to the original transferor for no consider-

268. See, e.g., I.R.C. § 6166 (permitting installment treatment of estate tax attributable to a closely held business); *id.* § 2032A (permitting valuation of farmland and closely held business realty at its use value); see also *id.* § 303 (permitting exchange treatment for a death-time redemption of certain closely held business interests).

269. See *id.* § 2036(c)(4)(A)(ii).

270. See 1988 HOUSE REPORT, *supra* note 9, at 420.

271. See I.R.C. § 2036(c)(4)(C).

272. See 1988 CONFERENCE REPORT, *supra* note 9, at 75. Technically, the deemed gift rule of § 2036(c)(4)(A) is phrased in terms of transfers to persons other than members of the original transferor's family. A subsequent transfer of the appreciation property to the original transferor might thus appear to be outside the deemed gift rule but for the specific rule of § 2036(c)(4)(C).

ation. Although the retransfer would trigger a deemed gift under section 2036(c)(4), the amount of the deemed gift would be zero.²⁷³

If the original transferor or original transferee transfers only a portion of either the retained or transferred interests, only a proportionate amount of the value of the appreciation property is subject to deemed gift treatment. The value of the remaining portion of the appreciation property continues to be subject to inclusion in the original transferor's gross estate. For example, assume that an individual transfers all of his common stock to a family member, while retaining all of the preferred stock. A subsequent transfer of one half of the preferred stock will trigger a deemed gift of one half of the value of the common stock at the time of the transfer.²⁷⁴ Only the value of the remaining half of the common stock will be includible in the transferor's gross estate under section 2036(c).

3. *Restoration of proportionality*

A subsequent transfer of the retained interest gives rise to deemed gift treatment only to the extent that the subsequent transfer restores proportionality.²⁷⁵ For example, assume that an individual owning 80% of the common and preferred stock of a corporation initially transfers 40% of the common stock, and subsequently transfers half of his remaining common stock and half of his preferred stock. The subsequent transfer of 40% of the preferred stock apparently restores proportionality with respect to the 40% of the common stock previously transferred, thus triggering a deemed gift equal to 40% of the value of the common stock, less the amount reported as a gift at the time of the original transfer and any right of recovery. The additional 20% of the common stock, however, would be includible in the transferor's gross estate at its value as of the time of the transferor's death.

The operation of the proportionality rule is less certain if the transfer of the preferred stock precedes the transfer of the common stock. In the above example, assume instead that the trans-

273. See Miller, *supra* note 9, at 1337.

274. See 1988 HOUSE REPORT, *supra* note 9, at 419.

275. *Id.* Technically, this result is reached under the statute by limiting the amount of the deemed gift to the "paragraph (1) inclusion (or proportionate amount thereof)." See I.R.C. § 2036(c)(4)(A)(ii).

feror initially transfers 40% of the preferred stock and subsequently transfers 60% of the common stock. Assuming one views the transfers in the aggregate, the result should be the same as in the previous example because the transferor has merely "postponed" the freeze. Accordingly, only 20% of the common stock should be drawn back into the transferor's gross estate. If one disregards the prior transfer of the preferred stock, however, 60% of the common stock would be drawn back under section 2036(c). Until Congress amends the statute to address this situation, the regulations should provide clarification to avoid disparate treatment arising from the order of transfers.²⁷⁶

The legislative history also indicates that deemed gift treatment applies only if a subsequent transfer "restores proportionality with respect to all classes of interests that gave rise to the application of section 2036(c)."²⁷⁷ For example, if the transferor gives away all of the common stock, while retaining two classes of preferred stock, a deemed gift will result only to the extent that the transferor subsequently transfers a proportionate amount of each class of preferred stock. According to the example in the legislative history, a subsequent transfer of 25% of one class and 75% of the other class of preferred stock would result in a deemed gift of only the 25% of the common stock with respect to which proportionality was restored.²⁷⁸ The example does not indicate why the two classes of preferred stock cannot be combined in appropriate circumstances to determine the portion of the common stock subject to deemed gift treatment. For example, if the two classes of preferred stock were equal in value and dividend rights, then the subsequent transfer would in effect remove 50% of the total retained interest and could be reasonably treated as triggering a deemed gift of 50% of the common stock under section 2036(c)(4).

D. Terminations and Lapses

The 1988 Act provides that terminations, lapses or other changes in any interest in the enterprise "shall be treated as transfers,"

276. See, e.g., *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1440.

277. 1988 HOUSE REPORT, *supra* note 9, at 419.

278. *Id.* at 419-20.

triggering application of section 2036(c)(4).²⁷⁹ This provision is intended to cure the gap in the statute as originally enacted in cases in which the original transferor's interest terminates or lapses more than three years before death.²⁸⁰ For example, the older generation might transfer common stock to the younger generation while retaining convertible preferred stock that, by its terms, would be automatically converted after ten years into common stock equal in value to the preferred stock.²⁸¹ If the transferor survived beyond the ten-year period, the original version of section 2036(c) apparently became inoperative.²⁸² Alternatively, the older generation could transfer a limited partnership interest to the younger generation while retaining a general partnership interest. If the partnership agreement provided that the partnership would terminate at the end of ten years, the value of the limited partnership interest would not be includible in the transferor's gross estate if he survived the ten-year period.

The treatment of terminations and lapses as transfers expands considerably the scope of the original statute. Although the statute is silent concerning partial terminations, the legislative history indicates that "[w]here the termination occurs gradually over time, the deemed gift occurs when the interest completely terminates."²⁸³ In the case of a debt obligation, for example, the deemed gift would occur when debt is fully retired, rather than as each payment is made.²⁸⁴ The regulations should clarify that a similar rule applies when a preferred shareholder has a right to convert preferred stock into common stock. They should treat the conversion as a termination of the retained interest and disregard the failure of the preferred shareholder to exercise the conversion privilege in any prior year.²⁸⁵ By analogy, if a person transfers a part-

279. I.R.C. § 2036(c)(4)(D)(iv).

280. See *supra* notes 110-11 and accompanying text.

281. See, e.g., *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1442.

282. If the transferor died within three years after termination of the retained interest, it was unclear whether § 2036(c) was applicable. Arguably, the termination would not constitute a "transfer" of the retained interest for purposes of the three-year rule. See *id.* at 1438.

283. 1988 HOUSE REPORT, *supra* note 9, at 420.

284. See *id.*

285. See *id.* Nonexercise of a conversion privilege or waiver of noncumulative dividend payments will merely increase the value of the common stock that is likely to be includible in the transferor's gross estate.

nership interest with a disproportionate right to appreciation, a deemed gift should occur to the extent that a partnership "flip" causes a shift in partnership allocations that restores proportionality.²⁸⁶ If the original transferor or transferee retains a direct or indirect interest in the transferred property, deemed gift treatment is inapplicable.²⁸⁷ The original transferor thus cannot accelerate the taxable event, for example, by transferring the retained interest to a wholly owned holding company.²⁸⁸

For property transferred before December 18, 1987, the 1988 Act clarifies that for purposes of section 2036(c) no subsequent transfer will be treated as having occurred because of any failure to exercise conversion or other rights, or because of any failure to pay dividends.²⁸⁹ This provision reinforces the grandfather treatment for transfers prior to December 18, 1987, under the original statute, but does not preclude periodic imputed gift treatment under *Dickman* principles. If a pre-December 18, 1987, freeze is left in place, any additional subsequent transfer of an interest in the enterprise may be subject to section 2036(c).²⁹⁰ In addition, the transitional rules in the 1988 Act provide for a "correction period," from December 18, 1987, through December 31, 1989, for remedying any transaction that would otherwise be subject to section 2036(c).²⁹¹

286. *Id.*

287. See I.R.C. § 2036(c)(4)(E).

288. See 1988 HOUSE REPORT, *supra* note 9, at 421. If the holding company is wholly owned by the original transferee, the transfer would trigger application of § 2036(c)(4) because the original transferor has severed his direct ownership. See *id.*

289. See 1988 Act, § 3031(h)(5), 102 Stat. at 3640 (regarding effective dates).

290. See Dees, *supra* note 9, at 886. If a transfer occurs after December 17, 1987, the method of measuring preexisting interests for purposes of the disproportionality test is unclear. See *Estate Freezes and IRC Sec. 2036(c)*, *supra* note 7, at 1439-40.

291. See 1988 Act, § 3031(h)(4), 102 Stat. at 3639:

CORRECTION PERIOD.—If section 2036(c)(1) of the 1986 Code would (but for this paragraph) apply to any interest arising from a transaction entered into during the period beginning after December 17, 1987, and ending before January 1, 1990, such section shall not apply to such interest if—

(A) during such period, such actions are taken as are necessary to have such section 2036(c)(1) not apply to such transaction (and any such interest), or

(B) the original transferor and his spouse on January 1, 1990 (or, if earlier, the date of the original transferor's death), do not hold any interest in the enterprise involved.

Id.; see also I.R.S. Notice, *supra* note 11, at 16.

E. Other Estate Planning Techniques

The Service has confirmed that section 2036(c) may apply to a wide range of estate planning techniques, including sales of remainder interests, split-interest purchases, grantor retained income trusts (GRITs), private annuities and installment sales. Although the Service's announcement clarifies the operation of the statute in some of these areas, numerous issues remain unresolved.

1. Remainder-interest sales

Prior to enactment of section 2036(c), a sale of a remainder interest for less than adequate and full consideration triggered inclusion under section 2036(a).²⁹² Although Congress did not amend section 2036(a), sales of remainder interests are now apparently governed by the more specific provisions of section 2036(c), which treat a transaction of this kind as a disproportionate transfer because it eliminates the transferor's right to potential appreciation. The transferred interest not only has a disproportionate potential for appreciation, but will appreciate by virtue of the mere passage of time. Under the original version of section 2036(c), a technical argument might have precluded operation of the statute, however, because the income interest terminated at the transferor's death. The present statute cures this technical problem by providing that a deemed gift will result when the income interest expires. Even though the actuarial value of the remainder interest increases steadily with the passage of time, no deemed gift will occur until the remainder vests.²⁹³

2. Split-interest purchases

The Service has also taken the position that section 2036(c) applies to split-interest purchases, contrary to the view of some com-

292. Notwithstanding some case law to the contrary, the adequacy of the consideration received should be measured against the discounted present value of the remainder interest, not the value of the entire property. See Dodge, *supra* note 3, at 283-84; Lane, *supra* note 7, at 301; see also Comment, *Gradow v. United States: Death of Remainder Interest Sale As An Estate Freezing Technique*, 8 Va. Tax Rev. 183 (1988); cf. *Gradow v. Commissioner*, 11 Cl. Ct. 808 (1987).

293. See 1988 HOUSE REPORT, *supra* note 9, at 420.

mentators.²⁹⁴ Split-interest purchases were attractive under prior law because taxpayers could manipulate the Treasury tables for valuing partial interests.²⁹⁵ Use of the Treasury tables to value partial interests is permitted, even if the expected yield is lower than the applicable discount rate reflected in the tables.²⁹⁶ Valuation of the respective term and remainder interests under the tables understates the value of the term interest whenever the market rate exceeds the table rate, and vice versa. If the property funded by the split-interest purchase produces current income at less than the table rate, the difference between the table rate and the yield will be reflected in disproportionate appreciation in the remainder interest that escapes the transfer tax base.²⁹⁷ Valuation tables offer an open invitation to exploitation by ingenious estate planners.²⁹⁸

The House amendment would have applied specifically to a split-interest purchase if, after the purchase, the parent owned 10% or more of the voting power or income stream of the property.²⁹⁹ Under the Service's interpretation of the substantial interest test, however, this requirement need be met only at the moment of transfer. Moreover, an agreement that contemplates the purchase of unidentified investment property may constitute an

294. See, e.g., Fuller & Strauss, *Split Purchases May Still Be Viable After RA '87 and TAMRA*, 70 J. TAX'N 22 (1989).

295. The Treasury tables, based on an assumed 10% discount rate, are contained in Treas. Reg. § 25.2512-5(f). The 1988 Act requires monthly adjustment of the table rate. See I.R.C. § 7520 (requiring interest rate equal to 120% of the federal mid-term rate for the month that includes the valuation date). The applicable factor for valuing a remainder interest based on a term of years is equal to $1/(1 + i)^t$, in which i equals 120% of the applicable federal rate and t equals the number of years in the term. I.R.S. Notice 89-24, 1989-10 I.R.B. 16; see Hastings, *The Treasury Department Valuation Tables: How They Work and How to Make Them Work for You*, 46 INST. ON FED. TAX'N ch. 53 (1988).

296. See, e.g., Priv. Ltr. Rul. 87-17-051 (Jan. 28, 1987) (donor retained right to make the property productive). But see Priv. Ltr. Rul. 86-42-028 (July 16, 1986) (donor lacked power to compel investment of principal at reasonable yield).

297. An appropriate income tax rule would partially eliminate the advantages of split-interest purchases by treating receipt of the remainder interest as a realization event. See Dodge, *supra* note 3, at 288-92; Lane, *supra* note 7, at 307-13; see also Blum, *Amortization of a Retained Terminable Interest After Transfer of a Remainder*, 62 TAXES 211 (1984); Kwall, *The Income Tax Consequences of Sales of Present Interests and Future Interests: Distinguishing Time from Space*, 49 OHIO ST. L.J. 1 (1988).

298. See, e.g., Oshins, *GRITS, Splits and Tidbits*, TR. & EST., Mar. 1987, at 28, 44-46.

299. See 1988 HOUSE REPORT, *supra* note 9, at 424. As the House Report noted, "the concerns underlying section 2036(c) do not depend on whether the substantial interest exists before or after the effective transfer." *Id.*

enterprise.³⁰⁰ The Service's guidance illustrates these principles in the context of an agreement between a parent and child to purchase a portfolio of securities for investment.³⁰¹ The securities are purchased through a brokerage account in which the parent has a life estate and the child has a remainder interest. The parent and child furnish consideration of \$75 and \$25, respectively, equal to the fair market value of their interests. In the example, the Service concludes that, "[t]hrough the implementation of the agreement," the parent has in effect transferred an interest in 75% of the potential appreciation in the securities in exchange for the child's 25% interest in the income from the securities. Accordingly, the parent has made a disproportionate transfer because the parent's share of the potential appreciation is greater before the transfer (100%/100%) than after (0%/100%).

3. GRITs

The 1988 Act creates a special rule for certain grantor retained income trusts (GRITs) having a term of ten years or less. Under the House version of the 1988 Act, terminating a GRIT would have triggered a deemed gift under the provisions of section 2036(c)(4) concerning lapse or termination of retained interests.³⁰² The Conference Committee adopted the House provision concerning lapses or terminations, but added a special rule contained in new section 2036(c)(6), exempting certain GRITs from the operation of the statute. Under section 2036(c)(6), retention of a "qualified trust income interest" is disregarded, and the transferor is treated as continuing to own the trust property as long as the qualified trust income interest continues. Section 2036(c)(6) defines a "qualified trust income interest" as a right to receive amounts determined solely by reference to the income from trust property if (i) such right is for a period not exceeding ten years, (ii) the income beneficiary transferred the property to the trust, and (iii) the income beneficiary is not a trustee of the trust.³⁰³

300. See *supra* notes 133-34 and accompanying text.

301. See I.R.S. Notice, *supra* note 11, at 10, ex. 16; see also *id.* at 11, ex. 19.

302. See 1988 HOUSE REPORT, *supra* note 9, at 420.

303. I.R.C. § 2036(c)(6)(B).

The treatment of the initial transfer to the GRIT as a completed gift is not affected, however, for purposes of section 2511. As a result, the grantor is treated as having made a gift equal to the value of the remainder interest, as determined under the Treasury tables, at the time of the initial transfer. The GRIT exception permits the grantor to achieve substantial gift tax savings by "leveraging" his unified credit.³⁰⁴ The effect is even more pronounced if the grantor is permitted to reduce the taxable gift by the value of a contingent reversion or general power of appointment.³⁰⁵ A literal reading of the statute does not suggest that a qualified trust income interest is the *only* interest that the grantor may retain. The Service has indicated, however, that the GRIT exception is generally unavailable if the grantor retains a contingent reversion or general power of appointment with respect to trust principal, unless the value of the prohibited interest is "insubstantial" relative to the value of the retained income interest.³⁰⁶

The special rule exempting GRITs represents a departure from the underlying purpose of the statute. The Conference Committee was apparently concerned that taxpayers might exploit this loophole to accomplish an indirect freeze by transferring preferred stock to a GRIT, while giving away the common stock to family members. In this situation, the Conference Report warns that the preferred stock transferred to a GRIT will be treated as retained by the transferor during the GRIT's term, and termination of the GRIT will give rise to a deemed taxable gift equal to the then current value of the transferred common stock.³⁰⁷ The transaction as a whole, but not the GRIT as such, will thus be subject to section

304. For example, assuming an interest rate of 10% under the Treasury tables, the present value of a 10-year income interest is approximately 61.44% of the value of the entire property subject to the income interest. Given a unified credit of \$600,000, the maximum amount that could be transferred to a statutory GRIT, without triggering a taxable gift, is approximately \$1,556,000.

305. See Oshins, *supra* note 298, at 28-29; see also Priv. Ltr. Rul. 87-27-031 (Apr. 3, 1987) (gift tax value of contingent remainder reduced in accordance with Table LN contained in Treas. Reg. § 20.2031-7).

306. See I.R.S. Notice, *supra* note 11, at 11-12. For this purpose, the value of the reversion or general power of appointment is considered insubstantial if it does not exceed 25% of the value of the retained income interest, determined without regard to the value of the reversion or power. *Id.* at ex. 25.

307. See 1988 CONFERENCE REPORT, *supra* note 9, at 75.

2036(c) just as if the preferred stock had never been transferred to the GRIT. If the grantor places his entire stock interest, or a proportionate share of his entire interest, in a qualifying GRIT, however, the transaction falls outside the statute.³⁰⁸ Despite the statutory exemption for GRITs under section 2036(c), the grantor may nevertheless be treated as making periodic annual gifts under *Dickman* principles if the yield on the trust property is excessively low.³⁰⁹

4. Annuities

The Conference Report clarifies that a trust in which the transferor retains an annuity interest is not treated as a qualified income trust.³¹⁰ The fixed annuity payment is not considered an amount determined solely by reference to the income from the trust property. Accordingly, section 2036(c) may apply to a grantor retained annuity trust (GRAT) or a private annuity sale.³¹¹ In a private annuity sale, one person, the annuitant, sells property to another, the obligor, in exchange for the obligor's unsecured promise to make specified payments to the annuitant during the annuitant's life.³¹² If the actuarial value of the annuity, valued under the Treasury tables, is equal to or exceeds the value of the transferred property, the annuity sale does not give rise to a taxable gift by the annuitant.³¹³ The principal income tax disadvantage of such a pri-

308. Section 2036(c)(6) apparently represents the exclusive safe harbor for GRITs. For example, a transfer of cash or marketable securities to a nonqualifying GRIT will trigger § 2036(c) because the GRIT itself is viewed as the "enterprise."

309. See, e.g., Priv. Ltr. Ruls. 88-23-030 (Mar. 8, 1988); 88-23-029 (Mar. 8, 1988); 88-15-005 (Jan. 7, 1988); 88-06-082 (Nov. 18, 1987); 88-05-029 (Nov. 9, 1987); 88-01-008 (Oct. 7, 1987).

310. See 1988 CONFERENCE REPORT, *supra* note 9, at 74 n.1.

311. Depending on how the transaction is structured, a transfer to a trust may be either a GRAT or a private annuity. Compare *Lazarus v. Commissioner*, 513 F.2d 824, 828-29 (9th Cir. 1975) (finding taxpayer's arrangement to be a GRAT) with *LaFargue v. Commissioner*, 689 F.2d 845, 850 (9th Cir. 1982) (upholding taxpayer's argument that arrangement was private annuity transaction).

312. Under the Treasury tables, the present value of an annuity is determined by multiplying the "annuity factor" for a term by the amount of the annuity. The annuity factor is equal to (income factor/*i*), in which *i* equals the applicable interest rate and the income factor is equal to (1 - the remainder factor). See I.R.S. Notice 89-24, 1989-10 I.R.B. 16.

313. See *Lane*, *supra* note 7, at 293-94; see also *LaFargue v. Commissioner*, 49 T.C.M. (CCH) 839, 842 (1985), *aff'd*, 800 F.2d 936 (9th Cir. 1986); Rev. Rul. 69-74, 1969-1 C.B. 43.

vate annuity arrangement is that all of the obligor's payments are treated as part of the purchase price of the property and a non-deductible "annuity amount."³¹⁴ From the annuitant's perspective, each payment is divided actuarially into a return of capital, capital gain and an annuity feature.³¹⁵

A sale of property to a family member in exchange for an annuity may be abusive if the discount rate used in valuing the annuity promise is low relative to the actual rate of return on the transferred property, allowing the related purchaser to fund the annuity payments entirely from the property's income. Under the current Treasury tables, this potential abuse may be relatively insignificant because the transferred property will seldom produce a yield substantially in excess of the assumed discount rate.³¹⁶ More significantly, a private annuity may avoid transfer taxes if the annuitant dies prematurely, with the result that his gross estate is not replenished by the expected payments under the annuity contract.³¹⁷ Therefore, a "hindsight" approach to valuation of annuities may be appropriate to remedy valuation uncertainties.³¹⁸

5. *Installment sales*

The Service has also confirmed that installment sales are within the scope of section 2036(c).³¹⁹ Unlike an annuity, the right to receive payments under an installment obligation usually does not lapse at death. The value of the property sold will be replaced in the seller's gross estate by the value of the note or proceeds thereof. If the installment note bears an inadequate rate of inter-

314. See, e.g., Rev. Rul. 55-119, 1955-1 C.B. 352; see also Zaritsky, *Bits and Pieces: Sales of Remainder Interests and Split Purchases*, 38 MAJOR TAX PLAN ch. 16, at 16-25 (1986).

315. See, e.g., Rev. Rul. 69-74, 1969-1 C.B. 43; see also Leimberg & McDaniel, *The Private Annuity Time Grab Revisited*, J. AM. SOC. CLU, Mar. 1985, at 34; Zaritsky, *supra* note 314, at 16-25.

316. See Dodge, *supra* note 3, at 294. A higher assumed interest rate reduces the value of an annuity interest and increases the value of an income interest. See Hastings, *supra* note 295, at 53-8.

317. See Dodge, *supra* note 3, at 295. The Service has ruled that the Treasury valuation tables may be used except in cases in which the annuitant's death is "clearly imminent." Rev. Rul. 80-80, 1980-1 C.B. 194, 195.

318. See Dodge, *supra* note 3, at 295-96.

319. I.R.S. Notice, *supra* note 11, at 5.

est, a taxable gift may result under section 7872.³²⁰ Other problems may arise if the installment note includes a self-cancelling feature. In *Estate of Moss v. Commissioner*,³²¹ an installment note with a self-cancellation feature was held not to be includible in the decedent's gross estate because the cancellation feature was "bargained for" in an arm's length transaction.³²² In the family context, it will usually be difficult to prove that adequate and full consideration was paid for the cancellation clause.³²³ A self-cancelling note is arguably similar to voting rights or other interests that lapse at the transferor's death. A broad interpretation of section 2036(c) therefore may be justified to prevent transfer-tax avoidance through self-cancelling rights or other forms of disappearing value.

6. Life insurance

Congress specifically authorized the Treasury to address the treatment of life insurance trusts and similar arrangements.³²⁴ The Service, however, has determined that life insurance should be generally excluded from the scope of section 2036(c) because section 2042 addresses specifically the estate tax treatment of life insurance, and the definition of a life insurance contract in section 7702 reflects a legislative determination of whether the personal or investment aspects of a contract predominate.³²⁵ Nevertheless, a life insurance trust may be treated as an enterprise to the extent the trust is funded with cash in excess of the amount reasonably necessary to fund insurance premiums.³²⁶

320. See, e.g., *Ballard v. Commissioner*, 854 F.2d 185 (7th Cir. 1988) (taxpayer entitled to rely on 6% safe harbor rate of former § 483 for gift tax purposes); see also Tech. Adv. Mem. 87-01-002 (Sept. 19, 1986) (treatment before § 7872).

321. 74 T.C. 1239 (1980), acq. in result, 1981-2 C.B. 2.

322. *Id.* at 1246-47. See generally Banoff & Hartz, *It's No Sin to SCIN! A Reply to Professor Blum on Self-Cancelling Installment Notes*, 60 TAXES 187 (1982); Blum, *Self-Cancelling Installment Notes—The New SCIN Game?*, 60 TAXES 183 (1982).

323. If the obligation has a term in excess of the seller's life expectancy, a self-cancelling note may be treated as a private annuity rather than an installment sale. See Rev. Rul. 86-72, 1986-1 C.B. 253; see also Tech. Adv. Mem. 89-06-002 (Sept. 16, 1988); Gen. Couns. Mem. 39,503 (June 28, 1985).

324. See 1988 HOUSE REPORT, *supra* note 9, at 428; 1988 SENATE REPORT, *supra* note 9, at 531; see also Dees, *supra* note 9, at 888-89.

325. I.R.S. Notice, *supra* note 11, at 6 & n.14; see I.R.C. §§ 2042, 7702.

326. I.R.S. Notice, *supra* note 11, at 7-8, ex. 7 & n.18.

IV. CURBING DISPROPORTIONALITY: AN ALTERNATIVE APPROACH

A. *Overview*

Although section 2036(c) equates retained discretionary controls with abusive estate freezes, the statute fails to provide an accurate measure of the disproportionality that constitutes the perceived abuse. A disproportionate shift in value will occur only to the extent that the transferor fails to insist on an adequate return on his contributed capital or future services. If the transfer tax base includes the shifted value, the purpose of section 2036(c) should be adequately served. In other areas involving intrafamily transactions, Congress has adopted a "wait-and-see" approach to determine whether value has actually shifted.

Under the existing statute, the proportional exclusion rule offers a rough measurement of disproportionate shifts in value based on the assumption that the transferred property appreciates or depreciates at the same rate as the retained interest. This assumption disregards the characteristics of the separate property interests that might justify differing rates of return in the hands of third parties in order to forestall manipulation of such characteristics in the context of intrafamily transfers. Valuation problems are also rendered less intractable if the fragmented interests are treated as undivided fractional interests in a single unit of property. Even if fragmented interests are thus reconstituted, however, astute planners still will be able to take advantage of valuation uncertainties concerning the value of the entire property. Because the excludible portion of the transferred property is determined as a constant fraction of the entire property, any initial undervaluation of the property as a whole will result in the exclusion of a correspondingly larger portion of the transferred property.

The proportional exclusion rule, although relatively easy to formulate and administer, does not always provide an accurate measure of the shifted value and sometimes produces arbitrary and harsh results. A better model can be derived from the family partnership rules of section 704(e), which permit the Service to disregard allocations of partnership income between family members when such allocations fail to reflect economic reality. These rules provide for reallocation of the distributive share allocable to a donee partner if the donor partner fails to receive adequate compen-

sation for his services, or the distributive share allocated to the donee's capital is proportionately greater than the distributive share allocated to the donor's capital.³²⁷ In the transfer tax context, the proposed section 704(e) approach would apportion the future income stream of the business, including any appreciation in assets of the business, in proportion to the relative capital interests and services of the transferor and transferee. To the extent that the value reallocated to the transferor exceeded the value of the transferor's actual interest, determined as of the time the capital shift is treated as complete, the excess value would be treated as an additional transfer to the transferee. The portion of the future income stream and appreciation properly allocable to the transferee's capital or services would be respected, and accordingly would not be drawn back into the transferor's gross estate.

Existing section 704(e) essentially applies assignment of income principles and provides a nonexclusive safe harbor to determine when a person will be considered a partner in a partnership for tax purposes.³²⁸ Thus, if a person holds an interest in a partnership in which capital is a material income-producing factor, the person will be recognized as a partner for tax purposes, regardless of whether the partnership interest was acquired by gift or by purchase.³²⁹ If a partnership interest is purchased directly from a family member, however, the seller and purchaser are generally treated as donor and donee, thus triggering the section 704(e) reallocation rules.³³⁰ Nevertheless, the form of the purchase will be respected and the reallocation rules will not be triggered if the purchase has the usual characteristics of an arm's length transac-

327. See I.R.C. § 704(e).

328. See W. McKEE, W. NELSON, & R. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 14.01 (1977 & Supp. 1988). Prior to enactment of § 704(e), whether a family partnership arrangement would be respected for tax purposes was uncertain. See, e.g., *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949) (facts-and-circumstances test).

329. See Treas. Reg. § 1.704-1(e)(1)(ii); see also Banoff, Long, Steele & Smith, *Family Partnerships: Capital as a Material Income-Producing Factor*, 37 TAX LAW. 275, 277 (1984).

330. Section 704(e)(3) provides that "an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital." See Treas. Reg. § 1.704-1(e)(4)(i), (ii)(b); W. McKEE, *supra* note 328, ¶ 14.03[3].

tion.³³¹ The existing section 704(e) reallocation rules address only the income tax consequences of partnership allocations.³³² Under present law, these rules apparently have no estate or gift tax consequences. Indeed, the section 704(e) rules may actually facilitate estate planning objectives because the income tax paid on the reallocated income reduces the donor's gross estate.³³³

The section 704(e) approach would eliminate the artificial distinction under the proportional exclusion rule depending on whether the transferee acquires his interest by purchase or by gift. The transferee's initial capital account would be credited with the fair market value of any consideration paid to the transferor as well as the gift tax value of any donated capital received from the transferor and treated as a completed gift. In other words, a proportionate share of the future income and appreciation attributable to donated capital could be removed from the transferor's estate at the cost of a current gift tax. Only the post-transfer appreciation allocated to the transferee's capital account in excess of this proportionate share would be reallocated to the transferor and included in his transfer tax base. The reallocated value would be determined under a yield-based approach to reflect the extent to which the transaction gives rise to a disguised capital shift. The yield-based approach is superior to the proportional exclusion rule because it permits more accurate measurement of the shifted capital and is responsive to changes in the ratio of donated and retained capital subsequent to the initial transfer.

B. Timing and Valuation of Gifts

One objection to the section 704(e) approach is that it would preserve the benefits of lifetime giving despite the discretionary controls retained by the donor. To the extent that existing law treats completed lifetime transfers more leniently than transfers occurring at death, the problem of when a transfer is deemed com-

331. See Treas. Reg. § 1.704-1(e)(4)(ii).

332. Whether special allocations of partnership gains and losses are subject to the § 704(e) regulations is unclear if such allocations have "substantial economic effect" under the § 704(b) regulations. See W. McKee, *supra* note 328, ¶ 14.05[1][c]; Elias, *supra* note 5, at 59-60. The § 704(e) regulations refer only to reallocations of partnership "income." See Treas. Reg. § 1.704-1(e)(3)(i)(b).

333. See Elias, *supra* note 5, at 61; Nelson, *supra* note 5, at 35.

plete has considerable importance. Although estate and gift tax rates have nominally been unified since 1976, the gift tax base is "tax-exclusive" while the estate tax base is "tax-inclusive."³³⁴ The systematic exclusion of the gift taxes from the gift tax base means that a completed lifetime transfer is generally taxed at a lower effective rate than a comparable transfer at death.³³⁵ This disparity would be largely eliminated if the gift tax were imposed on a tax-inclusive base.³³⁶

If the gift and estate tax bases were fully unified, the distinction between lifetime gifts and transfers at death would lose much of its significance for transfer tax purposes.³³⁷ In effect, the gift tax paid on a lifetime transfer would represent a full prepayment of the estate tax that would have been incurred had the transferor retained the property until death.³³⁸ Indeed, under the ALI proposals for

334. Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 2001-2010, 90 Stat. 1520 (1976). Prior to the 1976 Act, the gift tax was imposed on a separate tax base at graduated rates lower than the estate tax rates. The unification of the transfer tax rates (but not the transfer tax bases) under the 1976 Act prevents taxpayers from taking advantage of two separate sets of graduated transfer tax brackets. Nevertheless, as under prior law, the gift tax is imposed on the net amount transferred, while the estate tax is imposed on the amount transferred grossed up by the amount of the estate tax. Under the 1987 Act, the benefits of the unified credit and graduated estate and gift tax rates are phased out for estates exceeding \$10 million. See I.R.C. § 2001(c); 1987 Act, § 10401, 101 Stat. at 1330-430 to 1330-431.

335. The effective gift tax rate will equal $t/(1 + t)$ in which t is the effective estate tax rate. See Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1583 n.25 (1979) (deriving formula). At a 50% rate, a gift of \$66.67 will generate a tax of \$33.33. Expressed as a percentage of the gross transfer, i.e., the gift plus the gift tax incurred, the effective gift tax rate is 33.33%.

336. For proposals on unification of the gift and estate tax base, see, e.g., HOUSE COMM. ON WAYS AND MEANS AND SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS—UNITED STATES TREASURY DEPARTMENT 351-87 (Comm. Print 1969); 2 TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 374-83 (1984). Section 2035 requires reinclusion of the gift tax on taxable gifts made within three years of death. See I.R.C. § 2035.

337. See Warren, *The Timing of Taxes*, 39 NAT'L TAX J. 499, 500-01 (1987) (demonstrating that under certain conditions deferral or acceleration of a tax will not affect its present value); see also Gutman, *A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653, 654-55 (1988).

338. See Warren, *supra* note 337, at 500-01. The gross gift is equal to $A/(1 - t)$, in which A is the net gift and t is the tax-exclusive rate. For example, a net gift of \$30 would be taxed as a gross gift of \$50 if t equals 40%. The same result could be achieved by grossing up the rate, rather than the gift. The tax-inclusive rate will equal $t/(1 - t)$ in which t is the tax-exclusive rate. Thus, a 40% tax-exclusive rate is equivalent to a 66.67% tax-inclusive rate. See *id.*; C. SHOUP, FEDERAL ESTATE AND GIFT TAXES 16-17 (1966) (gross-up formula).

restructuring the transfer tax system, a lifetime gift would be treated as complete unless the transferor retained control over enjoyment of the property or retained the ability to revest the property in himself.³³⁹ As the ALI report acknowledges, this "easy-to-complete" rule would "allow a transferor to retain many strings on a transfer and nevertheless get the value of the future growth out from under transfer taxation, as long as the strings do not permit the transferor to pull the property back to himself."³⁴⁰

Even if the transfer tax base were unified, however, administrative considerations might favor a "hard-to-complete" rule in cases in which the transferor's retained rights make it difficult to ascertain the value of the transferred property at the time of the gift.³⁴¹ Under a hard-to-complete rule, there would be no need to determine the exact value of the transferred interest at the time of the initial transfer.³⁴² Instead, the transaction would be held open until the transferor died or relinquished the retained rights and the value of the transferred property could be ascertained more easily. By measuring the aggregate net wealth transfer only when the transferor relinquishes retained powers, the hard-to-complete rule eliminates the uncertainty of a premature valuation and thereby avoids the inevitable subsequent adjustments necessary to correct the inaccuracies of a premature valuation.³⁴³ Deferring the taxable event also would neutralize to some extent the "bracket" advantage attributable to the progressive rate structure and unified credit that tends to favor early completion of transfers before the value of the transferred property appreciates substantially.³⁴⁴

The hard-to-complete rule would make it possible in most cases to dispense with the reinclusion rules. This seems desirable not only for reasons of administrative convenience but also to avoid the potentially harsher results under the reinclusion rules as com-

339. See FEDERAL ESTATE AND GIFT TAXATION: RECOMMENDATIONS OF THE AMERICAN LAW INSTITUTE AND REPORTERS' STUDIES 41-44, 46 (1969).

340. *Id.* at 42.

341. See Gutman, *supra* note 337, at 681. See generally Gans, *Gift Tax: Valuation Difficulties and Gift Completion*, 58 NOTRE DAME L. REV. 493 (1983); Macris, *Open Valuation and the Completed Transfer: A Problem Area in Federal Gift Taxation*, 34 TAX L. REV. 273 (1979).

342. See Gutman, *supra* note 337, at 676.

343. *Id.* at 679.

344. *Id.* at 655.

pared with the normal estate tax rules.³⁴⁵ For example, assume that a transferor has an asset worth \$50 that will grow to \$100 at the time of the transferor's death.³⁴⁶ Assume, furthermore, that the effective estate tax rate is 40%. If the transferor retains the asset until death and it is included in his gross estate at a value of \$100, the transferor's beneficiaries will receive \$60 after payment of \$40 in estate taxes. Alternatively, if the transferor makes a present net lifetime gift of \$30 to his beneficiaries, incurring a gift tax of \$12 at the assumed 40% rate, the transferor's remaining \$8 of assets will grow to \$16 by the time of his death. The transferred property will grow to \$60 and, if section 2036(c) applies, the full \$60 will be drawn back into the transferor's gross estate, augmenting the gross estate to \$76 (\$16 plus \$60). This gross estate will be subject to a net estate tax of \$18.40 (\$30.40 tentative tax, less \$12 gift tax credit), which exceeds the value of the assets actually owned by the transferor at death (\$16). After payment of the additional estate tax, the beneficiaries will be left with assets having a value of \$57.60, which is less than the \$60 value that they would have received if the transferor had held the transferred property until death.

In the case of a completed lifetime gift, the payment of the gift tax reduces the transferor's gross estate by the future value of the assets used to pay the gift tax, resulting in estate tax savings. On the other hand, the transferor loses the future appreciation in the assets used to pay the gift tax. The estate tax adjustment for the tax on adjusted taxable gifts may fail to offset the full value of this lost appreciation because that adjustment is based on the dollar amount of the adjusted taxable gifts. Ignoring the effects of progressive rates and the unified credit, the net tax cost of making a

345. See Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction*, 51 U. CHI. L. REV. 1, 14 n.53 (1984); Sims, *Timing Under a Unified Wealth Transfer Tax*, 51 U. CHI. L. REV. 34, 48-49 (1984); see also Isenbergh, *Further Notes on Transfer Tax Rates*, 51 U. CHI. L. REV. 91 (1984).

346. If the after-tax rate at which assets are invested is assumed to be 10%, the value of the assets will double in approximately 7.25 years. Assuming periodic compounding, the future value is determined by multiplying the present value by $(1 + r)^y$, in which r is the periodic rate of appreciation and y is the number of periods between the present and the future dates. The present (or discounted) value of a sum to be received in the future is determined by multiplying the future value by $1/(1 + r)^y$. See A. ALCHIAN & W. ALLEN, *UNIVERSITY ECONOMICS* 180-85 (3d ed. 1972).

completed lifetime gift of property that will be drawn back into the transferor's gross estate is equal to the difference between (i) the future value of the amount of gift tax on the lifetime gift and (ii) the sum of the estate tax savings plus the gift tax on the lifetime gift.³⁴⁷ If the future value of the transferred property does not exceed its present value grossed up by the amount of gift tax paid, the reinclusion rules will not result in a more burdensome combination of estate and gift taxes because the estate tax savings achieved by removing the amount used to pay the gift tax from the transferor's gross estate will equal or exceed the additional tax cost of prepaying the gift tax.³⁴⁸ If the value of the transferred property was greater at the time of the transfer than at death, the adjustment for prior gifts may actually exceed the estate tax attributable to the reincluded property.

The reinclusion rules thus produce arbitrary and asymmetrical results. Although the legislative history describes section 2036(c) as "holding the transaction open" until the termination of the transferor's retained rights, that description is misleading.³⁴⁹ Under a true open-transaction approach, the transaction would be treated as incomplete and would not be subject to tax at the time of the initial transfer. There would be no need for the reinclusion rules because no transfer would be deemed to occur until the transferor relinquished the retained controls. Much of the complexity of present section 2036(c) with respect to gifts of appreciation property could be eliminated by consistent application of the hard-to-complete rule. Unification of the gift and estate tax rules concerning completed transfers is essential to sound administration of the

347. Leaving aside exemption amounts and bracket effects, the net tax cost is equal to $tA(1 + r)^y - t^2A(1 + r)^y - tA$, in which t is the nominal gift tax rate, A is the amount of the initial gift, r is the after-tax interest rate, and y is the number of compounding periods. Simplifying and factoring yields $tA((1 - t)(1 + r)^y - 1)$.

348. This result can be demonstrated algebraically by solving for the equation $tA((1 - t)(1 + r)^y - 1) = 0$. Simplifying and factoring yields $A(1 + r)^y = A/(1 - t)$. The expression on the left side of the equation represents the formula for determining the future value of the transferred property drawn back into the transferor's gross estate. The expression on the right side of the equation represents the formula for determining the grossed up value of the net gift, where the gift tax is imposed on a tax-exclusive basis.

349. See 1988 HOUSE REPORT, *supra* note 9, at 423.

transfer tax system.³⁵⁰ The approach of section 2036(c) is inconsistent with this goal because it imposes a second round of transfer taxes on transfers that have already been treated as complete for gift tax purposes.

The broader issue is whether the hard-to-complete rule represents an unduly harsh remedy for the potential abuses posed by estate freezes. Generally, a taxpayer is permitted to remove from his gross estate the future growth of assets transferred by gift during his lifetime. The hard-to-complete rule may be criticized for treating transfers of closely held business interests less favorably than gifts of other property with comparable appreciation potential. This adverse treatment also runs contrary to the favorable treatment generally afforded to family held businesses under the Code. Although adoption of a unified transfer tax base would largely eliminate this disparity, pervasive opposition still exists to unifying the estate and gift tax bases.³⁵¹

To the extent that section 2036(c) essentially addresses the problem of valuation uncertainty, it is necessary to explore the more limited objective of improving conventional valuation techniques and imposing appropriate sanctions for abuses. One alternative would be to require taxpayers to notify the Service of freeze transactions and to provide for expedited audit at the taxpayer's request of any gift tax return involving a freeze transaction.³⁵² Stricter enforcement of prior law, however, is not an adequate substitute for section 2036(c). Alternatively, the value of closely held

350. See, e.g., Task Force on Transfer Tax Restructuring, *Report on Transfer Tax Restructuring*, A.B.A. SEC. TAX'N REP., reprinted in 41 TAX LAW. 395, 404-05 (1988).

351. See *id.* at 405; see also Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 TAX LAW. 343 (1989); Gutman, *A Practitioner's Perspective In Perspective: A Reply to Mr. Aucutt*, 42 TAX LAW. 351 (1989). But see Gutman, *supra* note 337, at 656-57 (exposing the fallacy of arguments advanced in favor of retaining tax-exclusive gift tax base).

352. See *Moore Statement*, *supra* note 10, at 99-101. Under existing law, it is unclear whether the Service has authority to correct gift tax valuation errors for estate tax purposes. Compare *Boatmen's First Nat'l Bank v. United States*, 705 F. Supp. 1407 (W.D. Mo. 1988) (no authority to revalue) with *Ward v. Commissioner*, 87 T.C. 78 (1986) (contrary *dictum*). See also Tech. Adv. Mem. 84-47-005 (July 26, 1984). Because the tentative estate tax would be offset by any gift tax payable, although not actually paid, on revalued prior gifts, such revaluation would merely affect the starting point of the graduated estate tax rates. See I.R.C. §§ 2001(b), 2504(c); Caron, *Revaluation of Prior Gifts for Estate Tax Purposes After Expiration of Statute of Limitations For Year of Gift*, 67 TAXES 286 (1989).

stock or a partnership interest might be determined, for gift tax purposes, under a valuation rule that would maximize the value of the transferred interest by presuming that retained discretionary rights would be exercised to enhance the value of the transferred interest in the hands of family members.³⁵³ The advantage of such an approach is that it would directly address the problem of valuing retained discretionary rights that otherwise would artificially depress the gift tax value of the transferred property in the hands of related family members. Such a gift tax valuation rule might enhance revenue in the short term by increasing the gift tax payable with respect to lifetime transfers. It would further erode the estate tax, however, unless a contrary estate tax valuation rule were used to maximize the value of the transferor's retained interest at death. Inconsistent valuation assumptions for gift and estate tax purposes would merely exacerbate the uncertainty of valuation determinations and could lead to whipsawing of the government.

Assuming that section 2036(c) is not repealed, it is nevertheless necessary to redefine what constitutes a disproportionate transfer. Under the existing statute, the Service apparently views the terms "appreciation" and "income" as mutually exclusive categories rather than interrelated components of an overall investment. Under this view, the value of transferred appreciation can never be offset by the value of a retained income stream, even if the income stream represents a fair market rate of return on the retained property.³⁵⁴ To the extent that section 2036(c) is directed at valuation problems, however, a fair market rate of return on the retained property should obviate the need for the remedy of section 2036(c) because no disguised transfer of wealth has occurred.

One might argue, however, that section 2036(c) is directed at the retention of control or beneficial enjoyment of the transferred property rather than merely at the valuation problem. If this argument is taken seriously, one can view the transferor as retaining both the income stream and the potential appreciation, and any

353. See Report of the Section 2036(c) Task Force, *supra* note 10, at 2-3. The Report also suggests creation of a safe harbor for certain preferred interests that bear a cumulative dividend or preferred income right at least equal to the liquidation value of such interest multiplied by the applicable federal rate under § 1274 and compounded semiannually. *Id.* at 4-5.

354. See I.R.S. Notice, *supra* note 11, at 9, ex. 13 (preferred stock redeemable at par with a cumulative dividend preference equivalent to a fair market rate of return).

appreciation in the value of the transferred property should be included in the transferor's gross estate. The argument based on retained control or beneficial enjoyment, however, does not justify the reinclusion rule of section 2036(c). To the extent that section 2036(c) is triggered merely by the transferor's retention of voting power or other control over a closely held family business, the statute seems overly broad; and the reinclusion rule unnecessarily discourages the older generation from transferring a portion of the business to the younger generation.³⁵⁵ On the other hand, if the transferor has not sufficiently relinquished the transferred property, a simpler solution would be to hold the entire transaction open until the transferor's death.

With respect to the valuation problem, it is possible, looking at events after the date of the transfer, to measure disproportionality by comparing the yield on the transferred interest with the yield on the retained interest. Disproportionality is indicated to the extent that the yield on the transferred interest exceeds the yield on the retained interest, regardless of whether those yields represent income, appreciation or a combination of both. A yield-based approach more accurately reflects economic reality and is less easy to circumvent than an approach that treats "income" and "appreciation" as mutually exclusive categories. The artificial distinction between income and appreciation is likely to encourage the creation of appreciation rights disguised as income property and income rights disguised as appreciation property.³⁵⁶ A yield-based approach would also be preferable to existing law because it would ensure that the value of the control premium is includible in the transfer tax base. Under existing law, a controlling shareholder can substantially diminish the value of his shares for transfer tax purposes by fragmenting a controlling block into several minority blocks and claiming a valuation discount with respect to the sepa-

355. See Report of the Section 2036(c) Task Force, *supra* note 10, at 2.

356. For example, a "reverse" partnership freeze might be structured to avoid § 2036(c). The younger generation would receive an "income" interest with a high yield and a liquidation preference. The older generation would receive an "appreciation" interest with a right to any partnership income and liquidation proceeds remaining after the younger generation's preferred return. The high return on the younger generation's interest would effectively absorb any potential appreciation in the value of the older generation's interest.

rate minority blocks.³⁵⁷ In the past, the Treasury has opposed minority discounts and proposed that interests held by related individuals in the same property be aggregated for transfer tax purposes.³⁵⁸ Although the precise scope of the aggregation rules may require further elaboration, the present rules governing minority discounts should be reconsidered.³⁵⁹

As long as the transferred property is valued consistently, either as a minority interest or as part of a controlling block, the applicable valuation presumption would not affect the appreciation allocable to the respective transferred or retained interests under a section 704(e) approach.³⁶⁰ If the transferred stock is valued initially as a minority interest, the control premium will be reflected in a higher value for the retained interest at death. Conversely, if the transferred stock is valued initially as part of a majority block for gift tax purposes, the value of the retained stock at death will be lower for estate tax purposes. This result is proper to prevent double inclusion in the transfer tax base of the control premium, while ensuring that the control premium does not escape transfer tax due to inconsistent estate and gift tax valuations.³⁶¹

C. Purchases and Partial Consideration

If section 2036(c) were restricted to donative transfers, the advantages of an estate freeze could nevertheless be accomplished by structuring the transaction as a sale rather than a gift. A blanket exemption for any "bona fide sale for adequate and full considera-

357. See, e.g., *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981); *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982); see also Bogdanski, *Minority Discounts: Estate of Bright Meets Judge Posner*, 15 J. CORP. TAX'N 280 (1988); Comment, *Estate of Bright and Propstra: Rejection of Family Attribution in Estate Valuation*, 2 VA. TAX REV. 357 (1983).

358. See, e.g., 2 TAX REFORM FOR FAIRNESS, SIMPLICITY AND GROWTH, *supra* note 336, at 386-88. For an earlier proposal, see Fellows & Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978).

359. See, e.g., *Report on Transfer Tax Restructuring*, *supra* note 350, at 421-24.

360. See Fellows & Painter, *supra* note 358, at 908-10. In enacting the 1987 Act, the House agreed to abandon provisions concerning minority discounts in exchange for Senate approval of § 2036(c). See H.R. 3545, 100th Cong., 1st Sess. § 10108 (1987); 1987 HOUSE REPORT, *supra* note 8, at 1043-44; Dees, *supra* note 9, at 876.

361. See *Report on Transfer Tax Restructuring*, *supra* note 350, at 421, 423.

tion" would thus resuscitate the abuses section 2036(c) addresses. Although section 2036(c) presumes conclusively that an intrafamily sale is not bona fide, it would be preferable to permit the taxpayer to rebut this presumption by establishing that the sale lacks significant donative intent and effect.³⁶² This general rule would permit the proportionate appreciation in sales to family members to escape section 2036(c) treatment and would focus more explicitly on the donative intent often present in intrafamily sales. Even if "recapture" rules are unavoidable for certain intrafamily sales, careful attention should be given to the treatment of consideration received. A true arm's length sale would not result in any disguised wealth transfer because the price paid by an unrelated third party is generally the measure of fair market value.³⁶³ Although sales to family members should be subject to special scrutiny, the result should be the same for family members as for unrelated parties if the purchase price reflects the fair market value of the transferred property.

The proportional exclusion rule for purchases, adopted by the 1988 Act, is considerably superior to the prior consideration offset provisions of section 2036(c). Congress might have gone further and substituted the proportional exclusion rule for the present rules of section 2043(a) whenever property transferred for less than adequate and full consideration during life is drawn back into the transferor's gross estate. Instead, Congress created disparate rules for determining the consideration offset, depending on whether the retained interest is drawn back into the gross estate by section 2036(c) or the other retained-interest provisions.

Despite the appeal of administrative simplicity, many view the present rules of section 2043(a) as conceptually unsound because they require consideration to be valued at the time of the lifetime transfer even though the transferred property is included in the gross estate at its date-of-death value.³⁶⁴ If the value of the consideration is even slightly less than the value of the property transferred, measured as of the time of the initial transfer, the rules of

362. See Cooper, *supra* note 2, at 239.

363. See, e.g., Gutman, *supra* note 337, at 673.

364. See Lowndes, *supra* note 30, at 56-57, 82; *Report on Transfer Tax Restructuring*, *supra* note 350, at 410-11.

section 2043(a) accentuate the discrepancy between present and future value. For example, assume that a parent sells property to his child for \$450 when the fair market value of the property is \$500, and the property is worth \$1,000 at the parent's death. Under section 2043(a), the entire \$1,000 value is includible in the parent's gross estate, reduced by a consideration offset of \$450. If the parent had received an additional \$50 of consideration, however, the entire \$500 of appreciation would be outside the parent's gross estate. This arbitrary result could easily be corrected by replacing the existing rules of section 2043(a) with the proportional exclusion rule of section 2036(c) for retained interest transfers generally.

Unlike the proposed section 704(e) approach, the proportional exclusion rule of section 2036(c) applies only if the consideration cannot be traced to the original transferor; if the consideration derives from the transferor, the proportional exclusion rule is inapplicable and the appropriate adjustment under section 2036(c) is unclear.³⁶⁵ This tracing rule thus applies most harshly to families lacking sufficient wealth to provide the younger generation with adequate "original capital" to qualify for the statutory safe harbor; the tracing rule, perhaps unintentionally, allows families with more resources to avoid the harshest results of section 2036(c).³⁶⁶ Viewed broadly, most wealth owned by the younger generation probably derives ultimately from inherited family wealth and its attendant opportunities.

One of the reasons for enacting present section 704(e) in the family partnership context was precisely to overrule an analogous judicially developed "original capital" test.³⁶⁷ As one commentator has noted, the original capital test "was particularly troubling since it ignored the principle that income generated from the employment of capital follows the ownership of capital, and may be effectively assigned by a gift of the capital."³⁶⁸ In the income tax context, a transfer may be disregarded as incomplete in order to ensure that income will be taxed at the transferor's marginal rate.

365. See *supra* note 207 and accompanying text.

366. See *supra* notes 200-06 and accompanying text.

367. See *Commissioner v. Culbertson*, 337 U.S. 733, 743-48 (1949); W. McKee, *supra* note 328, ¶ 14.01[1].

368. W. McKee, *supra* note 328, ¶ 14.01[1].

By contrast, the original purpose for holding transfers subject to retained powers open until death for estate tax purposes (before enactment of the gift tax in 1932) was to prevent such transfers from escaping transfer tax entirely.³⁶⁹ The retained-interest provisions thus were developed originally to reinforce the estate tax; they arose "in a context in which there was no gift tax, and continued in a context in which the gift tax rate was lower than the estate tax rate."³⁷⁰ To the extent that lifetime transfers are included in the gift tax base, the original rationale for reincluding retained-interest transfers in the estate tax base is no longer compelling.³⁷¹ A better approach would be to permit proportional exclusion for true gifts as well as purchases and thereby avoid the problems of ascertaining intent and tracing sources of funds.³⁷²

D. Changes in Capital Structure

The application of a proportional exclusion rule is relatively simple if the transferor originally owns the entire enterprise and the ratio of donated and retained capital does not change after the original transfer. The amount includible in the transferor's gross estate in such a case can be expressed as $FV_e (1 - PV_c/PV_e)$, in which PV is the present value, determined as of the time of the initial transfer; FV is the future value, determined as of the date of the transferor's death; e is the value of the entire enterprise, including both the retained and the transferred interests; and c is the value of the consideration paid by the transferee. The application of the proportional exclusion rule quickly becomes more complicated, however, if the ratio of donated to retained capital changes subsequent to the initial transfer—for example, as a result of subsequent capital contributions or distributions. The 1988 Act specifically authorizes the Treasury to promulgate regulations to

369. See Dodge, *supra* note 3, at 246.

370. Gutman, *supra* note 337, at 680.

371. If the concern is the lower effective gift tax rate, the obvious solution is to unify the transfer tax base. If, instead, the concern is the valuation uncertainty, open-transaction treatment is preferable to reinclusion.

372. A purchaser would be treated as a donee unless the purchase agreement satisfies an arm's length standard under rules analogous to those of § 704(e). See *supra* notes 329-30 and accompanying text.

take into account "extraordinary dividends and other incremental changes in the capital structure."³⁷³

The provision concerning adjustments for changes in capital structure is intended apparently to complement the Treasury's authority to prescribe regulations preventing avoidance of section 2036(c) "through distributions or otherwise."³⁷⁴ The legislative history suggests that the Treasury may recast distributions to the transferee as additional taxable gifts, at the time of the distribution, to prevent the value of the enterprise from being siphoned off in a series of distributions that would otherwise escape transfer taxation.³⁷⁵ Distributions will alter the ratio of the donated and retained capital, as will any failure to pay reasonable compensation and any additional capital contributions by the transferor or transferee. Unfortunately, the legislative history provides little guidance concerning such shifts in the ratio of donated and retained capital. The legislative history does indicate, however, that the Treasury may adopt "such rules as are appropriate to eliminate the need to value the entire enterprise in order to make minor adjustments for consideration received by the transferor."³⁷⁶

Disproportionate distributions to the transferor should reduce the value of the portion of the enterprise includible in the transferor's gross estate. Such treatment of distributions corresponds to the underlying economic reality that a return on invested capital may be reflected as either current income or as unrealized appreciation in asset values. Failure to take distributions into account in this manner would lead to unwarranted and arbitrary results under the proportional exclusion rule. For example, assume that a parent owns all of the common and preferred stock of a corporation, and sells the common stock to a child for its fair market value of \$100 while retaining the preferred stock, also worth \$100. If the corporation has after-tax earnings of 10% and pays annual dividends of \$10 on the preferred stock, the value of the corporation will grow

373. See 1988 CONFERENCE REPORT, *supra* note 9, at 76; see also I.R.C. § 2036(c)(5) and *supra* text accompanying note 208.

374. See I.R.C. § 2036(c)(8); see also *supra* note 209 and accompanying text.

375. See 1988 HOUSE REPORT, *supra* note 9, at 421.

376. See 1988 CONFERENCE REPORT, *supra* note 9, at 76-77.

to \$233.10 at the end of three years.³⁷⁷ If the transferor dies at the end of Year 3, one half of the value of the enterprise (\$116.55) would be excluded from the transferor's gross estate under the proportional exclusion rule. Assuming that the value of the preferred stock remains \$100 and the value of the common stock grows to \$133.10, it would appear that \$16.55 of appreciation—the difference between the value of the common stock and the amount excluded under the proportional exclusion rule—has shifted disproportionately to the transferee.

In fact, no value has shifted disproportionately because the appreciation in the value of the common stock (\$33.10) exactly equals the future value of the annual \$10 cash flow to the transferor, assuming a 10% after-tax return on investments outside the enterprise and ignoring the effect of any federal income tax on the distributions. The proportional exclusion rule thus results in overinclusion in the transferor's gross estate if the future value of distributions is ignored. If no distributions occurred, the value of the enterprise would grow to \$266.20, and one half of this amount (\$133.10) would be excluded from the transferor's gross estate under the proportional exclusion rule. The amount includible in the transferor's gross estate (\$133.10) equals the value of the preferred stock (\$100) plus one half of the appreciation in the enterprise (\$33.10). The aggregate disproportionate shift in value (\$33.10) should be properly reincluded in the transferor's gross estate, assuming that no distributions occur.

Similarly, the proportional exclusion rule results in mismeasurement of the value shifted if, for example, a parent sells a remainder interest in property worth \$100 to a child while retaining a three-year term interest. Assuming an after-tax yield of 10%, the remainder interest has a discounted present value of \$75.13 and will grow to \$100 at the end of Year 3. If the value of the underlying property remains constant and current income of \$10 is paid annually to the transferor, no disproportionate shift in value will

377. By comparison, assume that \$200 is invested in a savings account at the beginning of Year 1, and \$10 is withdrawn on December 31 of each year. The balance in the savings account at the beginning of Year 2 will be \$210 (\$220 less \$10), which will grow to \$231 at the end of Year 2. After the \$10 distribution at the end of Year 2, the remaining balance of \$221 (\$231 less \$10) will grow to \$243.10, leaving \$233.10 (\$243.10 less \$10) after the distribution at the end of Year 3.

occur. The appreciation in the value of the remainder interest (\$24.87) is equal to the present value of the future income stream retained by the transferor (\$33.10), discounted at a 10% after-tax rate.³⁷⁸ Under the proportional exclusion rule, however, only a portion of the underlying property apparently would be excluded from the transferor's gross estate. If the consideration paid is measured against the present value of the entire property, the exclusion ratio would be approximately 75% ($\$75.13/\100), leaving an additional amount (\$24.87) includible in the transferor's gross estate.³⁷⁹ If the consideration paid is measured against the present value of the remainder interest only, the exclusion ratio would be 100%.

The proportional exclusion rule must be refined to take into account distributions and other events that occur after the initial transfer to avoid mismeasurement of the disproportionate shift in value. One way to take such events into account without having to revalue the enterprise on each event would be to adopt a yield-based approach to incremental changes in capital structure that shift the relative values of the transferred and retained interests. Under a yield-based approach, contributions and distributions would be treated as altering the proportionate interests of the transferor and transferee, represented by their initial capital accounts in the enterprise.

The accompanying charts illustrate the shift in values over a five-year period with respect to an enterprise consisting initially of \$100 of preferred stock and \$100 of common stock, assuming an after-tax annual yield of 15% for the enterprise as a whole. In Chart I, the only cash flow consists of dividends of \$10 paid each year on the preferred stock; no additional contributions or distributions occur. Chart II is identical to Chart I except that it illustrates two additional cash flows: First, the common stockholder makes a capital contribution of \$25 in Year 2 and, second, an ex-

378. The deferral of the income tax liability on the accrued appreciation in the value of the remainder interest is the equivalent of an interest-free loan from the government to the taxpayer equal to the deferred tax liability. Neutral treatment of unrealized gains under the income tax would require accrual-basis taxation, or imposition of an appropriate interest charge for the deferral benefit. See, e.g., Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT. TAX J. 565 (1973). See generally Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PENN. L. REV. 1111 (1986).

379. See *supra* note 292.

traordinary dividend of \$50 is paid on the common stock in Year 3. The cumulative capital accounts (inside values) represent the cumulative values of the initial capital accounts (\$100 for the preferred and common stock, respectively), adjusted for subsequent contributions and distributions that are assumed to occur at year end. The cumulative value of the distributions on the preferred and common stock (outside values) represent the values of the cash flows compounded at the applicable yield.³⁸⁰ Assuming that all growth in the enterprise is shared ratably, the cumulative inside value of the preferred stockholder's capital account would grow to \$133.71 in each case. If the preferred stock is actually valued at \$100 at the end of Year 5, \$33.71 of appreciation—the difference between the preferred stockholder's ending capital account of \$133.71 and the preferred stock's actual value of \$100—has shifted disproportionately to the common stock. The additional \$33.71 of appreciation is also equal to the excess of the fair market value of the common stock (\$234.85) over the value of the common stockholder's ending capital account (\$201.14). See Chart I. Because the yield-based approach treats contributions and distributions neutrally, the amount of the disproportionate shift in value (\$33.71) is not affected by the net additional cash flows that reduce both the fair market value of the common stock (\$206.74) and the common stockholder's ending capital account (\$173.03). See Chart II.

380. The applicable yield (or internal rate of return) is the annual yield (15%) that, when applied to all cash flows, produces a total present value equal to the present value of the initial capital accounts increased by the discounted present value of all additional capital contributions and reduced by the discounted present value of all distributions.

CHART I

END OF YEAR	PREFERRED DIVIDENDS		CUMULATIVE CAPITAL ACCOUNTS (INSIDE VALUE)		
	<u>Cash Flow</u>	<u>Cumulative Outside</u>	<u>Preferred</u>	<u>Common</u>	<u>Total</u>
<u>Initial</u>			\$100.00	\$100.00	\$200.00
1	\$10.00	\$10.00	105.00	115.00	220.00
2	10.00	21.50	110.75	132.25	243.00
3	10.00	34.73	117.36	152.09	269.45
4	10.00	49.93	124.97	174.90	299.87
5	10.00	67.42	133.71	201.14	334.85

CHART II

END OF YEAR	PREFERRED DIVIDENDS		COMMON DIVIDENDS	
	<u>Cash Flow</u>	<u>Cumulative Outside</u>	<u>Cash Flow</u>	<u>Cumulative Outside</u>
<u>Initial</u>				
1	\$10.00	\$10.00	\$ 0.00	\$ 0.00
2	10.00	21.50	0.00	0.00
3	10.00	34.73	50.00	50.00
4	10.00	49.93	0.00	57.50
5	10.00	67.42	0.00	66.13

END OF YEAR	CAPITAL CONTRIBUTIONS		CUMULATIVE CAPITAL ACCOUNTS (INSIDE VALUE)		
	<u>Cash Flow</u>	<u>Cumulative Inside</u>	<u>Preferred</u>	<u>Common</u>	<u>Total</u>
<u>Initial</u>			\$100.00	\$100.00	\$200.00
1	\$ 0.00	\$ 0.00	105.00	115.00	220.00
2	25.00	25.00	100.75	157.25	268.00
3	0.00	28.75	117.36	130.84	248.20
4	0.00	33.06	124.97	150.46	275.43
5	0.00	38.02	133.71	173.03	306.74

One might object that the yield-based approach is unrealistic if the transferor is unable to reinvest distributions on the preferred stock at the internal rate of return. If the after-tax yield on distributions is less than the internal rate of return, the value of the property actually owned by the transferor will be less than the imputed value under the yield-based approach. Modifying the yield-based approach to reflect alternative assumptions concerning the

after-tax yield on distributions, however, would entail additional complexity. Moreover, the tendency of closely held family businesses to retain assets for future growth means that distributions are likely to represent a relatively insignificant portion of the entire value of the enterprise. The incentive to retain earnings rather than make distributions would be correspondingly greater whenever the after-tax yield on distributions is significantly less than the internal rate of return.

In theory, amounts includible in the transferor's gross estate should be reduced for any built-in federal income tax liability.³⁸¹ For example, the compounded value of distributions taxable as dividends might be reduced by 30% to reflect the federal income tax liability. Adjusting for the federal income tax liability, however, would distort the comparison between retained earnings and distributions. Any earnings retained in the enterprise are likely to be taxed at equivalent rates upon distribution or liquidation.³⁸²

The yield-based approach avoids the difficulty under present section 2036(c) of determining whether distributions with respect to the transferred interest should be treated as additional taxable gifts at the time of each distribution. As long as cumulative inside values are adjusted to reflect contributions and distributions, and all cash flows are discounted at a uniform rate of return, any disproportionate capital shift can be ascertained readily by comparing fair market values with ending capital accounts. No additional gift tax need be imposed at the time of distributions. Instead, the taxable event can be postponed until the difference between fair market value and ending capital accounts is determined. Because distributions with respect to the transferred interest may represent merely a return on the transferee's initial capital account, or additional capital contributions, deferral of the taxable event avoids the need for retroactive adjustments.

A subsequent disposition of the retained or transferred interest is essentially equivalent to a deemed distribution that alters the proportionate interests of the original transferor and transferee.

381. See, e.g., Dodge, *Retentions, Receipts, Transfers, and Accumulations of Income and Income Rights, Ruminations on the Post-Byrum Role of Estate Tax Sections 2036, 2037, 2039, and 2043(a)*, 58 TEX. L. REV. 1, 58 (1979).

382. Even if the nominal rates are equivalent, however, postponement of the shareholder level tax on retained earnings represents a deferral benefit. See *supra* note 378.

Any capital shift occurring prior to the disposition will be reflected in the original transferor's or transferee's ending capital account balance. A disposition that completely terminates the original transferor's or transferee's interest should trigger immediate taxation of the aggregate capital shift because further deferral serves no useful purpose. If the disposition produces only a partial termination, however, the entire transaction should be held open to avoid interim valuations. The capital account balances should be restated immediately after each disposition to reflect the alteration in the original transferor's and transferee's respective interests. The original transferor's and transferee's capital accounts should be increased by the fair market value of any additional interest acquired and reduced by the fair market value of any interest disposed of. Restatement of the capital accounts would ensure that any subsequent appreciation in the enterprise would be allocated in proportion to the original transferor's and transferee's respective capital accounts.

If a disposition completely restores proportionality between the retained and transferred interests, closing the transaction with respect to all prior capital shifts seems appropriate. The restoration of proportionality safeguards against subsequent capital shifts for the benefit of the original transferee and should be treated as a complete termination of the retained and transferred interests. If the disposition fails to restore complete proportionality, however, it seems appropriate to hold the transaction open.

CONCLUSION

Perceived originally as a relatively obscure technical measure, section 2036(c) has come to occupy a central role in the transfer tax system. Indeed, section 2036(c) embodies a unique statutory scheme that threatens to engulf the general pattern of taxing retained-interest transfers. The extent of abusive estate freezing techniques prior to enactment of the statute is necessarily conjectural. The vehement opposition to this measure, however, suggests that such abuses were sufficiently widespread to justify drastic measures. In retrospect, many business clients and estate planners clearly had come to view estate freezing transactions as a generally acceptable and routine technique for minimizing transfer taxes.

Concerted efforts to repeal section 2036(c) have centered on the perception that the statute is an "anti-family business" measure.³⁸³ The opponents of section 2036(c) have argued strenuously that the complexity, breadth and vagueness of the statute pose an unreasonable impediment to the transfer of closely held businesses. The technical problems encountered in implementing the existing statute, however, must be weighed against the costs of outright repeal. If efforts to repeal the statute are successful, taxpayers might take full advantage of the opportunity to implement abusive estate freezes with impunity. By the same token, the Service might challenge such transactions on the basis of principles independent of section 2036(c), but hardly more settled in scope or application, leading to expensive and wasteful litigation. Moreover, the repeal of section 2036(c) without a substitute provision would produce an immediate and permanent revenue loss.

Although the arguments for repeal exaggerate the potential impact of section 2036(c) on "legitimate" intrafamily transfers (if not on the business of planning estate freezes), the technical problems with the existing statute become apparent quickly in even the most simple situations. One commentator has suggested that the sweeping, open ended tenor of section 2036(c) is defensible on the pragmatic ground that it has a salutary "in terrorem" effect.³⁸⁴ According to this argument, a clear understanding of the operation and purpose of the statute is unnecessary to accomplish its congressional purpose. Aggressive planning will be deterred even if, or precisely because, "no one is sure whether, or how, it works in all particulars."³⁸⁵ Indeed, the Service's long-awaited guidance concerning estate freezes discusses various statutory exceptions with specificity and detail, but leaves the statute's operative provisions open to speculation.

383. For various bills introduced to repeal § 2036(c), see JOINT COMM. ON TAX'N, 101ST CONG., 1ST SESS., DESCRIPTION OF TAX BILLS: S. 353 (EDUCATIONAL SAVINGS BONDS); S. 442 (VALUE ADDED TAX); S. 659, S. 838, S. 849 (ESTATE FREEZES); S.800 (MORATORIUM ON CERTAIN STATE TAX LAWS) (May 11, 1989). See S. 1750, 101st Cong., 1st Sess., § 6691 (1989) (repeal of §§ 2036(c) and 2207B); Daily Tax Rep. (BNA) No. 198, at G-6 (Oct. 16, 1989) (Senate floor vote deleting repeal provisions and other revenue-losing measures).

384. Bogdanski & Brown, *supra* note 9, at 1652.

385. *Id.* at 1651.

This Article rejects the arguments for both outright repeal and critical acceptance of the existing statute. As a policy matter, the viability of section 2036(c) is linked inextricably to its technical realization. The Article suggests that full unification of the gift and estate tax base would make it possible, in most instances, to dispense with the retained-interest provisions. If Congress is unwilling to implement a fully unified transfer tax base, however, another means to ensure as much consistency as possible between section 2036(c) and other transfer tax provisions is essential. Substitution of a proportional exclusion rule in lieu of the consideration offset rule of section 2043 for retained-interest transfers generally would represent a modest step in this direction. Finally, the Article has developed a yield-based approach that makes possible less arbitrary and more accurate measurements of shifts in value than does the inclusion of "appreciation" property under section 2036(c) in its present form.

Although the underlying concept of section 2036(c) is deceptively simple, the complexity of the existing statute provides a valuable lesson concerning technical implementation of tax reform. Clearly, Congress may appropriately enact statutes that set forth general rules in terms broad enough to permit elaboration through detailed regulations and administrative interpretation. The statute, however, must be sufficiently precise to indicate a coherent legislative intent. Section 2036(c) illustrates the dangers of introducing hastily considered and clumsily drafted amendments into an intricate statutory framework. If section 2036(c) proves ultimately unworkable, perhaps Congress will undertake a more rational and thorough reexamination of the transfer tax system.