1993

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Estate Planning in the Nineties:  
Friday the Thirteenth, Chapter 14:  
Jason Goes to Washington—Part I*

BY MARTIN D. BEGLEITER**

INTRODUCTION

Since the mid-1970s, the topic of “estate freezing” has arisen in any 
serious discussion of estate planning and has been widely analyzed in 
estate planning literature.† Entire conferences and panel discussions are
devoted to the topic. Attorneys who practice in the area of estate planning devote large amounts of time to learning the techniques of estate freezing, and recently the Internal Revenue Service ("IRS" or "Service") and Congress have devoted significant attention to the issue. In 1990, Congress completely revamped the rules for estate freezing by passing Chapter 14 of the Internal Revenue Code (the "Code"), engendering yet another round of discussion, conferences and, presumably, soon-to-be-written articles.

This Article attempts to formulate some likely techniques of estate planning that will evolve during the 1990s in the wake of Chapter 14, and analyzes the changes made by the Omnibus Budget Reconciliation Act of 1990 ("OBRA"). Although in some cases a technical analysis of portions of Chapter 14 will be required, this Article is not intended to be a detailed explanation of Code sections 2701-2704. It is not intended to be a blueprint for technical corrections to the Code or an analysis of every provision of Chapter 14. It is intended to discuss the new provisions and to suggest some estate planning techniques that will become prevalent during this decade. In addition, this Article discusses the different approaches taken by Congress to combat the perceived abuses in estate freezes, and evaluates the changes made by Chapter 14, particularly those driven by Code section 2701. Before proceeding, some background of the different situations attacked by OBRA is necessary.

I. THE TYPICAL ESTATE FREEZE

In a typical estate freeze, the creator of a small business desires to transfer ownership of the corporation to his children. He is often in his sixties or seventies and, in many cases, wishes to slow down by relieving himself of the day-to-day management of the business, or to otherwise

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1 See infra notes 42-55 and accompanying text.

2 Congress' first attempt at legislation was the enactment of I.R.C. § 2036(c) (1992), which was enacted in 1987. See infra notes 35, 80-136 for an analysis of § 2036(c). Section 2036(c) was repealed retroactively, and replaced by Chapter 14, I.R.C. §§ 2701-2704, enacted by Omnibus Budget Reconciliation Act §§ 11601(a), (c), 11602, Pub. L. No. 101-508, 104 Stat. 1388 (codified at I.R.C. §§ 2701-2704 (1992)).


4 I.R.C. § 2701 (1992); see also infra notes 167-93 and accompanying text.

5 This description is based upon the common framework of an estate freeze. See, e.g., Cafeteria, supra note 1, ¶ 2003, at 20-12.
decrease the amount of his work. One method available to accomplish the estate freeze is to reorganize the capital structure of the corporation. If one class of common stock exists, a new preferred stock is created. If the younger generation transferees are not already shareholders, the creator exchanges his common shares for common and preferred. He then makes gifts of the common stock to the children and retains the preferred stock. If the children are already shareholders, the creator exchanges his common stock for preferred stock and the children either retain their common stock or exchange it for new common shares of equal value. The preferred stock is designed so that its value closely approximates or equals the current value of the corporation. This enables the creator to give the common stock to his children at a low gift tax cost, sheltering the gifts from tax under the annual exclusion or, at worst, using a small amount of the unified credit. The preferred stock, because of its fixed redemption price, is fixed in value for estate tax purposes. As a result, the common shares will absorb all of the future appreciation of the corporation. By carving out of the corporate stock different rights such as control, income, present value and future appreciation, and transferring them to different members of the family group, the estate freeze caps the value of the present interest retained by the older generation, and all future appreciation (and either present or future control) is transferred to the younger generation with no or minimal transfer tax costs. Similar techniques are available for partnerships and usually involve the creation of limited partnership interests.

II. DEVELOPMENT OF THE FREEZE UNTIL 1987

A. The Early Years—Until 1977

There are significant non-tax reasons for engaging in a corporate reorganization with the creator retaining only preferred stock, or in some

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1 There may be non-tax in addition to tax reasons for doing this. See infra notes 20-24 and accompanying text.

2 This will allow the minimization of the effect of the gift tax upon the children receiving the corporation. See infra note 10 and accompanying text.

3 I.R.C. § 2503(b) (1992). This excludes amounts received from any person each year that are less than $10,000 from the definition of taxable gifts. Id.

4 Id. § 2505. This provision of the Code allows for a lifetime “credit against the [gift] tax” of $192,800. Id. § 2505(a). The credit is equivalent to an exclusion of $600,000 of gifts.


6 This description is adapted from Cafeteria, supra note 1, ¶ 2003, at 20-12.

7 Abraham & Zukin, supra note 1, ¶ 501.1, at 5-6. For examples of such provisions that may be used in an estate freeze to bolster value while serving to perfect a freeze, see infra notes 190-93, 277-306 and accompanying text.

8 See id.

9 See Alternative, supra note 1, ¶ 1801-2, at 18-8.
cases a small amount of common stock in addition to the preferred stock, and passing the common stock on to children and grandchildren. The creator may use an estate freeze to pass the business to succeeding generations so as to avoid being forced to sell all or part of the business to an outside concern in order to meet estate tax obligations. The orderly passing of family wealth to future generations is also a common goal. When control is passed to the younger generation during the client’s lifetime, having the creator present to advise the new owners greatly reduces the time necessary for the younger generation owners to learn the business and prevents costly mistakes and errors. The overlap of generational control, in addition to reducing the “learning curve” of the new owners, often allows the business to recover from the change in management more quickly.

Apparently, the concept of utilizing a change in the corporate capital structure to effect an estate freeze was used to some extent by practitioners as early as the late 1940s and was commented on in estate planning literature during the 1950s. The only response by the Service during this period was Revenue Ruling 59-60, which was very general in nature and focused on the valuation of closely held or unlisted stock. One article has stated that the ruling “offers statements that most experienced practitioners of estate value freezing have always acknowledged.”

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17 For example, the shareholders of a close corporation may wish to ensure that voting power passes in an orderly fashion to those members of the younger generation who actively participate in the business. This rationale has been accepted by the courts to support a finding of a valid business purpose within the context of an I.R.C. § 368(a)(1)(E) (1992) recapitalization. See, e.g., Dean v. Commissioner, 10 T.C. 19 (1948).


19 There are a variety of other non-tax reasons to desire an estate freeze. For example, the retiring client may seek to ensure a source of income during retirement, to encourage family participation in the business, to ensure the continued existence of the business, or to provide increased liquidity to the client’s estate. See Cafeteria, supra note 1, ¶ 2001, at 20-9 to 20-10.

20 See Wayne M. Gazur, supra note 1, at 112-13 (citing Samuel J. Foosaner, Stockholder Estate Problems, 92 Tfr. & Est. 908, 908 (1953)).


22 Abbin & Zukun, supra note 1, ¶ 502.5, at 5-16. These authors considered the following as important factors to consider when valuing preferred stock:
1. The most important factors to be considered in determining the value of preferred stock are voting rights, dividend coverage, and protection of liquidation preference.
2. These factors for closely held preferred stock are to be compared with the same factors for high grade, publicly traded preferred stock. Such comparisons need to take into account the adequacy of yields, the capability of dividend coverage, the prior and projected income flow, and the evaluation of the actual dividend rate assurance through
Nonetheless, during the 1950s the appearance of articles on this topic was infrequent and restricted mainly to journals specializing in estate planning. No significant cases focused the attention of the public or academia on the subject.

B. 1977—Estate Freezing Enters the Mainstream

In 1977, Professor George Cooper of Columbia Law School authored an article that quickly brought estate freezes to the forefront.\(^2\) Using the first important case involving a recapitalization\(^2\) as an example, Professor Cooper broadly criticized the technique as a serious evasion of the estate and gift tax.\(^2\) Professor Cooper presumed that the preferred stock was valued at the full value of the corporation at the time of the recapitalization and that the new common stock had a negligible value, and went on to state:

In other words, he froze his own estate, and, at the same time, achieved the triple goals of sophisticated estate planning—no loss of control, no current gift tax, and ability to pass on the future benefits of his business acumen free of tax. Moreover, since he retained voting control in the corporation he had the power to decide how much benefit the common shareholders received and when they received it.\(^2\)

Cooper noted that the only drawback of the preferred stock recapitalization technique to the parent was that the corporation was burdened with a heavy preferred dividend due to the high dividend rate required to make the value of the preferred stock equal to the value of the corporation, and that the parent who retained the preferred collected a large amount of

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\(^{22}\) Cooper, supra note 1.

\(^{23}\) Estate of Salsbury, 34 T.C.M. (CCH) 1441 (1975). In this case, the taxpayer attempted to have it all by maintaining control of the corporation while avoiding the impact of the gift tax. Id.

\(^{24}\) Cooper, supra note 1, at 164.

\(^{25}\) Id. at 173.
ordinary income that had previously been taxed at the corporate level. Cooper believed that this problem had deterred many recapitalizations, but that "[o]ther practitioners are, however, willing to try a lower dividend rate or even risk a noncumulative dividend to mitigate [the] burden [of the income tax]."

Professor Cooper further noted that use of a dual stock structure was a more common and significant technique of estate freezing in new corporations than in existing corporations, and that the technique offered possibilities for use in a holding company when the company’s capital structure included more than one class of stock for investments other than businesses.

To rectify this situation, and others he discussed, Professor Cooper recommended:

1. Adopting stricter means of valuating common stock interests;
2. Postponing the taxability of the gift until the value of the common stock is more clearly established;
3. Rethinking minority discounts in family gift situations, and generally broadening the range of facts considered on lack of marketability and other discounts;
4. Enacting statutes limiting marketability and blockage discounts, incorporating attribution rules into valuation determination and strictly limiting discounts;
5. Changing I.R.C. sections 2036 and 2038 to provide that the retention of the power to manage and select the manager of a business (including a partnership) by any method, including voting or contract rights, would be a retention of a power to affect the beneficial enjoyment under I.R.C. section 2036(a)(2) or a power to alter or amend under section 2038.

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Id. at 175. Curiously, Professor Cooper, although mentioning annual exclusion gifts, id. at 191-92, 211, failed to emphasize the additional tax avoidance possibility of combining the recapitalization with gifts of at least some of the preferred stock to the younger generation each year and thus totally avoiding tax on these gifts by virtue of the $3,000 (now $10,000) annual exclusion under I.R.C. § 2503 (1992).
Amending I.R.C. sections 2036 and 2038 to cover sales to family members where a parent retains an interest in the property;

Applying similar rules to new business ventures owned by children but controlled by parents; and

Substituting a periodic net wealth tax for the estate and gift taxes.

C. The Debate Phase: 1977-1987

Professor Cooper's article did what few other tax articles have done—it served to galvanize debate on a particular estate tax planning technique. In the ten years following the Cooper article, numerous articles on estate freezing appeared. In light of recent legislation, perhaps none of these articles is more important than a reprint of a panel discussion held at the American Bar Association Annual Meeting on August 14, 1979. This meeting brought together five of the leading estate planners from all areas of the country, each an expert in a certain area of estate freezing. The insights resulting from the panel discussion are incredible in light of Chapter 14. To summarize the views of the ABA panel, in the typical estate freezing recapitalization:

1. The common stock should be allocated a value of at least ten percent of the value of the corporation;
(2) Giving the preferred a greatly depressed dividend rate makes the preferred have a value substantially less than par. 45

(3) The dividend should be at least partially cumulative and hopefully entirely cumulative if it is desired that the preferred have a value equal to a substantial portion of the value of the company; 46

(4) Pay the dividend. If the company is not likely to pay the dividend, or if the owners do not intend to pay the dividend, the value of the preferred will be substantially diluted; 47

(5) A high dividend rate will not significantly bolster the value of the preferred if the preferred is weak in the first place; 48

(6) Voting power will improve the value of the preferred. The question here becomes whether the company has the capacity to redeem the stock if the voting preferred, which has control, decides to have the stock called. 49

who are active in this field of law believe that you can. One of the features of preferred stock is that it has priority in liquidation. It is protected against loss to some extent because the common stock absorbs the loss before the preferred does. That is why someone is willing to take only a fixed income position in the corporation without hope of capital appreciation. If there is only 1 percent, or 0.01 percent protection for the preferred by having a $1,000 common stock cushion in a $1 million corporation, the slightest loss would damage the preferred. As a practical matter, there is no protection for the preferred in this case at all. Moreover, there is no assurance that there will be a substantial ability to pay any dividends on the preferred. There is no pat answer to the question of what the proper cushion for the preferred should be; clearly, it is more than 1 percent or 0.1 percent. I suggest at least 10 percent.

Id. (emphasis added.) The other panelists agreed. See id. at 50-51, 54-56.

45 Id. at 56. This price at a discount to par results because valuation of preferred stock is a function of the dividend rate that is fixed and the rate of return required by investors when purchasing securities of a similar nature and risk. See Eugene F. Brigham, Fundamentals of Financial Management 208 (5th ed. 1989).

46 Rage, supra note 1, at 56. One panelist used a partially cumulative and partially noncumulative dividend. The cumulative dividend was 4% and the noncumulative dividend was set at a rate to bring the total dividend to 2% above the prime rate. Id. at 37-38. Cumulative dividends are important sources of value because, unlike noncumulative dividends, unpaid cumulative dividends carry forward to the next year. Brigham, supra note 45, at 522. But it is important to note that "if the noncumulative dividend for a voting preferred is set at a decent rate and if the holder in fact controls, through the vote of the preferred, the payment of that dividend, it should be irrelevant for valuation purposes that no portion of the dividend is cumulative." Rage, supra note 1, at 49 (comments of William F. Nelson). As we shall see, however, this is the one conclusion of the panel that is not accurate under I.R.C. § 2701 if the election is made. See infra notes 199-201 and accompanying text.

47 Rage, supra note 1, at 37, 56 (comments of Robert M. Meyers). If investors do not expect the company to pay a dividend, an investor's required rate of return is going to increase, thus driving the price of the stock down. In this case, such a result is driven by an expectation that causes the stock to be associated with a greater level of risk. For a discussion of the relationship between required returns and risk aversion, see Brigham, supra note 45, at 113-14.

48 Rage, supra note 1, at 56 (comments of Robert M. Meyers).

49 Id. at 56-57. It is nonetheless important to avoid making the preferred security too complex, as preferred stock is like a Christmas tree. "The tree is simple. It has straight lines and it is easy to
In sum, leading attorneys and valuation experts in the field of estate planning during this conference recommended a very cautious approach to estate freezing. They did not approve of putting too many ornaments\(^5\) on the tree,\(^5\) and argued that at least a partially cumulative dividend that would be paid was desirable.\(^2\)

Given the conservative principles advocated by the most sophisticated of the estate freeze experts, one must wonder if there were any significant abuses to correct. In light of these suggestions, it is interesting that in any discussion of estate freezing abuses, a bogeyman is always mentioned. These "bogeymen" are unnamed attorneys who are willing to go beyond the recommendations of the experts. For example, Professor Cooper stated:

> A more serious drawback to a preferred stock recapitalization, and the only significant reason given by any of our interviewees for not undertaking one in almost every closely held corporation situation is that the corporation becomes loaded with a heavy preferred dividend requirement and the parent finds himself the recipient of a large amount of ordinary income which has already been taxed at the corporate level. In order for the dividend to have credibility, more cautious practitioners seem to believe it should be cumulative and fixed at a rate somewhat higher than the going rate on similar stock issued by listed corporations, which may get into double figures [during] times of high interest rates. This dividend problem seems to have deterred many recapitalizations in recent years. Other practitioners are, however, willing to try a lower dividend rate or even risk a noncumulative dividend to mitigate its burden.\(^3\)

Similarly, the panel discussion used hypotheticals of corporate owners who wanted to go beyond the safe guidelines laid down by the panel.\(^5\) In an article published some years later, another author agreed, stating that he had "noted for several years many planners have been careless

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\(^1\) See supra note 46 and accompanying text.
\(^2\) Cooper, supra note 1, at 175 (emphasis added).
\(^3\) Rage, supra note 1, at 36, 54-56 (comments of Robert M. Meyers).
with the substance of freezes and have ignored the valuation problems inherent in using the risky 'estate planner's preferred'—a 6 percent noncumulative, nonredeemable, nonputtable, nonconvertible, nonvoting preferred stock." This hypothetical, and others, served as the basis for a movement in favor of legislating reform.

D. The Early Legislative Proposals

As noted in the last subsection, Professor Cooper's article stimulated debate on estate freezing. In addition, the article set the focus for the Service's attempts to restrict estate freezing techniques legislatively. A number of suggestions for tax reform that were made over the next ten years affected valuation, although some of them impacted estate freezing only tangentially.

The 1984 Treasury Proposals represented the first significant reform effort. These proposals suggested that minority and fractional share discounts in gift and estate tax valuations be limited and that such interests be valued as a pro rata share of the fair market value of the portion of the asset owned by the donor or decedent. Prior gifts of fractional interests in the asset, in addition to fractional interests of the donor's spouse, would be attributed to the donor or decedent. The rule would apply only if the donor retained a fractional interest after the gift, or if the donor had previously made a gift of a fractional interest in the asset, and would be used to determine whether a sale to a related party was a transfer for adequate consideration. While this proposal did not

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55 What's Hot, supra note 1, at 8; see also, Gazur, supra note 1, at 115-16 n.97 (using hypothetical to demonstrate tax avoidance potential of recapitalization).
56 Cooper, supra note 1.
57 See supra notes 24-40 and accompanying text.
58 As one participant in the panel discussion of the Section of Real Property, Probate and Trust Law of the ABA stated:
Professor Cooper wrote an article that described all of the bright new techniques that smart lawyers are using to euche the Treasury out of transfer taxes. So if you want a road map of where the Treasury and the Internal Revenue Service are going to seek legislative relief over the next ten years, just read this article, because, believe you me, people in the Treasury and the Internal Revenue Service have read it.
Rage, supra note 1, at 32 (comments of John A. Wallace).
59 See infra notes 60-71 and accompanying text.
61 Id. at 386-87.
62 Id. at 387.
63 Id.
directly affect estate freezes, as it was limited to minority and fractional discounts, the attribution and retention rules of the proposal were harbingers of things to come.\(^4\)

The President's tax proposal\(^5\) had no provisions affecting estate freezing. At the request of the Treasury Department, the Section of Taxation of the American Bar Association appointed a task force to study transfer tax reform. The Task Force Report\(^6\) stated that so-called lapsing votes at death should be valued on the basis of the powers the decedent retained until his death.\(^7\) As to Treasury proposals on minority and fractional share discounts,\(^8\) the Task Force Report took no position on the ground that the intended result of the application of the proposals under various fact patterns was unclear.\(^9\) On most of the situations considered by the Task Force, the members were divided.\(^10\) Furthermore, the Task Force focused little attention on estate freezes and buy-sell agreements, noting only that regulations could be promulgated to discourage the use of such techniques when they are, in effect, testamentary substitutes.\(^11\) While neither the proposal of the President nor the Task Force Report was enacted, they set the stage for the first attempt to use legislative means to control estate freezes.

### III. SECTION 2036(c): NIGHTMARE ON CONSTITUTION AVENUE

By 1987 Congress was ready to act. The staffs of the Joint Committee on Taxation and the House Ways and Means Committee prepared a description of revenue raising options.\(^12\) Included in this list were proposals to include in the gross estate the value of the common stock transferred in a recapitalization.\(^13\) In addition, the committee proposed the elimination of minority discounts.\(^14\) Both proposals were included in
a House bill. The House Report, after describing a preferred stock recapitalization and a classic partnership freeze, stated that "[t]he committee believes that keeping a preferred stock interest in an enterprise while giving away the common stock resembles a retained life estate, and should be treated as such." The Senate's version of the bill omitted both proposals. In conference, the minority discount provision was dropped and the estate freezing provision enacted.

Section 2036(c) was a grade-B horror show. The statute basically provided that if a person who holds a substantial interest in an enterprise transfers property that has a disproportionately large share of the potential appreciation in the interest in the enterprise, and retains a disproportionately large share in the income of, or the rights in, the enterprise, the retention is treated as a retention of the enjoyment of the transferred property and thus included in the transferor's gross estate. There are a number of significant words and concepts in section

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78 OBRA, Pub. L. No. 100-203, § 10402, 101 Stat. 1330. The Revenue Act of 1987 was one part of OBRA. See Monster, supra note 1, at 876.
80 I.R.C. § 2036(c) (1987), as enacted by OBRA, provided:
(c) Inclusion Related to Valuation Freezes.—
(1) In general.—For purposes of subsection (a), if—
(A) any person holds a substantial interest in an enterprise, and
(B) such person in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise, then the retention of the retained interest shall be considered to be a retention of the enjoyment of the transferred property.
(2) Special rule for sales to family members.—The exception contained in subsection (a) for a bona fide sale shall not apply to a transfer described in paragraph (1) if such transfer is to a member of the transferor's family.
(3) Definitions.—For purposes of this subsection—
(A) Substantial interest.—A person holds a substantial interest in an enterprise if such person owns (directly or indirectly) 10 percent or more of the voting power or income stream, or both, in such enterprise. For purposes of the preceding sentence, an individual shall be treated as owning any interest in an enterprise which is owned (directly or indirectly) by any member of such individual's family.
(B) Family.—The term "family" means, with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.
2036(c). These include "substantial interest," "enterprise," "in effect transfer," "disproportionately large," "potential appreciation," "family," "interest in the enterprise," and "rights." Of these, only "substantial interest" and "family" are defined in the statute. Even though in the legislative history "enterprise," "transfers," "disproportionately large share of potential appreciation" and "rights" are defined, several of these definitions are so vague as to be meaningless, while others, as defined, serve to include almost every estate planning transaction in the gross estate.

It quickly became apparent that section 2036(c) was inadequate to deal with the perceived problem and uncertain in scope. As a result, major changes were made in the statute in 1988. Furthermore, it is interesting to note the elaboration on what the statute was to accomplish found in the legislative history.

Section 2036(c) is directed at two concerns. The first is that the creation or transfer of disproportionate interests in a business or other

(C) Treatment of spouse.—An individual and such individual’s spouse shall be treated as 1 person.

(4) Coordination with section 2035.—For purposes of applying section 2035, any transfer of the retained interest referred to in paragraph (1) shall be treated as a transfer of an interest in the transferred property referred to in paragraph (1).

(5) Coordination with section 2043.—In lieu of applying section 2043, appropriate adjustments shall be made for the value of the retained interest.

"Id. § 2036(c)(1)(A).
"Id. § 2036(c)(1)(A)-(B).
"Id. § 2036(c)(1)(B).
"Id.
"Id.
"Id. § 2036(c)(2).
"Id. § 2036(c)(1)(B).
"Id.
"Id. § 2036(c)(3)(A).
"Id. § 2036(c)(3)(B).

"Enterprise" is defined in the legislative history as "includ[ing] a business or other property which may produce income or gain." H.R. REP. No. 495, 100th Cong., 1st Sess. 996, reprinted in 1987 U.S.C.C.A.N. 1245, 1742.

"Transfer" is defined in the legislative history as follows: "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 in its accomplishment." Id.

"[D]isproportionately large share of potential appreciation" is defined in the legislative history as "any share of appreciation in the enterprise greater than the share of appreciation borne by the property retained by the transferor." Id.

"Rights" is defined as follows: "Rights in the enterprise include voting rights, conversion rights, liquidation rights, warrants, options, and other rights of value." Id.

This is particularly true of the definitions of "enterprise" and "transfer." See supra notes 91-92.

"See Monster, supra note 1, at 877; see also Gazur, supra note 1, at 123.
property often allows the transfer of wealth outside the transfer tax system, either because of undervaluation at the time of the effective transfer or because of action or inaction of the transferor or transferee after that transfer.

The second concern underlying section 2036(c) is that, by retaining a disproportionate share of the income of, or rights in, an enterprise, the transferor in fact retains enjoyment of the whole enterprise. The transfer is incomplete at the time of the initial transfer, and if enjoyment is retained until death, the transfer is testamentary in nature.97

This invocation of undervaluation is new to section 2036(c), although it is not new to the discussion of estate freezes.98 Clearly, if section 2036(c) was going to satisfy these new concerns, changes were necessary. In the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"),99 Congress tried to solve some of the problems with the statute in two ways—clarifying some of the provisions and providing safe harbors.100

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Undervaluation may occur because the transferor claims a value for the transferred property lower than its fair market value. Undervaluation may result from the transferor granting a person a long-term option to purchase property at a fixed price.

Creation of disproportionate interests in property also permits the transfer of wealth free of transfer tax through the subsequent exercise or nonexercise of rights with respect to the enterprise. Even if the transferred property is properly valued at the time of the initial transfer, wealth may be transferred thereafter if the rights are not exercised in an arm's length manner. This may occur if, after the transfer, either transferor or transferee acts or fails to act or causes the enterprise to act or fail to act. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends to the preferred shareholder. Or, by exercising conversion, liquidation, put or voting rights in other than arm's length fashion (or by not exercising such rights before they lapse), the transferor may transfer part or all of the value of such rights. Even if such exercise or non-exercise results in a gift, which is uncertain, it is virtually impossible for the I.R.S. to monitor all post-transfer action or inaction with respect to such rights.

Id. at 5029.

98 See Monster, supra note 1, at 877.


100 As revised, I.R.C. § 2036(c) (1989) provided:

(c) Inclusion related to valuation freezes.—

(1) In general.—For purposes of subsection (a), if—

(A) any person holds a substantial interest in an enterprise, and

(B) such person in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise,
then the retention of the retained interest shall be considered to be a retention of the enjoyment of the transferred property.

(2) Special rules for consideration furnished by family members.—

(A) In general.—The exception contained in subsection (a) for a bona fide sale shall not apply to a transfer described in paragraph (1) if such transfer is to a member of the transferor's family.

(B) Treatment of consideration.—

(i) In general.—In the case of a transfer described in paragraph (1), if—

(I) a member of the transferor's family provides consideration in money or money's worth for such member's interest in the enterprise, and

(II) it is established to the satisfaction of the Secretary that such consideration originally belonged to such member and was never received or acquired (directly or indirectly) by such member from the transferor for less than full and adequate consideration in money or money's worth,

paragraph (1) shall not apply to the applicable fraction of the portion of the enterprise which would (but for this subparagraph) have been included in the gross estate of the transferor by reason of this subsection (determined without regard to any reduction under paragraph (5) for the value of the retained interest).

(ii) Applicable fraction.—For purposes of clause (i), the applicable fraction is a fraction—

(I) the numerator of which is the amount of the consideration referred to in clause (i), and

(II) the denominator of which is the value of the portion referred to in clause (i) immediately after the transfer described in paragraph (1).

(iii) Section 2043 not to apply.—The provisions of this subparagraph shall be in lieu of any adjustment under section 2043.

(3) Definitions.—For purposes of this subsection—

(A) Substantial interest.—A person holds a substantial interest in an enterprise if such person owns (directly or indirectly) 10 percent or more of the voting power or income stream, or both, in such enterprise. For purposes of the preceding sentence, an individual shall be treated as owning any interest in an enterprise which is owned (directly or indirectly) by any member of such individual's family.

(B) Family.—The term "family" means, with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.

(C) Treatment of spouse.—Except as provided in regulations, an individual and such individual's spouse shall be treated as 1 person.

(4) Treatment of certain transfers.

(A) In general.—For purposes of this subtitle, if, before the death of the original transferor—

(i) the original transferor transfers all (or any portion of) the retained interest referred to in paragraph (1), or

(ii) the original transferee transfers all (or any portion of) the transferred property referred to in paragraph (1) to a person who is not a member of the original transferor's family,
the original transferor shall be treated as having made a transfer by gift of property to the original transferee equal to the paragraph (1) inclusion (or proportionate amount thereof). Proper adjustments shall be made in the amount treated as a gift by reason of the preceding sentence to take into account prior transfers to which this subparagraph applied and take into account any right of recovery (whether or not exercised) under section 2207B.

(B) Coordination with paragraph (1).—In any case to which subparagraph (A) applies, nothing in paragraph (1) or section 2035(d)(2) shall require the inclusion of the transferred property (or proportionate amount thereof).

(C) Special rule where property retransferred.—In the case of a transfer described in subparagraph (A)(ii) from the original transferee to the original transferor, the paragraph (1) inclusion (or proportionate amount thereof) shall be reduced by the excess (if any) of—

(i) the fair market value of the property so transferred, over
(ii) the amount of the consideration paid by the original transferor in exchange for such property.

(D) Definitions.—For purposes of this paragraph—

(i) Original transferor.—The term "original transferor" means the person making the transfer referred to in paragraph (1).
(ii) Original transferee.—The term "original transferee" means the person to whom the transfer referred to in paragraph (1) is made. Such term includes any member of the original transferor's family to whom the property is subsequently transferred.
(iii) Paragraph (1) inclusion.—The term "paragraph (1) inclusion" means the amount which would have been included in the gross estate of the original transferor under subsection (a) by reason of paragraph (1) (determined without regard to sections 2032 and 2032A) if the original transferor died immediately before the transfer referred to in subparagraph (A). The amount determined under the preceding sentence shall be reduced by the amount (if any) of the taxable gift resulting from the transfer referred to in paragraph (1)(B).
(iv) Transfers to include terminations, etc.—Terminations, lapses, and other changes in any interest in property of the original transferor or original transferee shall be treated as transfers.

(E) Continuing interest in transferred property may not be retained.—A transfer (to which subparagraph (A) would otherwise apply) shall not be taken into account under subparagraph (A) if the original transferor or original transferee (as the case may be) retains a direct or indirect continuing interest in the property transferred in such transfer.

(5) Adjustments.—Appropriate adjustments shall be made in the amount included in the gross estate by reason of this subsection for the value of the retained interest, extraordinary distributions, and changes in the capital structure of the enterprise after the transfer described in paragraph (1).

(6) Treatment of certain grantor retained interest trusts.—

(A) In general.—For purposes of this subsection, any retention of a qualified trust income interest shall be disregarded and the property with respect to which such interest exists shall be treated as held by the transferor while such income interest continues.

(B) Qualified trust income interest.—For purposes of subparagraph (A), the term "qualified trust income interest" means any right to receive amounts determined solely by reference to the income from property held in trust if—

(i) such right is for a period not exceeding 10 years,
(ii) the person holding such right transferred the property to the trust, and
(iii) such person is not a trustee of such trust.

(7) Exceptions.—

(A) In general.—Paragraph (1) shall not apply to a transaction solely by reason of 1 or more of the following:

(i) The receipt (or retention) of qualified debt.
(ii) Except as provided in regulations, the existence of an agreement for the sale or lease of goods or other property to be used in the enterprise or the providing of services and—

(I) the agreement is an arm's length agreement for fair market value, and
(II) the agreement does not otherwise involve any change in interests in the enterprise.
(iii) An 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.

(B) Limitations.—

(i) Services performed after transfer.—In the case of compensation for services performed after the transfer referred to in paragraph (1)(B), clause (ii) of subparagraph (A) shall not apply if such services were performed under an agreement providing for the performance of services over a period greater than 3 years after the date of the transfer. For purposes of the preceding sentence, the term of any agreement includes any period for which the agreement may be extended at the option of the service provider.
(ii) Amounts must not be contingent on profits, etc.—Clause (ii) of subparagraph (A) shall not apply to any amount determined (in whole or in part) by reference to gross receipts, income, profits, or similar items of the enterprise.

(C) Qualified debt.—For purposes of this paragraph, except as provided in subparagraph (B), the term "qualified debt" means any indebtedness if—

(i) such indebtedness—

(I) unconditionally requires the payment of a sum certain in money in 1 or more fixed payments on specified dates, and
(II) has a fixed maturity date not more than 15 years from the date of issue (or, in the case of indebtedness secured by real property, not more than 30 years from the date of issue).

(ii) the only other amount payable under such indebtedness is interest determined at—

(I) a fixed rate, or
(II) a rate which bears a fixed relationship to a specified market interest rate.

(iii) the interest payment dates are fixed,
(iv) such indebtedness is not by its terms subordinated to the claims of general creditors,
(v) except in a case where such indebtedness is in default as to interest or principal, such indebtedness does not grant voting rights to the person to whom the debt is owed or place any limitation on the exercise of voting rights by others, and
(vi) such indebtedness—

(I) is not (directly or indirectly) convertible into an interest in the enterprise which would not be qualified debt, and
The amendment first eliminated the requirement that the income or rights retained by the transferor must constitute a disproportionately large share of the total income or rights in the enterprise.\(^{101}\) Furthermore, the amendment added a number of safe harbors for, among other things, qualified debt,\(^{102}\) agreements for the sale or lease of goods used in the enterprise,\(^{103}\) certain consulting or services agreements,\(^{104}\) and start-up debt.\(^{105}\) Additionally, a provision was added under which a gift from the transferor to the transferee is deemed to


\[^{103}\] Id. § 2036(c)(7)(A), (B).

\[^{104}\] Id.

\[^{105}\] Id. § 2036(c)(7)(D).
occur if the original transferor transfers his retained interest or if the
original transferee transfers the transferred property. When focusing
upon this provision, however, it is important to note that terminations,
lapses and other changes in the interest in property are considered
transfers.

Other amendments to section 2036(c) included the addition of a right
of contribution for the tax generated by section 2036(c) from the person
receiving the section 2036(c) property, and for deemed gifts. A new
consideration adjustment that provides for an exclusion of a portion of the
enterprise was also enacted.

These extensive amendments, however, did not resolve all of the
areas of statutory uncertainty; there remained many unknowns within the
statute. Major terms, such as "retained interest," "disproportionate-
appreciation," "in effect transfer," and "enterprise," remained
undefined. And since a bona fide sale to a family member did not
preclude inclusion in the transferor's gross estate, the consideration
offset provided in the statute was important. The determination of the
amount of consideration offset by the statute was complicated by the
tracing rules found in the statute. In addition to the tracing require-
ments, numerous other complexities often arose. Perhaps the
most perplexing problem, however, was the determination of dispropor-
tionate appreciation. The House report had defined the term as the
relationship between two ratios:

104 Id. § 2036(c)(4), (5).
105 Id.
106 Id. § 2036(c)(4)(D)(iv).
107 Id. § 2036(c)(4)(A).
108 Id. § 2036(c)(2). Perhaps because of the complexity of the amended statute, the Service was
given broad regulatory authority over the matters covered in this section. See id. § 2036(c)(8);
109 See Monster, supra note 1, at 878.
111 Id.
112 Tracing involves the matching of proceeds with a specified expenditure. As to be expected in
light of attempts to trace loan proceeds to a specific expenditure, problems can arise as a result of
the fungibility of money. See BORIS I. BITTER & MARTIN J. McMahan, JR., FEDERAL INCOME
114 To further complicate one's analysis under this statutory framework, it was often unclear
whether adjustments for interest and appreciation on the consideration from the date of receipt until
the transferor's death could be allowed in some situations. Also, the "deemed gift" rule, added by the
1988 amendments, would cause significant problems if given a broad interpretation. See Monster,
supra note 1, at 879-81.
115 H.R. REP. No. 795, 100th Cong., 2d Sess. 423 n.20.
Potential Appreciation of Transferred Property
Value of the Transferred Property

and

Potential Appreciation of Retained Interest
Value of Retained Interest

If the first ratio was larger than the second, the test was satisfied. However, the test required a problematic prediction of the amount of appreciation that would occur in the future.\(^{118}\)

Perhaps the most significant problem of the amended statute, however, was that the effect of section 2036(c) on traditional estate planning tools, such as the credit shelter trust\(^{119}\) and the irrevocable life insurance trust,\(^{120}\) as well as newer tools, such as the Grantor Retained Income Trust ("GRIT"),\(^{121}\) was uncertain.\(^{122}\) And the broad regulatory authority given the Service\(^ {123}\) gives rise to thoughts that Congress knew it had created a monster beyond its control.

Under its broad regulatory authority, the Service attempted to provide guidance to practitioners. In advance of regulations, the Service issued an "administrative pronouncement" complete with footnotes and forty-six examples on the workings of section 2036(c).\(^ {124}\) Even the Service recognized the statute’s problems:

Section 2036(c) applies if a person who holds a substantial interest in an enterprise (the "transferor") in effect transfers property having a

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\(^{118}\) See Monster, supra note 1, at 883. This was not the only problem of the statute. The second ratio is not found in the statute. Furthermore, the test required difficult valuations of the retained interests and the transferred property. Ironically, the difficulty of determining these values helped to engender the enactment of I.R.C. § 2036(c) (1989). Id. at 882, 884.

\(^{119}\) A “credit shelter trust” is a trust funded with assets having a value equal to the transferor’s or testator’s unused unified credit with provisions ensuring that it will not be taxed at the death of transferor’s or testator’s spouse. See THOMAS L. SHAFFER & CAROL ANN MOONEY, THE PLANNING AND DRAFTING OF WILLS AND TRUSTS 150-53 (3d ed. 1991); I.R.C. §§ 2010(a), 2505(a).

\(^{120}\) An “irrevocable life insurance trust” is a trust designed to be excluded from the grantor’s gross estate for federal estate tax purposes under I.R.C. § 2042. In order to meet the requirements of Treas. Reg. § 20.2042-1(c)(2) (1992), the trust is characterized by agreements designed to insure that “the insured will have no power to change the beneficiary, surrender or cancel the policy [or retain any other element of control].” GEORGE M. TURNER, IRREVOCABLE TRUSTS § 15.13, at 15-11 (2d ed. 1992).

\(^{121}\) This Article will not treat the GRIT in any detail because Chapter 14 treats the GRIT separately from estate freezes. Part II of this Article, which will focus on section 2702, will discuss the current treatment of GRITs.

\(^{122}\) Monster, supra note 1, at 888-93; Gazur, supra note 1, at 143-52.

\(^{123}\) See supra note 110 and accompanying text.

disproportionately large share of the potential appreciation in such interest, while retaining an interest in the income of, or rights in, the enterprise. The italicized terms embody the significant features and operative elements, and thus delineate the scope, of the statute. Unfortunately, they are neither adequately defined in the statute nor susceptible to generally accepted interpretation.\textsuperscript{112}

In the I.R.S. Notice, the Service attempted to interpret Congressional intent.\textsuperscript{126} Based on its examination of Congressional intent, the Service stated its view that section 2036(c) was not limited to corporate and partnership freeze techniques, "but also [applied] to other arrangements that circumvent the transfer tax system."\textsuperscript{127} More specifically, the Service stated that "other arrangements may include"\textsuperscript{128} the following:

1. GRITs and other trusts where the grantor retains a beneficial interest;
2. Private annuities, installment sales, sales of remainder interests and other intrafamily sales;
3. Sale-leasebacks and gift-leasebacks; and
4. Joint purchases.\textsuperscript{129}

Thus, the focus of the Service became tax avoidance. Transactions clearly within the language of the section could nonetheless be exempted if the Service determined that such transactions did not present the potential for tax avoidance.\textsuperscript{130}

I.R.S. Notice 89-99 was welcomed as valuable guidance to attorneys attempting to interpret the vague statute.\textsuperscript{131} For example, the exemptions for "enterprises" involving life insurance, the principal residence of an individual, and exclusively personal use property, provided clear-cut answers that were absent from the statute.\textsuperscript{132}

\textsuperscript{112} Id. at 422.

\textsuperscript{126} Id. at 423. Basically, the Service believed Congress was focusing on circumvention of the transfer tax system through undervaluation, the failure to exercise rights or powers contrary to the assumptions on which the interests were originally valued, and the coupling of the transfer of appreciation with the retention of income or other rights enabling the transferor to exclude the appreciation while still enjoying the property.

\textsuperscript{127} Id.

\textsuperscript{128} Id.

\textsuperscript{129} Id.

\textsuperscript{130} Id. The example given was arrangements involving exclusively personal use property.

\textsuperscript{131} See King, supra note 1, at 27.

\textsuperscript{132} I.R.S. Notice 89-99, 1989-2 C.B. 422, 424. For example, the Service provided guidance concerning transactions that would not be considered to be the transfer of a disproportionately large share of potential appreciation and general powers of appointment over the corpus in a GRIT. Id. at 428-31. In addition, strict rules governing buy-sell agreements and consideration were provided. Id. at 433-34.
Yet many things remained unclear. "Enterprise" and "disproportionate appreciation" remained undefined. Commentators were convinced that because of its vagueness, section 2036(c) extended beyond its target and seriously threatened all family businesses. The statute could be applied much too broadly, and the safe harbors often were both arbitrary and ambiguous. The critics, especially the business community and its representatives, did not go away.

IV CHAPTER 14: IS JASON WORSE THAN FREDDY?

A. The Problems of Section 2036(c)

Even as interpreted by I.R.S. Notice 89-99, section 2036(c) was subject to many criticisms. Some of the most telling were:

(1) As detailed to some extent above, section 2036(c) failed to define and limit its key concepts and definitions. Among such terms were "enterprise," "disproportionate appreciation," "retained interest" and "in effect transfer." 

(2) Partly because of the definitional problems, the scope of section 2036(c) was unclear. Therefore, the statute was extended well beyond its stated target—certain corporate recapitalizations—and became potentially applicable to almost every corporate transaction in a family held business. In a word, the statute was overinclusive.

(3) Section 2036(c) unfairly discriminated against family businesses. For example, adverse estate tax consequences could arise from an

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133 I.R.C. § 2036(c) (1989).
134 See Slayng, supra note 1, at 152.
135 Id.
136 Id.
139 See supra notes 81-95 and accompanying text.
140 See supra text accompanying notes 111-22; Slayng, supra note 1, at 152.
141 Slayng, supra note 1, at 152; S. Stacy Eastland, The Legacy of I.R.C. Section 2036(c): Saving the Closely Held Business After Congress Made "Enterprise" a Dirty Word, 24 REAL PROP. PROB. & TR. J., 259, 328 (1989) [hereinafter Legacy]; see generally Chairman Rostenkowski's discussion draft of a bill to modify section 2036(c) of the Internal Revenue Code of 1986, as amended relating to estate valuation freezes: Hearings Before the House Comm. on Ways and Means, 101st Cong., 2d Sess. (1990) [hereinafter Hearings].
142 Senate Explanatory Material Concerning Committee on Finance 1990 Reconciliation Submission Pursuant to H.R. Con. Res. 310, 101st Cong., 2d Sess., 136 CONG. REC. S15,629, 15,680 (daily ed. Oct. 18, 1990) [hereinafter Senate Report]. Due to the short deadline, the Senate Budget Committee sent the reconciliation bill to the floor without printing a formal report. The reports submitted by the various senate committees (including the Finance Committee) were submitted in lieu of a formal report at the beginning of the debate. Pages are cited to the Finance Committee
arm’s length transaction if the parties involved were related. Significantly, however, I.R.C. 2036(c) never applied to publicly traded businesses.

(4) Section 2036(c) was also underinclusive in that it neither eliminated estate freezes nor solved the valuation problems that caused Congress to legislate against freezes.

(5) As applied to certain transactions where there is no gift in a tax sense, section 2036(c) was at least potentially unconstitutional.

Many commentators and policy advocates argued that even under the most abusive estate freezes, the estate tax inclusion approach of section 2036(c) was the wrong way to solve the problem. These policy advocates based their position on an argument that the problem of estate freezes was not one of inclusion or exclusion, but one of the valuation of the various interests created by the estate freeze. The most common of the valuation problems involved placing a value on preferred and common stock interests.

The abuses involved allocating a disproportionately high value to the preferred stock, resulting in an undervaluation of the common stock. Moreover, as the abuses occur not at death, but at the time of the split in the ownership of the preferred and common interests, the problem of freezes is in reality a gift tax valuation problem, not an estate tax inclusion problem. If viewed from this more narrow approach that the

Explanations and to the Congressional Record. See also Legacy, supra note 141, at 325 (discussing preferred interests in closely held businesses); Slayng, supra note 1, at 152.

Stacy Eastland was the leading proponent of this theory. Id. at 328-30. This theory is based upon an argument that I.R.C. § 2036(c) may violate Article 1, Section 9 of the United States Constitution as an unapportioned direct tax on property. Since § 2036(c) does not require a gift element for transferred property, it may be applied to an economic bargain and thus constitute a direct tax on property. It is also potentially a denial of the Due Process and Equal Protection Clauses. Id. at 328-29. Eastland, an attorney practicing with Baker & Botts in Houston, Texas, chaired the ABA’s Section of Real Property, Probate and Trust Law Committee C-6 on Estate Planning and Drafting: Partnerships. Id. at 259.

I.R.C. § 2036(c) (1989).

Id. at 326-27; Hearings, supra note 141, at 1-4 (statement of E. James Gamble at 1; statement of John A. Wallace at 2-3; statement of Jere D. McGaffey at 2-3); Senate Report, supra note 142, at S15,680.

See, e.g., Hearings, supra note 141 (statement of E. James Gamble at 1).

See supra notes 24-32 and accompanying text.

See Cooper, supra note 1, at 225-26.

Hearings, supra note 141 (statement of Jere D. McGaffey at 1-2); Slayng, supra note 1, at 153; see also Legacy, supra note 141, at 324-25 (discussing the advantages of preferred ownership interests); Senate Report, supra note 142, at 58.
abuses are actually problems of gift tax valuation, a solution can be constructed that "allows legitimate preferred stock recaps and their partnership equivalents." Under such an approach, fair valuation of such interests created by the estate freeze would be required, legitimate recapitalizations would be allowed, and only abusive freezes would be attacked.

B. The Development of a Replacement

As mentioned in the preceding section, section 2036(c) was subject to severe criticism. The problem came to a head in the Spring of 1990. Representative Daniel Rostenkowski, Chairman of the House Ways and Means Committee, introduced a Discussion Draft of a new statute that would repeal section 2036(c) and substitute a gift tax valuation approach. A hearing on the Discussion Draft took place on April 24, 1990. On June 27, 1990, the Senate Finance Committee and two subcommittees held a joint hearing on the Discussion Draft, and on August 1, 1990, Chairman Rostenkowski introduced H.R. 5425, which served to modify and elaborate upon the format presented in the Discussion Draft.

The Senate soon followed the House's initiative. On September 26, 1990, Senators Bentsen, Boren and Daschale introduced S. 3113, which repealed section 2036(c) and substituted a different method of regulating estate freez.es. On October 13, 1990, S. 3113 was modified to track many of the key provisions of H.R. 5425. The Senate Bill, introduced on October 13, became sections 11,601 and 11,602 of the Revenue Reconciliation Act, which became part of the Omnibus Budget Reconciliation Act ("OBRA") of 1990, enacted on November 5, 1990.

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153 Hearings, supra note 141, at 1-2.
154 I.R.C. § 2036(c) (1989).
155 See supra note 141.
157 Id.
158 Id.
159 Id.
160 Id.
161 Id.
C. Summary of Chapter 14

Section 2036(c) was repealed retroactively and was replaced with four new sections. Section 2701, with which this Article is concerned, covers estate freezes. Section 2702 deals with valuations of interests in trusts and analogous situations. Section 2703 covers buy-sell agreements and other restrictions on transfers. Section 2704 involves interests with voting rights which lapse.

Since the discussion of section 2701 in the remainder of this Article is organized by suggestions as to the conditions under which a recapitalization is and is not appropriate, a brief overview of section 2701 will be provided. This is necessary as the main crux of this Article involves the appropriate use of preferred and common interests in a restructuring, rather than a technical explanation of the statute’s provisions.

In the words of the statute, section 2701 is applicable “[s]olely for purposes of determining whether a transfer of an interest in a corporation or partnership to a member of the transferor’s family is a gift,” and, if so, the value of the gift. Under the provisions of the statute, if a transferor transfers common stock, but retains preferred stock in an entity, any liquidation, put, call, or conversion right of the preferred stock (hereinafter referred to as “extraordinary payment

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163 Id. § 11,601(a), (c).
165 Id. § 2701(a)(4)(B)(i) (1992) as common stock, if in a corporation, or if the interest is in a partnership, the interest in which the income and capital rights are junior to all other equity classes.
166 Technically, applicable retained interest, defined in I.R.C. § 2701(b) (1992) as an interest that contains a liquidation, put, call, or conversion right, or a distribution right if the transferor and applicable family members control the entity immediately before the transaction. Control requires the holding of at least 50% by value or vote. In partnerships, it requires 50% of the capital or profits interest or being a general partner in a limited partnership. I.R.C. § 2701(b)(2) (1992). Applicable family members are the transferor’s spouse, ancestors of the transferor and her spouse, and spouses of ancestors. I.R.C. § 2701(e)(2) (1992).
167 A “put” is an option to sell a security as specified in an agreement, during a specified period at a fixed price. See HAMILTON, supra note 12, at 474.
168 A “call” is an option to purchase a security as specified in an agreement, during a specified period at a fixed price. Id. at 540.
169 A conversion right entitles the holder of the preferred stock to convert the stock into a fixed number of common shares in the same enterprise. Id. at 548.
rights'') is deemed to have a value of zero.\textsuperscript{175} If the corporation is a controlled entity,\textsuperscript{176} any distribution right\textsuperscript{177} except a qualified payment right\textsuperscript{178} is valued at zero.\textsuperscript{179} Qualified payment rights are basically cumulative dividend rights payable on a periodic basis at a fixed rate\textsuperscript{180} and are valued at fair market value.\textsuperscript{181}

Since the value of the gift is determined by the subtraction method,\textsuperscript{182} in most cases a lower value of the preferred stock will cause a higher taxable gift and a higher gift tax. This is because in most estate freezes involving recapitalizations, the common stock is given away and the preferred retained.\textsuperscript{183}

If the preferred interest contains a qualified payment right and the dividends are not paid within four years of the due date,\textsuperscript{184} the transferor's taxable estate or taxable gifts are increased by the amount of the unpaid dividends plus hypothetical earnings\textsuperscript{185} on the dividends.\textsuperscript{186} The earnings are determined by assuming that the dividends were paid on the due date and reinvested on that date at a yield equal to the discount rate used in determining the value of the applicable retained interest at the time of the transfer.\textsuperscript{187} This

\textsuperscript{175} I.R.C. § 2701(a)(3)(A) (1992). There are limited exceptions to this valuation provision. For example, fixed rights, exercisable at a fixed time and amount, are excluded from the definition. Id. § 2701(b)(2)(B). Similarly excluded are rights to convert into a fixed number of shares in the same class as the transferred shares if the right does not lapse, can be adjusted for splits and similar changes, and must be adjusted for accumulated but unpaid dividends. Id. § 2701(c)(2)(C).

\textsuperscript{176} Id. § 2701(b)(2); see supra note 171.

\textsuperscript{177} A distribution right is a right to receive distributions on stock or an interest in the partnership. I.R.C. § 2701(c)(1)(A) (1992). Again, there are exceptions to the general rule laid down by the statute. Distribution rights in junior equity interests, extraordinary payment rights, and I.R.C. § 707(c) guaranteed payments are excluded. Id. § 2701(c)(1)(B).

\textsuperscript{178} Qualified payment rights include dividends on cumulative preferred stock, and similar partnership interests, payable periodically at a fixed rate. Id. § 2701(c)(3)(A). The cumulative preferred stock exemption is logical because unpaid dividends must be paid before the common shareholders receive any dividends. See HAMILTON, supra note 12, at 549.


\textsuperscript{180} See supra note 178.


\textsuperscript{182} Treas. Reg. § 25.2701-3(b) (1992). The subtraction method is the method used to determine the amount of a gift resulting from an I.R.C. § 2701 transfer. The value of family-held senior equity interests (i.e., preferred stock) is subtracted from the fair market value, before the transfer, of family-held interest in the entity. The resulting amount is allocated among the transferred interests and other subordinate family-held equity interests. The regulations provide a step-by-step method for determining the final allocation. Treas. Reg. § 25.2701-3(b) (1992).

\textsuperscript{183} See supra notes 7-16 and accompanying text.


\textsuperscript{185} See infra note 188 and accompanying text.


\textsuperscript{187} Id. § 2701(d)(2)(A)(f). See infra note 205.
increase is limited, however, to the increase in value of interests junior to the preferred stock. While section 2701 is broad in its general scope, it is limited by a number of specific provisions within the statutory framework. For example, the following are not subject to section 2701.

1. Preferred stock and common stock for which market quotations on an established securities market are available;

2. The retained interest if it is of the same class as the transferred interest;

3. The retained interest where it is proportionately the same as the transferred interest, ignoring nonlapsing differences in voting power; and

4. Transfers that result in a proportionate reduction of each class of stock held by the transferor.

With this in mind, there are a number of rules to use when developing an estate freeze.

V Rule 1—Use Cumulative Preferred Stock or Similar Partnership Interests

Prior to a discussion of the first rule of estate freezing under Chapter 14, it is necessary to focus briefly upon the portions of section 2701 this Article will discuss. The classic recapitalization or partnership freeze is rarely done with marketable securities or with one class of securities with differences in voting rights. It is possible that in the future one might see a partial freeze based on a proportionate reduction in each class of stock held by the older generation member. For example, a closely held corporation with only common stock could recapitalize and issue common and preferred. The grantor-owner could then transfer, for example, one-half of the common and one-half of the preferred to the younger generation. Section 2701 would not apply to this transfer. Such transactions would insulate the transferor from estate inclusion of the

189 I.R.C. § 2701(d)(2)(B) (1992). If the transferor did not own the entire class of preferred, the limit is adjusted for his ownership percentage. Id.
190 Id. § 2701(a)(1), (2)(A).
191 Id. § 2701(a)(2)(B).
192 Id. § 2701(a)(2)(C).
194 Although it is possible that an S corporation could do a partial freeze of the latter type, the freeze would not be truly effective because of the appreciation potential of the retained stock.
appreciation on the common transferred from the date of transfer until death.

Whether such transactions will become more common in the future may depend on many factors, including significant non-tax factors such as the age and health of the owner, his desire to cut down on the time spent in the business, and the ability and desire of the younger generation to run the company.

Other than the proportionality exemption, in most normal cases in which a recapitalization will be considered it can be assumed that the section 2701 exemptions will not apply and thus the transaction will fall within the scope of section 2701. Moreover, in most cases the corporation involved will be a controlled entity where the transferor and the applicable family members have at least fifty percent ownership, either by value or by vote, immediately before the transaction. Therefore, all distribution rights other than qualified payment rights are valued at zero.

The first rule for estate freezing in the 1990s is simple: the preferred stock must be cumulative. The reason is that cumulative preferred stock is the only stock that contains a qualified payment right and is thus

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196 Id. § 2701(b).
197 Id. § 2701(a)(3)(A). Nonetheless, if the corporation is not a controlled entity, any distribution right will be valued at fair market value. Thus, noncumulative dividends will become available to increase the value of the preferred and limit the gift tax on the transfer. As discussed earlier, one of the abuses believed to be present in estate freezes of the 1970s and early 1980s was the creation of high-rate noncumulative dividends with no expectation of payment. See supra notes 28-31 and accompanying text. Thus, theoretically, could still happen if the corporation is not a controlled entity. However, the Service has begun to attack the non-payment of such noncumulative dividends as gifts. See Priv. Ltr. Rul. 87-230-07 (Feb. 18, 1987). Similarly, the Service may police situations in which holders of convertible preferred stock refrain from converting their securities when such a conversion would be financially beneficial to the holder of the preferred interest. See Priv. Ltr. Rul. 87-26-005 (Mar. 13, 1987) (failure to exercise conversion rights was gift from preferred to common shareholders).
198 I.R.C. § 2701(a)(3) (1992). To get to this result takes several steps. First, the statute applies to applicable retained interests. Id. § 2701(a)(1)(B). Applicable retained interests include distribution rights in controlled entities, id. § 2701(b)(1)(A), and liquidation, put, call and conversion rights. Id. § 2701(b)(1)(B). These rights are valued under § 2701(a)(3). Liquidation, put, call and conversion rights and distribution rights other than qualified payment rights are valued at zero per operation of § 2701(a)(3). Furthermore, distribution rights include any right to distributions from stock or partnership interests except junior equity interests and § 707(c) guaranteed payments. Id. § 2701(c)(1). Finally, qualified payment rights, rights that are not valued at zero by § 2701(a)(3), are rights to periodic, fixed-rate dividends on “cumulative preferred stock (or a comparable payment under any partnership interest)” Id. § 2701(c)(3)(A). As a result of the interworkings of these sections, it becomes obvious that one must use cumulative preferred stock to avoid a valuation of zero under section 2701(a)(3) because of the necessity of maintaining a qualified payment right under section 2701(c)(3)(A).
the only stock that is valued at fair market value.\footnote{200} Therefore, if the client's desire is to pay a low gift tax, or to avoid the payment of any gift tax, the value of the preferred must be equal to a large portion of the value of the corporation. The only way to meet this objective is through the use of cumulative preferred stock.\footnote{201}

**VI. Rule 2—Always Pay the Cumulative Dividend Within Four Years of the Payment Date**

Suppose a client does not need the cumulative dividend or wishes to avoid increasing the size of his estate and requests that the dividend be used by the corporation to expand its business. Any such attempt, of course, could trigger an argument by the IRS that such an act would amount to a gift to the common shareholders.\footnote{202} The Service, however, has another option, an option that is drastic for the client. Section 2701 provides that failure to pay a cumulative dividend results in an increase in the transferor's taxable estate or taxable gifts.\footnote{203} As a result, the transferor's estate or gifts would be increased by the amount of dividends not paid within four years of the due date of the dividend.\footnote{204} This amount is further increased as the amount of dividends not paid is compounded by the "discount rate used in determining the value of the applicable retained interest"\footnote{205} at the time of the original transfer, less

\footnotesize
\begin{itemize}
  \item \footnote{201} It should be noted that the rate of the cumulative preferred can be either fixed or tied to a specific market interest rate (for example, prime rate less 4%). I.R.C. § 2701(c)(3)(A), (B) (1992). The regulations require the dividend to be payable annually and permit a dividend of a fixed amount. Treas. Reg. § 25.2701-2(b)(6) (1992).
  \item \footnote{203} I.R.C. § 2701(d)(1) (1992). The increase is to taxable gifts if the retained interest is transferred or if the payment is made more than four years after the due date. The increase is to the taxable estate on death of the transferor if the applicable retained interest is included in his or her estate. Id. § 2701(d)(3). Special rules are prescribed for transfers to spouses and applicable family members. Id. § 2701(d)(3)-(4).
  \item \footnote{204} Id. § 2701(d)(2)(C).
  \item \footnote{205} Id. § 2701(d)(2). The term "discount rate" is ambiguous. It has been suggested that the rate be the one used in valuing the corporation. See Carlyn McCaffrey & Susan P. Witkin, *Asset Freezes and New Valuation Rules of Chapter 14*, 25 U. MIAMI INST. ON EST. PLAN. ¶¶ 900, 901.4, at 9-16 (1991). Several other choices, such as the applicable federal rate under § 1274, or the § 7872 and § 7520 rates, are possibilities. Id. Perhaps a choice more in keeping with the purpose of § 2701 would be the cumulative dividend rate set in the original transaction or elected by the transferor if the transferor took advantage of the provisions of I.R.C. § 2701(c)(4)(C)(ii) to treat otherwise non-qualifying distribution rights as qualified payments. If a payment on a cumulative preferred dividend is not made, it must be assumed that the amount of the dividend is reinvested in the corporation. It must also be assumed that the transferor who is the holder of the applicable retained interest cannot expect to earn more on the funds invested in the corporation than the rate of the cumulative dividend. Therefore, the choice of the cumulative dividend rate is logical in this context, and would be
the value of any dividends actually paid similarly compounded.\textsuperscript{206} For the purposes of compounding, the dividends are treated as if they were paid on the due date. It is also important to note that the termination of the interest,\textsuperscript{207} or of the individual’s rights,\textsuperscript{208} is a taxable event.\textsuperscript{209} The increase resulting from compounding is limited, however, to the percentage of the class owned by the transferor multiplied by the increase in the value of junior equity interests after the transfer.\textsuperscript{210}

In the prototype estate freeze where the transferor has retained all of the preferred and transfers all the common to the younger generation, the limit is the appreciation in the common.\textsuperscript{211} Lest one think that the consistent with the valuation of such funds under modern valuation techniques such as the Capital Asset Pricing Model. See \textit{BRIGHAM, supra} note 45, at 602. This is consistent, in theory, with what a corporation would be required to pay as a cost of retained earnings to a reasonable investor. \textit{Id.} at 602-03. It is to be regretted that the statute is not more specific on the rate to be used. Nor do the regulations provide much aid. For example, Treas. Reg. \$ 25.2701-4(c)(3) (1992) provides: “The appropriate discount rate is the discount rate that was applied in determining the value of the qualified payment right at the time of the transfer to which section 2701 applied.”

\textsuperscript{209} \textsuperscript{2} I.R.C. \$ 2701(d)(2) (1992); see \textit{supra} note 205.

\textsuperscript{207} I.R.C. \$ 2701(d)(2) (1992).


\textsuperscript{209} The taxable transfer may be postponed if at the time of the termination of the individual’s rights to a qualified payment, the property would be included in his or her gross estate if the individual died immediately after the termination. In such a case, the increase in gifts is postponed until the earlier of the individual’s death or the time the property would not be includable in the individual’s gross estate (except under section 2035). Treas. Reg. \$ 25.2701-4(b)(2) (1992). The statute contains attribution rules, which can also cause taxable events. \textit{See id.} \$ 25.2701-4(b)(1). See I.R.C. \$ 2701(e)(3) (1992) and Treas. Reg. \$ 25.2701-6 (1992) for the attribution rules.

\textsuperscript{211} I.R.C. \$ 2701(d)(2)(B) (1992).

\textsuperscript{211} Treas. Reg. \$ 25.2701-4(c)(6) (1992) states this limitation as follows:

(i) \textit{In general.} The amount of the increase to an individual’s taxable estate or taxable gifts is limited to the applicable percentage of the excess, if any, of—

(A) The sum of—

(1) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the taxable event without regard to any accrued liability attributable to unpaid qualified payments; and

(2) Any amounts expended by the entity to redeem or otherwise acquire any such subordinate interest during the period beginning on the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated) and ending on the date of the taxable event (reduced by any amounts received on the resale or issuance of any such subordinate interest during the same period); over

(B) The fair market value of all outstanding equity interests in the entity that are subordinate to the applicable retained interest, determined as of the date of the transfer to which section 2701 applied (or, in the case of an individual treated as an interest holder, on the date the interest of the prior interest holder terminated).

(ii) \textit{Computation of limitation.} For purposes of computing the limitation applicable under this paragraph (c)(6), the aggregate fair market value of the subordinate interests in the
penalty is not substantial, Professor Stacy Eastland has estimated the increase on the following set of facts:

P owns 80% of the partnership interests of Freeze, Ltd. (all of Freeze Ltd.'s assets are worth $2,250,000). For years her attorney has been telling her that she should consider making some significant gifts of her partnership interests in Freeze, Ltd. to her two children, C1 and C2. From time to time, P did make some small gifts and collectively C1 and C2 own 20% of the limited partnership interests of Freeze, Ltd. P has been reluctant to make any more gifts because (i) she wants control of the partnership (it is her life); (ii) she is afraid that making significant gifts of her enterprise to her children would result in cash distributions to her children, which would spoil them; and (iii) she wishes to retain the option of receiving cash flow from her business in case she has deteriorating health. However, P recognizes that her business will probably grow substantially in the future and as a result under our estate tax laws the government will be a senior partner in her business, all of which distresses her. In 1991, her attorney suggested that she do a reorganization that results in her receiving a frozen limited partnership interest and not elect to treat that frozen distribution right as a qualified payment. More specifically, her attorney suggests: P and her children enter into the following reorganization of the partnership. In 1991 P will receive 8% non-cumulative preferred partnership interest with a par value of $1.8 million. P will have the discretionary right to put that preferred partnership interest into the partnership at any time for $1,000,000. Upon liquidation of the partnership the preferred partnership interest will be entitled to $1.8 million but would not be entitled to any other part of the growth of the partnership. P will be the managing partner. P will have the first right to purchase any additional preferred partnership interest or growth partnership interest that is issued by the partnership. The partnership is to terminate in 2041. Under normal valuation principles under IRC § 2512, P would have been charged with

entity are determined without regard to § 25.2701-3(c).

(iii) Applicable percentage. The applicable percentage is determined by dividing the number of shares or units of the applicable retained interest held by the interest holder (or an individual treated as the interest holder) on the date of the taxable event by the total number of such shares or units outstanding on the same date. If an individual holds applicable retained interests in two or more classes of interests, the applicable percentage is equal to the largest applicable percentage determined with respect to any class. For example, if T retains 40 percent of the class A preferred and 60 percent of the class B preferred in a corporation, the applicable percentage with respect to T's holdings is 60 percent.
making a $100,000 gift by participating in the reorganization. In other words, P's preferred interest is worth $1,700,000. Cl's interest and C2's interest is worth 40% less than its liquidation value before the freeze, or $270,000. In the year 2021, at the time of P's death the partnership is worth $6,000,000. From 1991 to 2021, the partnership only had the wherewithal to distribute $72,000 a year to P, pursuant to her non-cumulative distribution rights.\textsuperscript{212}

Assuming that P elected to have her noncumulative preferred partnership interest treated as a qualified payment interest, the maximum upward adjustment equals $144,000 multiplied by the assumed discount rate for fifteen years.\textsuperscript{213} Assuming a ten percent discount rate, the maximum adjustment is $5,032,761.\textsuperscript{214} However, since the appreciation in the growth interest is only $4,000,000, the adjustment is limited to $4,000,000 \textsuperscript{215} because of the operation of Treasury Regulation section 25.2701-4(c)(6).\textsuperscript{216} Notice that this analysis presumes that one-half of the payments due are made. The adjustment, absent the $4,000,000 limiting factor,\textsuperscript{217} would be much greater if the payments to P had been less or nonexistent. Another commentator has computed that the increase on $1,000,000 of ten percent cumulative preferred stock if dividends are not paid for ten years results in an increase to the taxable base of $2,599,000.\textsuperscript{218} To avoid such increases it is vital that dividends be paid when due, or at least within four years of the due date.\textsuperscript{219}

VII. RULE 3—DON'T BE GREEDY.
SET THE DIVIDEND AT A RATE THE CORPORATION OR PARTNERSHIP CAN AFFORD

This rule is really a combination of the last two rules. The preferred must be cumulative to accomplish the freeze.\textsuperscript{220} But setting the dividend

\textsuperscript{212} Eastland Outline, supra note 156, at 120-21.
\textsuperscript{213} Id. at 128.
\textsuperscript{214} Id. at 129.
\textsuperscript{215} For a more detailed account of this analysis, see id.
\textsuperscript{216} See supra note 211 and accompanying text.
\textsuperscript{217} Treas. Reg. § 25.2701-4(c)(6) (1992); see supra note 211 and accompanying text.
\textsuperscript{218} Jere D. McGaffey, Corporate Freezes and Section 2701, in A.L.I.-A.B.A. VIDEO L. REV., ESTATE PLANNING UNDER NEW CHAPTER 14 AND THE PROPOSED REGULATIONS 63, 77 (June 13, 1991) (citation to transcript on file) (noting the tremendous impact that the compounding of payments has upon ultimate value, and therefore, the taxable base of the taxpayer).
\textsuperscript{219} The value of the transferor's estate or gifts for tax purposes is only increased by the amount of unpaid dividends past due by more than four years by operation of I.R.C. § 2701(d)(2)(C) (1992). For a discussion of this point, see supra notes 202-05 and accompanying text.
\textsuperscript{220} See supra notes 194-201 and accompanying text.
rate too high could result in large increases in later years' taxable gifts or in the decedent's taxable estate.\textsuperscript{221} It is highly unlikely that these later increases will be anticipated by the client or his family, who typically will wish to avoid estate or current gift taxation. Such increases could destroy the effectiveness of the estate plan. Therefore, the dividend should be set at a rate that can be easily covered by the corporation's or partnership's anticipated cash flow. Possible developments and downturns in the business should be taken into account and the rate set should be reasonable and well within the capacity of the corporation to pay.\textsuperscript{222}

As demonstrated in the last section, the draconian penalty for unpaid distributions provides great incentives for payment of the cumulative dividends on time.\textsuperscript{223} Similarly, it mandates caution when setting the dividend rate and it militates against "electing in."\textsuperscript{224} Prior to moving on, however, a brief pause is required to discuss what appears to be a significant omission in the statute.

In order to avoid increases in the transferor's taxable estate or taxable gifts, the dividends must be paid.\textsuperscript{225} In planning her estate, a business owner can probably anticipate with a fair degree of accuracy the cash flow of her business for at least several years.\textsuperscript{226} This information, of course, is crucial in designing the preferred stock and setting the dividend, because the dividend must be set at a rate that the corporation

\textsuperscript{221} This situation would result if the rate was set so high that the corporation could not meet the payments to the point that dividends older than four years were in arrears. Such a situation would trigger compounding under I.R.C. § 2701(d)(2) (1992). For a discussion of the workings of this statute, and closely related statutes, see supra notes 202-05 and accompanying text.

\textsuperscript{222} The result of such a strategy, of course, is that the transferor will make a greater gift at the time of the recapitalization than was the case prior to 1990. For example, suppose A owns all the stock in a $5,000,000 corporation. He recapitalizes the corporation into preferred and common, retaining the preferred and giving the common to his children. Assume a cumulative dividend rate on the preferred of 10% would support a preferred value of $4,400,000. However, after evaluating his cash flow and future expectations, A decides the corporation can afford to pay only a five percent rate. Assume that the five percent cumulative dividend supports a preferred value of $3,000,000. A has not previously used his unified credit. With a 10% cumulative dividend, P would have made a $600,000 gift (ignoring annual exclusions) and paid no gift tax. With a five percent dividend he makes a gift of $2,000,000 (ignoring annual exclusions) and pays a gift tax of $780,800. However, assuming the dividends are paid when due, there will be no increase in his gross estate or future taxable gifts.

\textsuperscript{223} See supra notes 212-18 and accompanying text.

\textsuperscript{224} Section 2701(e)(4)(C)(ii) provides that the transferor may elect to treat otherwise non-qualifying distribution rights as qualified payments. See supra note 205.

\textsuperscript{225} See supra notes 202-07 and accompanying text.

\textsuperscript{226} Of course, if the company is about to embark on a risky new venture, or market conditions are expected to change radically, a reasonably accurate forecast of cash flows will be considerably more difficult. In the case of a stable company within a mature industry, however, projections of cash flows to the degree of accuracy necessary can often be achieved through an effective use of financial planners. See Brigham, supra note 45, at 378-79.
can afford to pay regularly. However, section 2701 has no provision for the interruption of a dividend due to an unanticipated event. For example, suppose the business suffers a large adverse court judgment that will prohibit the payment of dividends for several years. Or, perhaps more likely, suppose the company incurs clean-up liability under CERCLA. In such a case, the client would be hit with increased estate or gift tax liability. It is unlikely that the drafters of section 2701 contemplated this scenario.

The statute does, however, contain two provisions that may mitigate this type of problem. First, the statute provides that distributions paid within four years of the due date are treated as having been made on the due date. Therefore, such payments made during this four-year window will prevent the imposition of any additional estate or gift tax. Thus, if the impact of the adverse event is of moderate degree, the possibility exists that the business can recover enough to pay the dividends within four years of the due date. Second, the limitation on the increase to the increased value of junior equity interests can be of assistance. A catastrophic business reversal, such as bankruptcy or CERCLA liability, would clearly reduce the value of the common stock, and could in fact cause the value of the common stock to be worth less than when the transfer was made. In such case, of course, no addition to the client's later gifts or taxable estate would occur. The problem with these two mechanisms is that they are useful only for limited periods. They would not provide relief in all cases.

For example, assume that the client recapitalizes the stock of his family-owned business into seven percent cumulative preferred and common stock. He retains the preferred and gives the common to his children. For the first four years the preferred dividends are paid, but in

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228 This liability would result by operation of I.R.C. § 2701(d)(2)(C). For a discussion of this provision, see supra notes 202-18 and accompanying text.

229 Clearly such an unfortunate turn of events would not have been considered by the drafters of I.R.C. § 2701 (1992) to be an abusive estate freeze. Therefore, penalizing those caught in this situation appears to contradict the goal stated in the statute's legislative history of "allow[ing] legitimate preferred stock recaps." Hearings, supra note 141 (statement of Jere D. McGaffey at 1-2).


231 Id. § 2701(d)(2).

232 Id.
year five the government finds toxic wastes on the land owned by the business and the client incurs massive clean-up costs. No dividends are paid for the next ten years. After the clean-up costs are paid the company grows prosperous again. If the transferor lives throughout this entire period and does not die, for example, until thirty years after the transfer, the missed dividends will nonetheless be compounded, resulting in an unanticipated increase in the client’s estate.\(^{233}\)

VIII. RULE 4—THE VALUE OF THE COMMON STOCK IS ALWAYS TEN PERCENT OF THE VALUE OF THE EQUITY INTERESTS IN THE CORPORATION\(^ {234}\)

As previously mentioned when discussing the classic estate freeze of the late 1970s and early 1980s, the goal was to value the preferred stock at the total value of the company and the common stock at zero.\(^ {235}\) Then, when the common stock was given to the younger generation and a taxable gift was made, the value of the gift was zero. Clearly, Congress saw this as an abuse. The Senate Finance Committee Report,\(^ {236}\) followed by the conference committee,\(^ {237}\) provided as follows:

The committee believes that the residual interest in a corporation or partnership may have value in excess of current projected cash flows because it carries with it the right to future appreciation. The market often gives substantial value to this “option value.” Accordingly, the committee bill provides for a minimal value for the residual interests in a corporation or partnership. This minimum value, in effect, sets a floor on the discount rate used in valuing the preferred interests in a corporation or partnership that is not dramatically below the market rate.

\(^{233}\) Id. § 2701(d)(2)(C). The damage of this section can be limited, however. One possibility of limiting the damage in this case is to take advantage of a provision found in I.R.C. § 2701(d)(3)(A)(iii) (1992), which allows the taxpayer to pay the qualified payment and stop the compounding. In the example above, client could have paid the 10 years of missed dividends as soon as the company was able (say in year 18) and stopped the compounding on the missed dividends. The election to pay past dividends is made on a gift tax return. Treas. Reg. § 25.2701-4(d)(2), (3) (1992). If the election is made on a timely filed return, the taxable event occurs on the date the dividend is paid. If the election is made on a late return, the taxable event occurs on the first day of the month before the return is filed. Id. § 25.2701-4(d)(4). A statement containing certain information must accompany the return. Id. § 25.2701-4(d)(3)(iii).

\(^{234}\) Actually, the junior equity interest is equal to 10% of the sum of the total value of all equity interests in the corporation and the corporation’s debt to the transferor and applicable family members. I.R.C. § 2701(a)(4)(A) (1992).

\(^{235}\) See supra notes 7-16 and accompanying text.

\(^{236}\) See Senate Report, supra note 142, at 59; 136 CONG. REC. at S15,861.

This floor reflects the minimal coverage that a purchaser of the preferred stock might require in the market for traded securities.\textsuperscript{238}

The statute provides that all junior equity interest in a corporation or partnership shall have a value of no less than ten percent of the sum of the total value of all equity interests in the corporation and the debt owed by the corporation to the transferor and applicable family members.\textsuperscript{239} Junior equity interest is defined as common stock or partnership interests that are junior as to income and capital rights.\textsuperscript{240} In short, the statutory rule is that common stock can be valued at no less than ten percent of the value of the equity interests, including preferred equity interests, in the corporation. The regulations state:

\textit{Minimum value rule—}

(1) \textit{In general}: If section 2701 applies to the transfer of an interest in an entity, the value of a junior equity interest is not less than its pro-rata portion of 10 percent of the sum of—

(i) The total value of all equity interests in the entity, and

(ii) The total amount of any indebtedness of the entity owed to the transferor and applicable family members.

(2) \textit{Junior equity interest}. For purposes of paragraph (c)(i) of this section, junior equity interest means common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests. Common stock means the class or classes of stock that, under the facts and circumstances, are entitled to share in the reasonably anticipated residual growth in the entity.\textsuperscript{241}

It is clear that section 2701 and the regulations contemplate the possibility of more than one class of junior equity interest in an entity. It is equally clear that it is these junior equity interests in total that must be valued at ten percent of the total value of the equity interests in the entity.

\textsuperscript{238} See Senate Report, supra note 142, at 59, 136 Cong. Rec. at S15,681.


\textsuperscript{240} Id. § 2701(a)(4)(B).

\textsuperscript{241} Treas. Reg. § 25.2701-3(c)(1), (2) (1992). The only commentator to address this problem so far states that Regulation § 25.2701-3(c)(1), if read literally, would mean that "the minority interest discount cannot affect the minimum value rule." \textsc{Richard B. Covey, Practical Drafting} 2893 (1992). Such an interpretation would be directly contrary to the congressional history. \textit{See infra} note 247 and accompanying text. Therefore, it is unlikely that the words of the regulation will be given a literal meaning.
What is unclear is whether a minority discount\(^{242}\) is applied before or after the ten percent minimum. For example, in our simple freeze where all the common stock is transferred to the children, assume the cumulative preferred stock is also voting stock and the preferred stock can outvote the common.\(^{243}\) Is the value of the common stock ten percent before the application of any minority discount, or after such discount?

This critical issue is indirectly addressed by the Treasury Regulations as follows:

\begin{itemize}
  \item \textbf{(4) Step 4—Determine the amount of the gift}
  \begin{itemize}
    \item \textbf{(ii) Reduction for minority or similar discounts.} Except as provided in § 25.2701-3(c), if the value of the transferred interest (determined without regard to section 2701) would be determined after application of a minority or similar discount with respect to the transferred interest, the amount of the gift determined under section 2701 is reduced by the excess, if any, of—
      \begin{itemize}
        \item \textbf{(A)} A pro rata portion of the fair market value of the family-held interests of the same class (determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701), over
        \item \textbf{(B)} The value of the transferred interest (without regard to section 2701).\(^{244}\)
      \end{itemize}
  \end{itemize}
\end{itemize}

This regulation appears to authorize a minority discount, assuming "class"\(^ {245}\) means the common stock in our simple example. However, the result could be different if the cumulative preferred were also voting stock as in our example. It is then possible that the parenthetical phrase in regulation section 25.2701-3(b)(4)(ii)(A) would mandate that the fair

\(^{242}\) A minority discount is used when valuing the shares held by a non-control shareholder in a closely held corporation. This discount is necessary in a traditional non-tax valuation context because of the high premium placed on control by investors. As such discounts may in some cases be as high as 90 percent, it is a crucial issue as to whether or not the value of the common stock under I.R.C. § 2701 (1992) is determined before or after the application of such discounts. For a discussion of the issues associated with the calculation of the minority discount, see HAMILTON, supra note 12, at 250-52.

\(^{243}\) The significance of voting rights in terms of the value of the preferred stock under I.R.C. § 2701 (1992) will be discussed infra at notes 283-92 and accompanying text.


\(^{245}\) Id. § 25.2701-3(b)(4)(ii)(A).
market value of the family-held interest required the addition of a control premium, since it was all family-held. Under such an interpretation, a control premium would be used in determining the regulation section 25.2701-3(b)(4)(ii)(A) value, and a minority discount would be used in determining the regulation section 25.2701-3(b)(4)(ii)(B) value. Such an interpretation is not likely, however, because the reduction in the amount of the gift is the difference between these two values. Using a control premium in the first value would increase the difference between the two values, thus serving to increase the minority discount. It is doubtful that the Service meant this interpretation to prevail when it adopted the regulations.

IX. RULE 5—AVOID BELLS AND WHISTLES ON THE PREFERRED

Long before the enactment of section 2701, a commentator stated:

Fundamentally, I look at a standard preferred stock as though it were a Christmas tree. The tree is simple. It has straight lines. And it is easy to understand. But then we start to put ornaments on this Christmas tree, all kinds of ornaments. We give it a low dividend rate, or a high dividend rate, or a high call price, or we make it noncumulative, and so on. As a matter of fact, we have so many ornaments that we can't see the tree. I recently did a valuation of a preferred stock that was all ornaments and no tree! But, I warn you, someone has to value the preferred stock. If you insist on putting so many ornaments on this tree that it is not possible to value it, you are exposing your client to a significant risk.

Among estate planners, the various characteristics added to the preferred in an attempt to support a value equal to the equity value of the entity were often referred to as bells and whistles during casual conversation.

After Chapter 14, bells and whistles are to be avoided. They are useless at best, and can be harmful. The basic rule of section 2701 is that a put, call, conversion or liquidation right is valued at zero if section 2701

246 Id.
247 It is clear from the legislative history that section 2701 was not to affect minority and marketability discounts. Therefore, it is likely that the regulation quoted above would not be read so as to exaggerate the size of the minority discount through the use of an uncertain interpretation. See Senate Report, supra note 142, at 61, 136 Cong. Rec. at S15,681. "The bill does not affect minority discounts or other discounts available under present law." Id.
248 Rage, supra note 1, at 54 (comments of Robert M. Meyers).
applies to the transfer. The regulations group these rights as "extraordinary payment rights" and include in the definition any similar right "the exercise or nonexercise of which affects the value of the transferred interest." For example, a call right includes "any warrant, option, or other right to acquire one or more equity interests." Clearly, giving such rights to the preferred has no tax advantages because they will be deemed to be valueless.

There are several exceptions to the rule that extraordinary rights are valued at zero. The first exception is for rights that must be exercised at a fixed time and for a specific amount. Such rights include the right to have the holder's stock redeemed at a specific price on a given date and a right to have the stock redeemed at death for a certain amount. Excluding such rights from the category of extraordinary payment rights means that the right is valued at fair market value. Such a right will clearly increase the value of the preferred, but only to the extent of the present value of the increase resulting from the fixed price set for redemption at this future date.

Another exception is made for nonlapsing conversion rights. These are rights to convert the retained interest into a fixed number or percentage of the class of the transferred interest. To be excepted the right must:

(1) Be in terms of a fixed number or percentage of shares of the same class as the transferred stock (except for voting differences);
(2) Be nonlapsing;
(3) Be subject to proportionate adjustments for capital changes, including splits,

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250 For a discussion of extraordinary payment rights, see supra notes 168-81 and accompanying text.
252 Id.
255 Id. § 25.2701-2(a)(4).
256 For a discussion of the valuation of such preferred stock interests, see Brigham, supra note 45, at 208-14. A second exception is for a guaranteed payment of a fixed amount under I.R.C. § 707(c). I.R.C. § 2701(c)(1)(B)(iii). This exception is limited to partnerships and would not appear useful in the context of estate freezes.
258 Id. § 2701(c)(2)(C)(i). These are not included in the term "liquidation, put, call or conversion right." Id. § 2701(c)(2)(C).
259 Id. § 2701(c)(2)(C)(ii).
260 Id. § 2701(c)(2)(C)(iii).
(4) Be subject to adjustments for cumulative and unpaid dividends like those in section 2701(d).\textsuperscript{263}

The important question is whether any of the exceptions describe interests that would be useful in bolstering the value of the preferred and be fixed in value so as to effect a freeze. The answer in most cases is probably no. While both exceptions (for rights that must be exercised at a specific time and for a fixed amount and for nonlapsing conversion rights) might support a small increase in the value of the preferred, the value of the right would be greatly diminished because of the impact of discounting to reflect the time value of money.\textsuperscript{264} Moreover, even though the right which must be exercised at a fixed time and for a fixed amount does have some value, there is considerable risk in using this technique because the Service may view the non-exercise of the right to be a gift from the preferred shareholders to the common shareholders.\textsuperscript{265} However, it is unlikely that such a failure to exercise would be a “taxable event” triggering a tax on any unpaid distributions because the statute requires a transfer of the applicable retained interest.\textsuperscript{266} The mere failure to exercise the right would not appear sufficient to meet this test.

A similar analysis would appear applicable to the nonlapsing conversion right. However, because such rights are not required by statute to contain a fixed exercise date, an appropriate discount factor could be difficult to determine, making such rights more difficult to value.\textsuperscript{267} Moreover, while it might support a greater value for the preferred, it would not freeze the preferred’s value since the preferred would become convertible into common which should make the preferred subject to appreciation.\textsuperscript{268} While it may be difficult for the Service to apply a gift

\textsuperscript{263} Id. § 2701(c)(2)(C)(iv). In the case of a partnership, the regulations define the right as “a non-lapsing right to convert an equity interest in a partnership into a specified interest (other than an interest represented by a fixed dollar amount) of the same class as the transferred interest.” Reg. § 25.2701-2(b)(4)(iv)(B) (1992).

\textsuperscript{264} As an additional problem, even if it is determined that the conversion right does have value, it is very difficult to determine the additional value of such a right. Brigham, supra note 45, at 540.

\textsuperscript{265} This would be an extension of Prvn. Ltr. Rul. 89-07-002 (Nov. 1, 1988) (gift when controlling shareholder of closely held corporation voluntarily did not receive a portion of the amount payable on redemption of his controlling shares); Prvn. Ltr. Rul. 87-26-005 (July 7, 1987) (failure to exercise conversion right on convertible preferred stock held to be a gift to common stockholders); Prvn. Ltr. Rul. 87-23-007 (June 15, 1987) (failure to take action to protect right to a noncumulative dividend held to be an indirect gift). For an analysis and critique of the later two rulings, see What’s Hot, supra note 1, at 22-30.


\textsuperscript{267} Id. § 2701(e)(2)(C)(ii).

\textsuperscript{268} Rege, supra note 1, at 57 (comments of Robert M. Meyers). This appreciation, of course, is from the upscale growth potential inherent in a convertible security that results from the conversion of the preferred stock into common stock. This conversion allows the holder of the converted stock
analysis to the failure to convert, the Service could nonetheless argue that such a failure to convert when the common's value is much higher than the preferred constitutes a gift.269 Also, since the conversion right must be nonlapsing, it could be argued that the preferred's value was equal to the value of an equivalent number of shares of common at the date of decedent's death. As a result of this potential downside, it does not appear that such rights will be useful attributes of preferred stock.270

Bells and whistles on preferred stock are not only useless, (because usually valued at zero) but can actually be harmful. This harm stems from a statutory rule that if the preferred has both a qualified payment right271 and an extraordinary payment right,272 the stock is valued as if the liquidation, call, put or conversion right was exercised to produce the lowest possible value for all the rights.273 This "lower of274 rule is illustrated in an example provided with the regulations:

P, an individual, holds all 1,000 shares of X Corporation's $1,000 par value preferred stock bearing an annual cumulative dividend of $100 per share and holds all 1,000 shares of X's voting common stock. P has the right to put all the preferred stock to X at any time for $900,000. P transfers the common stock to P's child and immediately thereafter holds the preferred stock. Assume that at the time of the transfer, the fair market value of X is $1,500,000, and the fair market value of P's annual cumulative dividend right is $1,000,000. Because the preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (i.e., the right to receive cumulative dividends), the lower of rule applies and the value of these rights is determined as if the put right will be exercised in a
manner that results in the lowest total value being determined for the rights (in this case, by assuming that the put will be exercised immediately). The value of P's preferred stock is $900,000 (the lower of $1,000,000 or $900,000). The amount of the gift is $600,000 ($1,500,000 minus $900,000). 275

From this analysis, it is clear that liquidation, put, call, conversion, and similar rights should be avoided whenever possible. If they must be used, it is necessary to consider very carefully what the impact of the use of such provisions will be on qualified payment rights under the "lower of" rule. 276

X. AN ASIDE: RIGHTS THAT HAVE VALUE OTHER THAN CUMULATIVE DIVIDEND RIGHTS

A cumulative dividend alone would probably have to be at a very high rate 277 to support a value of the preferred anywhere close to the value of the corporation's equity. 278 Therefore, we must explore other attributes that have value that might be used to increase the value of the preferred interest. Such rights include:

1. Voting rights; 279
2. Liquidation participation rights; 280
3. Participation rights; 281 and
4. Preemptive rights. 282

A discussion of these rights follows.

A. Voting Rights

Voting rights are clearly neither distribution rights nor extraordinary payment rights. 283 They are, therefore, not subject to section 2701 and

275 Id. § 25.2701-2(a)(5) (1992); see also id. §§ 25.2701-2(d), ex. 3, 25.2701-3(d), ex. 1.
276 Id. § 25.2701-2(a)(3).
277 A rate higher than that of most small companies could be expected to sustain. See Rage, supra note 1, at 56.
278 Id. This is based on the fact that the value of a share of preferred stock, void of any upscale potential, is valued as a function of its fixed dividend rate coupled with the likelihood that the payment will be made. Therefore, the preferred stock would need a dividend rate high enough to support such a value coupled with the expectation of actual payment. See BRIGHAM, supra note 45, at 208.
279 See Slayng, supra note 1, at 157; see infra notes 283-92 and accompanying text.
280 Treas. Reg. § 25.2701-2(b)(4)(ii) (1992); see Slayng, supra note 1, at 157; see infra notes 293-99 and accompanying text. The other rights mentioned in Regulation § 25.2701-2(b)(4) (mandatory payment rights, nonlapsing conversion rights, and § 707(c) guaranteed payments) have already been discussed. See supra notes 254-70 and accompanying text.
281 See supra note 1, at 157; infra notes 302-03 and accompanying text.
282 See Eastland Outline, supra note 156, at 104; infra notes 305-06 and accompanying text.
283 Voting rights are not extraordinary payment rights because they are not liquidation, put, call
are valued at fair market value.\footnote{Curiously, the statute says nothing about how such rights are to be valued. The regulations, however, make it clear that such rights are valued at fair market value. Treas. Reg. § 25.2701-2(a)(4) (1992) provides: Valuing other rights. Any other right (including a qualified payment right not subject to the prior paragraph) is valued as if any right valued at zero [sic] does not exist and as if any right valued under the lower of rule is exercised in a manner consistent with the assumptions of that rule but otherwise without regard to Section 2701. Thus, if an applicable retained interest carries no rights that are valued at zero or under the lower of rule, the value of the interest for purposes of section 2701 is its fair market value. Even if this regulation had not been promulgated, it is likely that a close reading of Treasury Regulation § 25.2512-1 would indicate that the valuation of voting rights would be at fair market value. \footnote{See supra note 286.}} Voting power improves the value of the preferred.\footnote{In fact, voting is probably the most significant right with respect to valuation left unaffected by the enactment of Chapter 14.\footnote{Id. at 56-57. In fact, “non-control” shares can sell at a discount of as much as 90% of the value of control shares. With this in mind, it is clear that the value to the preferred if control is held is significant. See \textit{Hamilton}, supra note 12, at 251.} It is highly likely that the use of voting preferred will increase and may become a standard means of increasing the value of the preferred. This likelihood is augmented by the fact that little other than the cumulative dividend is available to improve value.\footnote{\textit{See supra} note 286.} Indeed, the voting right under most circumstances is the best potential attribute of the preferred remaining to increase value.\footnote{Furthermore, the effectiveness of cumulative dividends to meet the objective of sustainable preferred share value is limited by the ability of the family corporation to produce cash flows sufficient to meet the dividend requirements. \footnote{This is because of the high premium that results from voting control. \textit{See supra} note 286 and accompanying text.\footnote{The preferred stock, unless given away prior to death, will be included in the client’s gross estate under I.R.C. § 2033 (1992). Of course, annual exclusion gifts of the preferred stock are a possibility, depending on the age of the client, but if voting power increases the value of the preferred, it will take longer to transfer it to the younger generation because of the $10,000 limit on the annual exclusion. See I.R.C. §§ 2503(b), 2513 (1992).}}

The downside of using voting rights is that they will increase the value of the preferred stock on later gifts or in the client’s estate.\footnote{\textit{Rage}, supra note 1, at 56 (comments of Robert M. Meyers). This enhancement of value may not be great, however, if the preferred stock is a minority interest or if the number of shares of preferred outstanding is small and if it supports its value with other features. \textit{Id.}}} The client can no longer avoid this result by having the voting power lapse at the client’s death,\footnote{This technique was made famous in \textit{Estate of Harrison} v. Comm’r, 42 T.C.M. (CCH) 1307} as Congress has attempted to foreclose this option...
by enacting Chapter 14. Nevertheless, it is almost certain that the use of voting preferred will increase.

B. Liquidation Participation Rights

Liquidation participation rights are described in the regulations as "a right to participate in a liquidating distribution" and are classified as "neither extraordinary payment rights nor distribution rights." Given this, one would think that these rights would be valued at fair market value. However, the regulations prescribe a special rule for these rights:

If the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation, the liquidation participation right is valued as if the ability to compel liquidation—

(A) Did not exist, or

(B) If the lower of rule applies, is exercised in a manner that is consistent with that rule.

The source of this rule is unclear. Presumably it derives from the fact that the right to compel liquidation is defined as an extraordinary payment right, which is valued at zero. If the family controlled enough votes to compel liquidation and liquidation participation value took account of the family's control, the preferred would have to be valued at the liquidation value. This was exactly the result section 2701 was enacted to avoid. The rule prescribed in regulation section 25.2701-2(b)(4)(ii) reduces substantially any value-enhancing effect the right to participate in liquidation might have. This right may be useful,
but the valuation experts will have to judge its value on a case-by-case basis.

C. Participating Preferred

Participating preferred is preferred stock that shares in the entity’s post-transfer appreciation with the common.\(^3\)\(^0\) This variation will bolster the preferred’s value because of the potential increase in the value of the preferred that results as the company’s overall profits increase.\(^3\)\(^0\) However, since the preferred’s value can grow, this technique does not accomplish the desired freeze.\(^3\)\(^0\) Therefore, it is doubtful if its use will increase.

D. Preemptive Rights

One commentator has suggested that preemptive rights,\(^3\)\(^0\) like voting rights, are neither distribution rights nor put, call, liquidation, or conversion rights and are thus valued at fair market value.\(^3\)\(^0\) This is probably correct, but also probably not very useful for either corporations or partnerships. The Service could cogently argue that preemptive rights were worth very little in family corporations since it is unlikely that new stock or partnership interests will be issued. Moreover, if new stock or partnership interests are issued and the client does not enforce her preemptive rights, the client would be subject to the same gift tax argument made on noncumulative dividends and conversion rights.\(^3\)\(^0\)

XI. Rule 6—Use Common Sense Both in Determining Whether to Freeze and in Structuring the Freeze

The estate freeze was always potentially subject to abuse. Commentators recognized this quite early,\(^3\)\(^0\) and these perceived abuses eventually

\(^{301}\) See HAMILTON, supra note 12, at 353.

\(^{302}\) Rage, supra note 1, at 57 (comments of John R. Cohan).

\(^{303}\) A preemptive right is a contractual arrangement between the security holder and the issuer giving the security holder the right to purchase any new issues of the security subsequently issued. See BRIGHAM, supra note 45, at 446.

\(^{304}\) Eastland Outline, supra note 156, at 104.

\(^{305}\) See supra note 265 and accompanying text.

\(^{307}\) See Rage, supra note 1, at 21 ("Particular tax techniques can always be carried too far, and it seems to us that the concept of estate freezing, somewhat like the concept of ESOPs, is being recommended around the country as a palliative for almost every estate planning problem.").
led to the enactment of former section 2036(c). Estate freezes should be evaluated carefully and realistically so as to avoid the enactment of restrictive statutes like former section 2036(c), to comply with current statutes like section 2701, and to give quality service to the client. The first aspect of this evaluation is to choose the clients for whom estate freezing will lead to an advantageous result as there are situations in which it is not useful and may indeed be detrimental. One commentator has stated:

This is not to say that all, nor even most, operating companies should recapitalize. Recapitalizations should be considered for all successful, growing companies. Estate and income tax considerations, cash needs, business growth, investment alternatives and other practical business and family considerations, however, will be evaluated differently by different business owners.

It should also be noted that there exist many other estate planning techniques that can be used as alternatives to estate freezing. Not the least of these is the outright gift, assuming the client really wishes to give up all or some control of the business. The purpose of this Article is not to discuss each of these techniques. It is rather to suggest that techniques other than corporate or partnership recapitalization may be more appropriate in any given situation and that all available techniques should be considered when developing a client's estate plan. Put another way, estate freezes in general and business reorganizations in particular should be used only when they make sense from both a business and estate planning perspective and when they accord with the client's wishes and expectations.

The second aspect of a careful and realistic evaluation of estate freezes is in designing the freeze once it is determined that it is the appropriate technique. Always structure the freeze in a nonabusive form and do not be greedy. Even with this in mind, it is necessary to ask what principles should be used. What kind of a freeze will work under 2701?

The answers to these questions lie in the recognition that section 2701 was enacted to cure only "potential estate and gift tax valuation abuses.

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308 See Gazur, supra note 1, at 124.
309 See Rage, supra note 1, at 21-22 (introduction by John A. Wallace).
310 See id.
311 Slayng, supra note 1, at 156.
312 See, e.g., Cafeteria, supra note 1. Evaluating the effectiveness of these techniques after the enactment of Chapter 14 is beyond the scope of this Article.
313 See, e.g., Hamson, supra note 1, at 366-67.
The Senate Finance Committee, where section 2701 originated, took great care to emphasize that the transfer of family business and most intrafamily transactions are legitimate. The proper techniques in freezing estates have been practiced by better estate planners for many years. Nonabusive techniques were not intended to be prohibited by section 2701.

Perhaps the most surprising aspect of estate freezes is that almost every rule employed in section 2701 reflects the practice of the better estate planners in 1980. To show this, a list of the rules under section 2701 follows. The list is accompanied by citations to a panel discussion held at the 1979 ABA annual meeting by a group of expert estate planners, reflecting their prescient conclusions that the same rules should apply:

1. Only a cumulative dividend can support a substantial value for preferred stock;
2. The preferred has value only if the dividend is paid; the dividends must be set at a rate that the company is able to pay;
3. The failure to pay the dividend has tax consequences;

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315 The Senate Report provides as follows:

Reasons for Change

Repeal of section 2036(c)

The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor.

Moreover, the committee is concerned that the statute's complexity, breadth, and vagueness posed an unreasonable impediment to the transfer of family businesses. The committee also is concerned that many taxpayers have refrained from legitimate intrafamily transactions because of uncertainty about the scope of its rules. Moreover, the current rules are overinclusive because they apply if the transferor retains virtually any interest in the income from, or rights in, the enterprise.

Accordingly, the committee bill repeals section 2036(c) retroactive to the date of its enactment.

Replacement for section 2036(c)

While the committee believes that section 2036(c) is not the appropriate method of taxing freeze transactions, the committee nonetheless is concerned about potential estate and gift tax valuation abuses. Accordingly, the committee bill generally substitutes for section 2036(c) a series of targeted rules generally designed to assure a more accurate determination of the value of the property subject to transfer tax.

In developing a replacement for current section 2036(c) the committee sought to accomplish several goals: (1) to provide a well defined and administrable set of rules; (2) to allow business owners who are not abusing the transfer tax system to freely engage in standard intrafamily transactions without being subject to severe transfer tax consequences; and (3) to deter abuse by making unfavorable assumptions regarding certain retained rights.

Id.

314 Id.

317 Rage, supra note 1, at 37, 56-57 (comments of Robert M. Meyers).

318 Id. at 37-38, 56 (comments of John R. Cohan and Robert M. Meyers, respectively).

319 Id. at 56 (comments of Robert M. Meyers). The panelists, quite understandably, did not foresee
(4) The common is worth at least ten percent of the entity’s value in a recapitalization;\textsuperscript{320} and

(5) Bells and whistles are basically worthless, except for voting rights.\textsuperscript{321}

Estate freezing in the 1990s will be very similar to estate freezing as practiced by leading estate planners in the late 1970s.

CONCLUSION—WHAT GOES AROUND COMES AROUND—

THE DEFEAT OF JASON?

Section 2701 of the Code is clearly not in its final form. Technical corrections legislation was introduced in both 1991 and 1992.\textsuperscript{322} Many comments were made by organizations on changes to the law and on the regulations as proposed before final adoption.\textsuperscript{323} The Service is beginning to issue private rulings interpreting section 2701.\textsuperscript{324} In all probability it will take a number of years before the major issues involved in interpreting section 2701 begin to be settled.

Indeed, there is disagreement over the basic issue of whether estate freezes using preferred and common interests are still viable. One well-
respected commentator states the answer for most closely held businesses is no because the rules are so onerous.\textsuperscript{325}

If the preferred interest is noncumulative, the value of that interest will be valued at zero in determining the value of any common stock transferred by gift because the preferred interest is a distribution right. If the preferred interest is cumulative, it must be valued standing alone. The result will be that even with a high interest rate it will be difficult with most closely-held businesses to have the preferred interest valued at its stated value. "Junk bond" yields may afford a comparison as to what interest rate would be required to achieve this objective. In addition, if dividends are not paid, the preferred owner's gross estate will be increased by the unpaid amount plus a compounding factor pursuant to IRC Sec. 2701(d) subject to a four year moratorium late payment period. Finally, the IRS must be apprised on a gift tax return of the potential application of IRC Sec. 2701 to prevent the gift tax statute of limitations remaining open on a gift of common stock.\textsuperscript{326}

An equally respected commentator disagrees:

Because the preferred stock's value is tied to dividend rights, some commentators argue that most corporations will be unable to issue preferred stock under Chapter 14 because of inadequate earnings. That view cannot be accurate with respect to operating companies. For a hypothetical investor to purchase common stock in a family business a fairly high rate of return is required to offset the risk and lack of liquidity. This required rate of return reduces the company's value. The preferred stock has less risk and, accordingly, should have to carry a lesser rate. Indeed, in most cases the rate should be substantially less. Preferred stock of General Motors yields less than Treasury obligations.\textsuperscript{327}

Both commentators may be right. Clearly, it will be more difficult to justify a high value for the preferred and it will be impossible in almost all cases to have the preferred equal to all or nearly all of the equity value of the company.\textsuperscript{328} But voting rights are still valued at fair market value and minority discounts are still available. While the gift of common

\textsuperscript{325} PRACTICAL DRAFTING 2368-69 (Jan. 1991).
\textsuperscript{326} Id. at 2369.
\textsuperscript{327} Id., supra note 113, at 156.
\textsuperscript{328} If for no other reason than the 10 percent rule. § 2701(a)(4).
associated with the freeze may no longer be zero, it may be within the $600,000 exemption equivalent of the unified credit. Partial freezes limiting the appreciation of the client's interest in the entity and reducing the gift tax paid on transfer of the common as compared with an outright gift of the corporation is still possible in many situations. Obviously, the cash flow of the business must be carefully examined. The compounding of dividends missed\textsuperscript{329} may daunt many estate planners. But the most impressive evidence that estate freezing under section 2701 should still be possible lies in the amazing correspondence between the practice of the best estate planners in 1979 and the rules of section 2701.\textsuperscript{330} If the best estate planners were doing freezes while voluntarily complying with rules substantially similar to those under section 2701, freezes should be do-able today. Abusive freezes probably will not work. Freezes that are justifiable and realistic without considering section 2701 should work.

Section 2701, to a substantial extent, codified the methods of the best estate planning practitioners in the late 1970s and 1980s regarding estate freezes. Unlike former section 2036(c), section 2701 correctly identified the source of the abuse in estate freezing as a gift tax valuation problem. Congress attempted to prevent abuses while allowing justified estate planning techniques. Time will tell whether Congress succeeded.

\textsuperscript{329} I.R.C. § 2701(d)(3).

\textsuperscript{330} See \textit{supra} notes 317-21 and accompanying text.